American Insurance Association

April 30, 2012

Via Electronic Mail (regs.comments@federalreserve.gov)

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Proposed Regulation YY - Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (RIN 7100-AD-86; Docket No. 1438)

Dear Ms. Johnson:

The American Insurance Association (AIA) appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's (Board) proposed Regulation YY (Proposed Rule) to implement the enhanced prudential standards and early remediation requirements set forth in Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act)[1]. The Proposed Rule would apply to U.S. bank holding companies with total consolidated assets of at least $50 billion and to nonbank financial companies that have been designated as "systemically important financial institutions" (SIFIs) pursuant to Section 113 of the Dodd-Frank Act and its associated rule. AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses, writing more than $117 billion annually in premiums. Our members have a strong interest in ensuring that implementation of the Dodd-Frank Act – particularly with respect to regulations like the Proposed Rule that would apply heightened supervision – proceeds in a manner consistent with the Act's intent of differentiating among the financial sectors and does not yield a single, monolithic approach.

This is particularly important for the property-casualty insurance industry, which has not been (and is not) a source of instability to the financial system or U.S. economy. Indeed, as we have stated numerous times in comments responding to Section 113, a fair and reasonable risk-weighted application of the statutory considerations in that section should yield very few, if any, regulated property-casualty insurers that are designated as SIFIs.[2] Nonetheless, because

[1] 77 Fed. Reg. 594 (Jan. 5, 2012).

[2] We have outlined the reasons why regulated property-casualty insurers do not pose a systemic threat in submissions to the Financial Stability Oversight Council. *See, e.g.,* Comments of the American Insurance Association in Response to Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision

the Board has published the Proposed Rule for comment in advance of the Council's SIFI determination process, we offer the following perspective, which assumes *arguendo* that the outcome of the determination process may differ from our expectations.

AIA believes that the Dodd-Frank Act compels a separate rulemaking for SIFIs. Accordingly, the Board should await further progress on the Section 113 determination process to ascertain whether any insurance companies are likely to be designated. If so, at that time, the Board can determine the focus and form of any such separate rule that should be developed and proposed for public comments to reflect prudential regulatory and remediation differences in the insurance sector.

Equally important, by framing the Proposed Rule's standards for the banking sector and not considering the varying interests of the nonbank financial sectors that are subject to the Section 113 process, the Board has left potential SIFIs in those sectors with two problems. First, where the primary purpose of heightened prudential regulation is to lessen the possibility that those companies will become a systemic threat or be in danger of default, that purpose is undermined where the capital standards are not appropriate to the company. Second, companies that may be designated face a difficult – and unnecessary – decision as to whether to expend substantial resources reformulating their business and organizational structures to comply with bank-centric standards and risk incurring a competitive disadvantage vis-à-vis other insurers. Both concerns can be remedied through a separate, tailored rule that aligns with the outcome of the Section 113 determination process.

BACKGROUND

Statutory Provisions

The Dodd-Frank Act was enacted in the wake of one of the worst financial crises in American history. Title I of the legislation was largely designed to establish a system of monitoring, coordination and oversight so that U.S. financial sector regulators could identify and supervise in a transparent manner those financial firms that could be legitimately characterized as "systemically important." Congress made a deliberate decision to apply heightened prudential supervision to depository institutions based solely on a total consolidated asset trigger of $50 billion, and to consider nonbank financial companies for heightened supervision under Section 113 based on a number of risk-related considerations that include asset size, but not based

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and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Docket No. FSOC-2010-0001) (Nov. 5, 2010) (available at www.regulations.gov, *Doc. ID FSOC-2010-0001-0029 through FSOC-2010-0001-0029.3*); Comments of the American Insurance Association in Response to Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Docket No. FSOC-2010-0001) (Feb. 25, 2011) (available at www.regulations.gov, *Docket ID FSOC-2011-0001-0027*); Comments of the American Insurance Association in Response to Second Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Docket No. FSOC-2010-0001) (Dec. 16, 2011) (available at www.regulations.gov, *Docket ID FSOC-2011-0001-0056*).

solely on that factor. In the course of doing so, Congress also distinguished between U.S. nonbank financial companies and foreign nonbank financial companies, considering the latter in terms of their U.S. operations and importance in the United States, while taking into account the extent of prudential oversight exercised by a foreign company's home country regulator.

Section 165 of the Dodd-Frank Act provides that the Board establish prudential standards, on its own or on the Financial Stability Oversight Council's (Council or FSOC) recommendation, for covered bank holding companies (covered BHCs) and covered non-bank SIFIs that are more rigorous than those applied to other nonbank financial companies or BHCs. Those heightened standards are to be based on the same factors considered by the Council in designating SIFIs pursuant to Section 113.[3] As the Board indicates, Section 165 "requires that the enhanced standards established pursuant to that section increase in stringency based on the systemic footprint and risk characteristics of individual covered companies."[4] The enhanced prudential standards required by Section 165 relate to (a) risk-based capital and leverage; (b) liquidity; (c) enterprise risk management; (d) submission of a resolution plan and credit exposure reports; and (e) concentration limits.[5]

In establishing enhanced prudential standards, the Board may tailor application of the standards by individual company or financial industry sector according to a series of risk-related factors such as capital structure, "riskiness," complexity, nature of the company's (and its subsidiaries') financial activities, size and any other risk related factors the Board deems appropriate.[6] More importantly, according to Section 165(b)(3), the Board must "take into account differences" between SIFIs and covered BHCs and modify the standards as appropriate in light of any predominant financial activity of the company, including activities for which particular standards may not be appropriate. Both provisions of Section 165 are intended to encourage the development of heightened prudential standards that reflect the risk-related considerations underlying the SIFI designation process. Thus, it is readily apparent that the Dodd-Frank Act directs the Board *not* to adopt a "one-size-fits-all" approach in developing and applying the enhanced prudential standards to covered companies.

Section 166 requires the Board, in consultation with the Council and the Federal Deposit Insurance Corporation (FDIC), to issue regulations that provide for the early remediation of the financial distress of covered companies.[7] The purpose of early remediation is to establish a series of specific remedial actions to be taken by a covered company that is experiencing increasing financial distress, in order to minimize the probability that the company will become insolvent and the potential harm of such insolvency to the financial stability of the United States.[8] Regulatory requirements to implement Section 166 include (a) defining financial

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[3] Dodd-Frank Act § 165(a)(1)(B).
[4] 77 Fed. Reg. at 596.
[5] Dodd-Frank Act § 165(b)(1)(A).
[6] *Id.*, § 165(a)(2).
[7] *Id.*, § 166(a).
[8] *Id.*, § 166(b).

condition measures for the company, and (b) establishing remediation standards that increase in stringency as the financial condition of the company declines.[9]

The Proposed Rule

The Proposed Rule imposes certain enhanced prudential standards on covered companies, including enhanced risk-based capital and leverage requirements,[10] liquidity standards,[11] requirements for overall risk management (including establishing a risk committee),[12] single-counterparty credit limits,[13] stress test requirements,[14] and a debt-to-equity limit for covered nonbank financial companies.[15]

Covered companies would also need to establish monitoring and compliance programs. Company boards, risk committees, and senior management would be held to new liquidity risk management and governance requirements, including periodic review and approval of liquidity risk models.

The Proposed Rule also implements the early remediation requirements in Section 166 relating to establishing measures of financial condition and remediation requirements. The Proposed Rule increases in stringency with the risk characteristics and level of systemic risk posed by the covered company. This ratcheting up of requirements is designed to provide incentives for covered companies to reduce their systemic footprint and to consider the external costs that their failure or distress would impose on the financial system.

The Proposed Rule also establishes a core set of concrete rules to complement the Federal Reserve's existing efforts to enhance the supervisory framework for covered companies.

Although Sections 165 and 166 of the Dodd-Frank Act apply to foreign companies, the Proposed Rule does not apply to foreign banking organizations. The Board indicated that it will propose rules for foreign banking organizations in the future. However, the Proposed Rule will apply to a foreign banking organization's U.S.-based bank holding company. With respect to SIFIs, as stressed throughout the preamble to the Proposed Rule, the standards applied to covered BHCs

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[9] *Id.*, § 166(c).
[10] 77 Fed. Reg. at 598.
[11] *Id.* at 599.
[12] *Id.* at 600.
[13] *Id.* With respect to interconnectedness and counterparty exposure, the Proposed Rule generally caps the aggregate net credit exposure of any covered company and its subsidiaries to any counterparty (and its subsidiaries) at 25% of the covered company's capital and surplus. For "major covered companies," the Proposed Rule limits their aggregate net credit exposures to another major covered company to 10% of the company's consolidated capital and surplus. "Major covered companies" are defined as bank holding companies with $500 billion or more in total consolidated assets and any SIFI designated under Section 113. See § 252.92(aa) (defining "major covered company") (77 Fed. Reg. at 651).
[14] 77 Fed. Reg. at 600.
[15] *Id.* at 601.

(and, in one case, to extremely large BHCs defined as "major" covered companies) will also apply to covered nonbank financial companies.

Discussion

I. *The Dodd-Frank Act Requires the Federal Reserve to Promulgate a Separate Regulation for SIFIs.*

Our review of numerous provisions in the Dodd-Frank Act compels the conclusion that the Board is required to promulgate a separate rule for SIFIs that applies enhanced prudential standards that differentiate covered nonbank companies from covered BHCs. Collectively, those provisions distinguish financial companies based on numerous risk-related factors, including the nature of the financial activity under review, the industry business model, the competitive market structure, the regulatory framework, and the existence of an orderly resolution mechanism.

Section 165(b)(3) requires the Board to develop and implement prudential supervisory standards that take into account the differences among nonbank financial companies supervised by the Board and bank holding companies based on factors expressly set forth in the statute. This subsection is connected to Section 113, in that it instructs the Board to account for the statutory considerations outlined in that section when prescribing standards, and "to the extent possible, ensure that small changes in the factors listed in subsections (a) and (b) of section 113 would not result in sharp, discontinuous changes in the prudential standards..."[16] Moreover, that section also mandates that the Board "adapt" the prudential standards "in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."[17] Compliance with this statutory direction cannot be accomplished, as the Board's Proposed Rule suggests, in a *post hoc* manner by adjusting the bank-centric standards following a SIFI designation. To the contrary, the company- and industry-specific analysis followed in Section 113 is a predicate to a separate SIFI regulation under Section 165.

Other provisions in Title I (and elsewhere) of the Dodd-Frank Act reinforce our position that separate regulatory treatment for SIFIs is the requirement established by Congress for Board oversight of covered financial companies. For example, Section 170 of the Dodd-Frank Act provides a mechanism for the Board, in consultation with the Council, to exempt certain types of nonbank financial institutions from any heightened prudential supervision. Similar to Section 165(b)(3), this section requires the Board to take into account the risk-related factors under Section 113 when developing a rule.[18] Likewise, from an activity-based perspective, Section 120 of the Act establishes a mechanism for the constituent agencies of the FSOC to identify industry-wide activities in a particular financial sector that may threaten the stability of the U.S.

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[16] Dodd-Frank Act § 165(b)(3)(B).
[17] *Id.*, § 165(b)(3)(D).
[18] *Id.*, § 170(b).

financial system and to make recommendations to the primary financial regulatory agency to apply additional standards to those activities.

Both of these sections – one creating exemptions from heightened regulation and the other recommending industry-wide activities for heightened primary regulation – clearly contemplate standards that distinguish between BHCs and other types of financial institutions based on industry business model, financial regulatory architecture, and risk-related activities. In order to comport with this statutory intent, the Board cannot apply the standards set forth in the Proposed Rule to nonbank financial companies designated as SIFIs, but rather must promulgate a separate rule for such entities.

In addition to these sections, with respect to the specific application of the Proposed Rule's early remediation standards pursuant to Section 166 to insurance company SIFIs, we note that Title II of the Dodd-Frank Act may compel separate regulatory provisions in the event an insurer is so designated. Title II establishes an alternative resolution system administered by the FDIC for those distressed financial companies that have been determined to be systemically important. However, that title also exempts insurance companies (both those that would otherwise be considered "covered" under Title II and insurance subsidiaries of significant financial services firms) from the FDIC's orderly liquidation procedure in deference to the state-based insurance solvency and guaranty fund system.[19] As a result, Congress has made the judgment that the orderly liquidation of an insurer is already addressed by the state-based process and does not require the application of Title II's resolution process. Because the actual resolution of an insurance SIFI (or insurance subsidiary of a SIFI) will be conducted according to state law, both the resolution plan and tiered early remediation standards under Section 166 would necessarily follow suit.

II. *The Proposed Rule Reinforces the Need for a Separate Rulemaking for SIFIs.*

The Proposed Rule itself further bolsters the principle that SIFIs should be subject to a separate regulatory process pursuant to Sections 165 and 166. In the preamble, the Board acknowledges that Section 165 of the Act requires it to "take into account differences" between covered BHCs and SIFIs, and to tailor its prudential regulation to individual covered companies.[20] While the Board proposes to do so through application and potential adjustment of the Proposed Rule's standards, this does not provide any comfort to non-bank financial companies that have not been designated SIFIs and that operate under financial regulatory standards that are completely different than those applied to BHCs. As explained further below, the determination process under Section 113 must run its course in order for the Board to understand the company- and industry-specific risk-oriented considerations that will drive SIFI designations. Indeed, application of the Stage 1 metric thresholds alone may well reveal that regulated property-casualty insurance companies will not be subject to any further

[19] *Id.* at § 203(e).

[20] 77 Fed. Reg. at 596.

scrutiny under Section 113 and that any separate SIFI rule under Sections 165 and 166 can therefore effectively exempt such companies.

Equally important, the Board has established a precedent for separate treatment of the insurance industry by indicating its intent to issue a different rule for the treatment of foreign banking organizations. In the introduction, the Board states "this proposal does not apply to foreign banking organizations, and the Board expects to issue a separate proposal shortly that would apply the enhanced standards ... to foreign banking organizations."[21] As the Board subsequently notes, the need for a separate rule for foreign banking organizations is propelled by the "diverse structures" of these organizations and "wide variety of approaches to prudential regulation" by home country regulators. Moreover, Section 165 "instructs the Board ... to give due regard to the principle of national treatment and equality of competitive opportunity" and to "take into account" home country supervision.[22] Surely, if the Board can rely on Section 165 and regulatory complexity to justify a separate rulemaking for foreign banks, the Board should promulgate a separate rule for the insurance industry that aligns with the Dodd-Frank Act and the Board's regulatory intent.

III. *Any Separate SIFI Rule Should Await the Outcome of the Section 113 Designation Process.*

The Board should defer judgment on whether to apply the enhanced prudential standards required under Section 165 to property-casualty insurers until the FSOC determines which institutions warrant heightened prudential supervision pursuant to Section 113. As the Board knows, the FSOC has provided additional guidance in its recently adopted final rule on Section 113, which establishes a three-stage process for determining which nonbank financial companies have the potential to be a source of systemic risk.[23] This process contemplates the application of uniform quantitative thresholds to identify companies that will be subject to further evaluation and to screen out other companies from the process. In Stage 2, a qualitative analysis of companies that meet the Stage 1 metric thresholds would be applied using a broad range of public and regulatory information; and for companies the FSOC believes merit further review in Stage 3, there would be an opportunity to provide information that was not available in the prior stages. More importantly, the latter two stages of the Section 113 process employ a combination of qualitative and quantitative standards aimed at placing the systemic potential of nonbank financial companies in context.

Whereas the Board already knows the universe of BHCs that will be subject to heightened prudential supervision under the Proposed Rule, a similar universe of SIFIs has not as yet been determined. Furthermore, if the Stage 1 thresholds apply a useful guide, the FSOC may ultimately designate as SIFIs, few, if any, companies principally engaged in the business of property-casualty insurance. Thus, while we believe we will be successful in convincing FSOC

[21] *Id.* at 595 (emphasis supplied).
[22] *Id.* at 598.
[23] 77 Fed. Reg. 21637 (April 11, 2012).

that property-casualty insurers do not possess characteristics that would make them a source of systemic risk, the Proposed Rule forces the undersigned trade association and its member companies to evaluate the standards without prior benefit of the Section 113 evaluation process.

IV. *The Board Should Also Wait for Insurance Regulatory Efforts to Play Out.*

It would also be appropriate for the Board to defer judgment on applying a separate SIFI rule to property-casualty insurers until the conclusion of several ongoing efforts by insurance regulators – both in the U.S. and internationally – to modernize financial regulation of insurers and fill any perceived or real gaps revealed during the financial crisis.

First, the National Association of Insurance Commissioners (NAIC) has undertaken a Solvency Modernization Initiative (SMI), which seeks to enhance the regulatory review of capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. One of the tools for accomplishing this is an "Own Risk and Solvency Assessment" (ORSA), whereby an insurer would conduct an internal assessment of the risks associated with its current business plan and the sufficiency of capital resources to support those risks.

Second, the European Union (EU) has adopted, and is in the process of implementing, Solvency II, which addresses supervisory review/governance and risk management; market discipline through supervisory reporting and public disclosure; and may include group wide determinations on quantitative capital requirements.

Third, the International Association of Insurance Supervisors (IAIS) is in the process of establishing a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), which seeks to promote more effective supervision of these groups, and regulation that is more reflective of actual business practices. In addition, as a separate exercise, the IAIS is developing criteria to determine whether any insurance companies could be global SIFIs (G-SIFIs). To the extent the G-SIFI process is informed by the domestic effort under Section 113, it would be prudent for the Board to wait for both processes to play out.

Fourth, the Federal Insurance Office (FIO) is finalizing a study of how to modernize and improve the system of insurance regulation in the United States. Any recommendations that are part of the FIO study will help inform the ongoing reform efforts in the states and before the NAIC.

Separately and collectively, these state, federal and international modernization actions will yield enhancements to the insurance regulatory architecture both here and abroad that further underscore the need for a separate Board rule for SIFIs, in the event they are engaged in the business of insurance.

V. *Enhanced Prudential Standards Aimed at Banks are Wholly Inappropriate for Property-Casualty Insurers.*

The Proposed Rule assumes that certain metrics that have been developed under Basel III and the Basel Committee on Banking Supervision (BCBS) for banks and bank holding companies can be adapted for nonbank SIFIs, including property-casualty insurers. We respectfully disagree. There are no circumstances under which it would be appropriate to subject property-casualty insurers to capital standards applicable to banks. The Basel III and BCBS regulatory frameworks are designed to address enterprise risk of a banking organization as a whole. They are ill-suited to be applied on a piecemeal basis to selected activities engaged in by non-depository institutions.

Property-casualty insurers have risks that are significantly different than banks and that are not addressed in Basel III. For example, the predominant risks facing a property-casualty insurer are pricing, underwriting and the risk that the insurer has not appropriately estimated its claim payment obligations under the terms of the policies issued to its customers. Additionally, depending on an insurer's business model and the lines of business it underwrites, an insurer may enter into reinsurance contracts and be subject to collection risk that entails credit risk, including estimation risk (the risk of properly estimating the amount due under the terms of the reinsurance agreement), dispute risk (the risk that the reinsurer agrees with the types of losses the ceding company presents for payment), and regulatory and legal risk. Basel III does not adequately address these and other risks faced by property-casualty insurers and reinsurers, and also does not take into account regulatory safeguards that have been put into place to address counter-party risk (e.g., collateral support conservative valuation allowances and risk-based capital penalties). Conversely, property-casualty insurers and reinsurers are not subject to call risk, as are most banks, since payment of a claim by an insurer is subject to a covered loss occurring before a payment is made.

We understand the Board's desire to use prudential standards with which it is already familiar, especially since much time and effort has been expended in collaborating with international banking officials to develop the Basel III standards. However, for nonbank SIFIs such as property-casualty insurers, the most effective approach for developing effective standards and measures for a covered company that is an insurer is to start with insurance standards currently in place and make appropriate adjustments from there. We agree with earlier comments provided by the Geneva Association to the Council when it stated that "inappropriately designed regulation and standards could bring consequences for the industry and consumers, including higher regulatory burden costs to designated companies which are not justified by the likely benefits, competitive imbalances within the financial services sector, and higher consumer' costs for insurance cover."[24]

[24] *See* www.regulations.gov for comments submitted by The Geneva Association on the proposed procedure and process to designate nonbank financial companies for enhanced supervision by the Federal Reserve System, reference 12 CFR Part 1310, RIN 4030-AA00, 19 December 2011.

The Proposed Rule suggests a number of metrics for establishing leverage and liquidity standards for nonbank SIFIs. We have provided comments regarding each set of metrics.

Risk-Based Capital Requirements and Leverage Metrics

We agree that the Dodd-Frank Act requires the Board to adopt more stringent risk-based capital standards than those that are already applicable to nonbank SIFIs. However, the Proposed Rule proceeds on the assumption that the new Basel rules are inherently more stringent, even though they were designed for, and apply solely to, banking enterprises and there has been no showing that they have any relevance to property-casualty insurers. As stated above, any risk-based capital standards for covered companies, such as property-casualty insurers, should start with standards that have been specifically tailored for the industry sector in which that covered company participates.

For example, the Proposed Rule would require the application of the Basel III/BCBS capital plan requirements. Those requirements indicate that a covered company would need to maintain capital above the Board's minimum risk-based capital ratios (Total Capital ratio of 8%, Tier 1 capital ratio of 4%), and Tier 1 leverage ratio (4%) under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon.[25] That terminology is wholly inapplicable to property-casualty insurers. We strongly object to using banking-related terms because the assumptions and concepts underlying them may not be as relevant to property-casualty insurers. We encourage the Board to work with the insurance industry and insurance regulators to develop terminology and utilize concepts that are consistent with the standards commonly used in the insurance industry.

The Board defines Tier 1 capital for bank holding companies as core capital elements less certain items including goodwill and other intangible elements. Core capital consists of:

1. Common equity, including undivided profits and paid-in-surplus;
2. Certain types of cumulative and non-cumulative perpetual preferred stock; and
3. Minority interests in consolidated subsidiaries.[26]

Tier 1 capital is then used in the following key ratios for evaluating leverage for banking institutions:

1. Tier 1 Leverage Capital ratio (Tier 1 Capital/Average Assets)
2. Tier 1 Risk-Based Capital ratio (Tier 1 Capital/Risk Weighted Assets)
3. Total Risk-Based Capital ratio (Total Capital/Risk Weighted Assets)[27]

It is not at all readily apparent how these metrics would provide meaningful information for a property-casualty insurer, as Tier 1 capital is not a measurement of an insurer's regulatory

[25] 77 Fed. Reg. at 602.
[26] 12 C.F.R. Part 225, Appendix A, Capital Adequacy Guidelines for Bank Holding Companies; Risk-Based Measures.
[27] *Id.*

capital. Since the focus of insurance regulation is on meeting the needs of the policyholder, the calculation of an insurer's regulatory capital is far more conservative and excludes many balance sheet items that are included in the calculation of a banking organization's Tier 1 capital. In addition, the current risk-based capital requirements applicable to property-casualty insurers appropriately risk-weight assets, market and credit risks, underwriting and pricing risks, liability risks, and general business risks based upon measures tailored for the insurance industry, with most of the weighting going to pricing, underwriting, and liability risks which are largely ignored in the determination of capital requirements for banks. The insurance regulatory approach of identifying and risk-weighting the risk factors associated with an insurer provides a fuller and more risk-sensitive evaluation of an insurer's capital structure.

In order to apply bank-centric metrics to the insurance industry, insurers would need to convert their existing financial reporting systems, if possible, to a banking-based system. This task would prove extraordinarily burdensome and expensive. Moreover, imposing this cost on insurers is unnecessary when a rigorous, time-tested risk-based capital system for the insurance industry already exists.

Second, bank capital ratios are used to rank banking institutions from well-capitalized to critically under-capitalized. However, these requirements are arbitrary when applied to insurers because they are not calibrated to insurance-specific risk factors.

Third, the proposed requirement provides no indication that it would be consistent with the existing insurance regulatory goals of meeting the needs of policyholders. Nothing in the Proposed Rule addresses the relationship of the proposed leverage ratios to the existing obligation to protect insurance policyholders. The goal of protecting policyholders should provide the parameter for developing nonbank prudential measures to evaluate an insurer's capital position. The reliance on bank-centric concepts and metrics, however, raises questions of whether the needs of insurance policyholders have been considered at all. The regulatory goals of protecting policyholders and strengthening solvency should operate in tandem.

Finally, the proposed capital plan would undermine an effective insurance risk-based capital system and impose a short 180-day transition period for implementing the new capital plan,[28] giving no consideration for how the existing system could be used to fulfill Dodd-Frank Act objectives. We strongly urge the Board to defer action on the Proposed Rule as applied to insurers in order to assess how existing insurance industry standards and regulatory tools can be used to meet the mandates under the Dodd-Frank Act, rather than force insurer SIFIs – should there be any – into an inappropriate, arbitrarily-imposed and adapted banking standard.

The Proposed Rule also states that the Board plans to later issue a proposal for implementing a quantitative risk-based surcharge.[29] The Proposed Rule indicates that the Board would consider how the capital surcharge would "meaningfully reduce the probability of failure of the largest, most complex financial companies and would minimize losses to the U.S. financial system and

[28] 77 Fed. Reg. at 603.
[29] *Id.* at 599.

the economy if such a company should fail."[30] Without a better understanding of the capital structure and risk profile of nonbank financial companies like property-casualty insurance companies, we question why the Board would consider mandating a capital surcharge. Such a mandate begs the question of why such a surcharge is necessary and what purpose it would serve as applied to an insurer SIFI.

Liquidity Requirements

According to the Proposed Rule, Basel III seeks to create a framework for strong liquidity risk management and quantitative liquidity measurements. The Proposed Rule would impose two new liquidity ratios, which are based on the Basel III liquidity framework:

The Liquidity Coverage Ratio (LCR):

$$\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} \geq 100\%$$

and

The Net Stable Funding Ratio (NSFR):

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

As with the proposed leverage ratios, our concerns with these proposed metrics are definitional – the terminology appears to be banking-specific – and with their applicability, in that the insurance industry already uses more targeted and informative liquidity measurements, such as the Adjusted Liabilities/Liquid Assets ratio, which may provide stronger liquidity information about an insurer. We again urge the Board to engage with the insurance industry and insurance regulators to ensure that appropriate liquidity measurements are used when applying them to SIFIs.

In addition to the quantitative measurements, the Proposed Rule contains an extensive discussion of the qualitative aspects for providing for strong risk management of the nonbank SIFI's liquidity. And in this regard, we believe the Proposed Rule is overly prescriptive. The suggested risk management improvements include:

- *Corporate Governance Requirements*: the Proposed Rule would require the board of directors to oversee the covered company's liquidity risk management processes, including reviewing and approving the liquidity risk management strategies, policies and procedures.[31] In so doing, the Proposed Rule imposes numerous specific duties upon the board. We are concerned from two perspectives. First, the specific duties are unduly cumbersome and blur the line

[30] *Id.* at 604.

[31] *Id.* at 600.

between regulation and management; unless the company is in receivership, we do not believe it is the role of regulators to dictate the specific functions that directors and officers should fulfill with respect to the corporate enterprise. Second, the requirements are focused on areas where the risk is not material to property-casualty insurers. Liquidity is generally not a major risk area for property-casualty insurers, due to investment rules that already limit investments in non-liquid assets, the lack of liability call risk, and regular cash inflows from renewal business. Instead, the Proposed Rule should lay out overarching principles or guidelines, but leave the specifics of implementation to the board of directors and management staff. Given the nuances of the specific business of a SIFI, the board of directors and management are in a better position to determine how principles can be translated into concrete action within the company. Of course there should be a mechanism for communicating to the Board on the company's effectiveness in implementing the principles.

- *Liquidity Buffer*: the Proposed Rule would impose a requirement for a liquidity buffer.[32] The rationale for the buffer, according to the proposal, is "to withstand liquidity stress under adverse conditions."[33] The assumptions inherent in the discussion of the liquidity buffer are troubling, in that the Proposed Rule implies that a liquidity buffer may avoid the kind of liquidity distress that many companies experienced during the financial crisis. The statement that "[d]uring the financial crisis, financial companies that experienced severe liquidity difficulties often held insufficient liquid assets to meet their liquidity needs as market sources of funding were severely curtailed"[34] is retrospective and not helpful. The liquidity requirements for property-casualty insurers are generally much lower than those faced by banks, as property-casualty insurers are not subject to call risk (as discussed earlier in this submission). Instead, the larger risk is whether the insurer has sufficient assets to meet its policyholder obligations. A financially troubled property-casualty insurer will generally be technically insolvent before it runs short of liquid assets, given the investment restrictions that are imposed on such insurers. The proposed liquidity buffer does not address or guard against property-casualty insurance insolvencies, which usually are the result of larger claim payments than the insurer recognized on its balance sheet. Insurance-related metrics, however, should focus on the indicators of potential insolvency that may exist long before liquidity concerns arise.

  The criteria for the liquidity buffer could actually worsen a company's financial condition, in that capital that could be more productively deployed will be allocated to "highly liquid assets," which are defined by the Proposed Rule as (a)

[32] *Id.* at 609.
[33] *Id.*
[34] *Id.*

cash; (b) government or government-sponsored securities; and (c) any other asset that a covered company can demonstrate to the satisfaction of the Board has low credit risk and low market risk, is traded in an active secondary two-way market, and is a type of asset that investors historically have purchased during stressed markets. However, the Proposed Rule fails to recognize that, in a distressed market situation, assets in the (c) category may be in limited supply; assets in the (b) category may have depressed values; and the (a) category assets – cash – will not generate much return while utilized as liquidity buffer assets. The desire to increase liquidity could force companies to engage in inefficient and counterproductive investment practices.

- *Independent Review*: the Proposed Rule would require an independent review function – undefined – for evaluating the company's liquidity risk management.[35] We believe, however, that such a requirement would be redundant and would be an unnecessary waste of resources as property-casualty insurers are not subject to call risk and have continuing incoming cash flows from renewal premiums from current policyholders.

In summary, we believe that, as applied to property-casualty insurance companies that may be designated as SIFIs, all activities of an insurer should be regulated according to the insurance business model, using insurance-specific regulatory standards. While the Basel-developed standards may be useful in stimulating discussion between the Board and state insurance regulators, as well as the FIO, international insurance groups, and insurers, the starting point for Section 165 enhanced prudential standards for nonbank financial companies that may be designated under Section 113 must be the insurance industry's business model.

CONCLUSION

For all of the foregoing reasons, we strongly urge the Board to propose a separate regulation for SIFIs that will promote enhanced prudential and early remediation standards that are appropriate to the risk features and regulatory constructs of the nonbank financial sectors under heightened supervision. For property-casualty insurers, the Board should await the outcome of the Council's determinations under Section 113 and the multilateral insurance regulatory modernization discussions, as those may very well inform whether heightened standards are even necessary for regulated property-casualty insurers given the low risk nature of the business model and the conservative management practices and financial regulatory architecture supporting that model. We appreciate the opportunity to provide comments on the Proposed Rule.

[35] *Id.* at 606.

Respectfully submitted,

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