AMERICAN ACADEMY *of* ACTUARIES

April 30, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

RE: Docket No. 1438, RIN 7100-AD-86

On behalf of the Financial Regulatory Reform Task Force (Task Force) of the American Academy of Actuaries[1] (Academy), I wish to provide the following comments on the proposed rule, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies* issued by the Board of Governors of the Federal Reserve (Board). Our comments are intended to provide objective recommendations to the Board as it prepares to carry out its responsibility to establish additional prudential standards to apply to non-bank financial service companies identified by the Financial Stability Oversight Council (FSOC) as companies whose business activities or financial distress could pose a threat to the financial stability of the United States.

Recognizing the statutory responsibility of the Board with respect to systemically important financial institutions ("SIFIs"), our comments focus on the application of the proposed enhanced standards addressing risk based capital, leverage regulations, liquidity standards, risk management processes, counterparty limits, stress test requirements, debt to equity limits, and early remediation to US insurers that currently are under the regulatory supervision of one state functional regulator.

The risks assumed by these insurers fundamentally differ from those assumed by banks and the balance of the financial services industry. Our work group is concerned that the application of standards developed to be appropriate for the banking industry will result in requirements which do not reflect the risks present in the insurance sector and will have the unintended consequences of impairing the competitive position of these insurers for reasons unrelated to the risks they assume. This concern extends equally to insurance companies individually or as part of a diversified financial services holding company. As a result, our comments focus on the first two questions posed with respect to applicable sections of the rule.

Question 1: What additional characteristics of a non-bank covered company—in addition to its business model, capital structure, and risk profile—should the Board consider when determining how to apply the enhanced standards and the early remediation requirements to such a company?

[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Question 2: What are the potential unintended consequences and burdens associated with subjecting a nonbank covered company to the enhanced standards and the early remediation requirements?

Insurance Industry Characteristics

Insurers are fundamentally different from banks. Unlike banks, insurance liabilities are inextricably linked to their funding. That is, insurance liabilities arise from the sale of an insurance policy and are funded by the associated payment of premiums by policyholders, rather than by borrowing. There is no separation of funding and lending operations.

Furthermore, insurance liabilities are not as liquid as bank liabilities. Many insurance contracts do not have a cash option. For those that do, there are frequently contractual limits for which there are penalties and/or income taxes incurred upon premature surrender. Cash options are only accessed by the cancelation or surrender of an insurance policy. Many policies include a contractual right to delay cash surrender payments for up to six months. In times of financial difficulty, the functional regulator maintains the right to restrict the exercise of any cash withdrawal options.

Insurance is purchased to provide protection against an insurable event. If policyholders forfeit these benefits they may be unable to readily replace them. Moreover, in the instances where an insurance company has experienced an accelerated exodus of fund withdrawals, the impact has been confined to that company. There has been no observed contagion effect between companies due to the financial distress of another. Simply stated, insurance companies are not exposed to the same liquidity risk inherent to banks.

The Board would be well-served to leverage the existing statutory solvency regime already in place for insurance companies in developing enhanced prudential standards. This regime, overseen by state insurance regulators, is founded on a statutory basis of accounting. For regulatory purposes, all insurance companies must prepare financial statements on a statutory basis that conservatively records assets and liabilities. The intent is to ensure that policy benefits are paid in the event of the insolvency of the insurance company. We are not aware of a comparable statutory reporting regime for banks.

Insurers routinely perform stress tests to evaluate variables that are most impactful to their business. These sensitivities include an assessment of the effect on company financial results for contingencies such as changes in mortality, catastrophic events, policy persistency, expenses or other experience. In addition, with life insurers, sophisticated cash flow testing is performed to demonstrate that reserves would be adequate under a number of moderately adverse interest rate scenarios. State regulation requires that a range of scenarios including moderately adverse conditions be included in this test. Most companies include many more scenarios in their cash flow tests, and include stochastically generated random scenarios. In addition, companies will stress test these results for changes in mortality, catastrophic events, policy persistency, expenses or other experience.

The accuracy of the reserve calculation and, in the case of life insurers, the results of the cash flow testing are certified by a qualified actuary appointed by the company board of directors.

This actuary must meet professional qualification standards established by the American Academy of Actuaries which include achieving fundamental education and experience in relevant areas of actuarial practice, as well as maintaining the necessary expertise through continuing education. The actuary must perform his/her work consistent with professional standards of practice. Failure to do so could result in disciplinary action, including the loss of the ability to perform this work in the future. The actuary's report is frequently provided to the company board of directors. There is no similar company board-appointed role in the banking industry.

In addition to preparing financial statements on a conservative statutory basis, companies must hold risk-based capital (RBC). The National Association of Insurance Commissioners (NAIC) introduced RBC standards in 1993 after an intensive two-year effort. It has continually evolved as new experience and risk techniques have emerged and new products have been introduced. The Academy is very active in the process of maintaining and enhancing the RBC regime.

The NAIC RBC regime also enables the framework for the early identification and remediation of undercapitalized insurance companies. Ever increasing regulatory intervention is prescribed at prospectively lower amounts of capital. These thresholds are company action level, authorized control level and mandatory control level. Companies generally maintain capital at multiples of the company action level RBC.

At the company action level, companies must submit a plan of remediation to their supervisor. If capital falls further to the authorized control level, the regulator is permitted to rehabilitate the company. Rehabilitation or liquidation by state guaranty associations is required to occur at the mandatory control level, when company capital and surplus is still positive but falls below a sustainable level. In addition, unfavorable trends in statutory capital or other operating characteristics are identified in the NAIC Insurance Regulatory Information System (IRIS). This system is also used to initiate heightened regulator attention.

The NAIC RBC system incorporates specific capital requirements to cover asset, credit, interest rate, market, underwriting, insurance and business risks as appropriate to life, property and casualty and health insurers. These factors are specific to classes of invested assets, different product risks and, in the case of life insurance companies, specific company interest rate and market risks. They also reflect the underlying statutory accounting basis and its attendant conservatism. Developed and enhanced for more than 20 years, there is arguably no comparable risk-based capital regime of commensurate track record or rigor in use in any other financial services environment in the world.

Potential Unintended Consequences

The application of bank prudential standards to insurance businesses would be a step backward in effective regulation. It would undoubtedly have unintended consequences. This will occur whether applied to an insurer individually or as part of a diversified financial services holding company. The use of bank-centric standards to an insurance company that is part of a group is as inappropriate and ineffective as if they were applied to an individual company. The adverse consequences, whether indirect or diluted, would be as deleterious.

Bank risk-based capital requirements have rightly been developed for the facts and circumstances unique to banks. They are not as granular as those that have been developed for insurance companies and do not take into account the risk characteristics of insurance liabilities. As a result, adverse consequences are not merely possible, but likely.

The use of bank risk-based capital methods will result in insurance products being assessed inappropriate levels of capital. That is because the factors have not been developed to reflect the risks unique to insurance that vary by product risk and other characteristics. Some insurance products will be assessed too much capital while others may not have enough. The effect may be to incent companies to pursue higher risk liabilities, while eschewing lower risk benefits. This is precisely the type of company behavior that prudential supervision seeks to avoid and which current NAIC RBC addresses.

The cost of providing insurance company products could become non-economic. It is important that risk-based capital requirements be finely calibrated to the underlying risk of the product. In the absence of this, companies will refuse to offer insurance or customers will bear the brunt of higher non-economic costs.

The withdrawal of insurance products from their markets would obviously be detrimental to the economy and consumers. Insurance is an essential means of managing risk while pursuing economic growth. The loss of this coverage would also defeat the public policy goal of increasing personal savings.

Alternatively, the non-economic costs of enhanced prudential supervision will be added to the consumers' costs. To the extent that these costs do not reflect the underlying risks, one financial product could be advantaged over another. This may cause consumers to migrate to financial services products that do not provide the same level of insurance benefits and guarantees. The effect would be to undermine the public policy goal of encouraging individuals to provide for their own financial security.

In Summary

In order for the Board to evaluate the effectiveness of the additional prudential regulation as it applies to the insurance industry it must first consider the unique features of the risks assumed by the industry in relation to banks, the differences in the business models and the nature of the functional regulation to which the insurance industry is subject.

To the contrary, the proposed rule would effectively apply (enhanced) bank standards to insurance businesses. While these standards may be appropriate for banks, it cannot be assumed that they would be equally appropriate for insurance companies. Enhanced prudential standards for insurance companies should be developed specifically based on a sound understanding of their businesses and underlying risks. This is essential for the preservation of financial stability as well as the promotion of public policy.

We do recognize that an insurer which is identified as systemically relevant will be subject to additional prudential regulation. However, in this instance the objective should be to identify additional requirements which are appropriate for the risks assumed by the insurer. As actuaries we appreciate the complexity involved in applying a single set of standards to a variety of industries and circumstances. We would be pleased to assist you in this effort to develop appropriate standards.

If you have any questions or concerns regarding these comments, please feel free to contact me through the Academy via Tina Getachew, Senior Analyst, Risk Management and Financial Reporting (getachew@actuary.org).

Sincerely,

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American Academy of Actuaries