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October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219

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

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Regulatory Capital Rules:

Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (OCC Docket ID OCC-2012-0008, RIN 1557- AD 46; FRB Docket No. R- 1442, RIN 7100 – AD 87; FDIC RIN 3064-AD95);

Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009, RIN 1557 – AD 46; FRB Docket No. R- 1442, RIN 7100 – AD 87; FDIC RIN 3064-AD96); and

Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010, RIN 1557 – AD 46; FRB Docket No. R- 1442, RIN 7100 – AD 87; FDIC RIN 3064-AD97)

Dear Sir or Madam:

Prudential Financial, Inc. (“Prudential”) appreciates the opportunity to comment to the Federal banking agencies regarding the three notices of proposed rulemaking to implement the Basel III capital framework in the United States (the “Proposals” or “Proposed Rules”). Prudential is committed to

supporting the objectives of the Dodd-Frank Act, including capital standards that encourage the financial strength of financial institutions in the United States and ensure the stability of the United States financial system. It is very important that the regulatory standards are the right and appropriate standards for United States financial institutions.

The Proposals apply to depository institutions and their holding companies, including savings and loan holding companies. While they do not say that the Federal Reserve Board (the “Board”) would apply those same capital standards to nonbank financial companies designated by the Financial Stability Oversight Council (“Council”) for enhanced supervision by the Board, it seems at least plausible that the Board would use them as the basis for a capital framework for those companies. Prudential does not assume that any company predominantly engaged in the life insurance business would be so designated by the Council, and we believe that Prudential should not be designated for enhanced supervision by the Board. Nevertheless, we are concerned that the Proposals, to the extent they apply to savings and loan holding companies that are predominantly engaged in insurance, would be inappropriate and set a wrong precedent for insurance capital standards.

Prudential is a financial services company with major operations in the United States and Japan. Prudential offers life insurance, annuities, and retirement products and services to individual and institutional customers, through proprietary and third party distribution networks. The vast majority of Prudential’s business is conducted through insurance company operating subsidiaries, which are comprehensively regulated by governmental supervisory agencies in the jurisdictions in which they operate.

Prudential is a member of the American Council of Life Insurers (“ACLI”), which has submitted a comment letter regarding the Proposed Rules. Prudential agrees with and supports the ACLI comments regarding the deficiencies of the Proposed Rules and the need for the Board to propose new capital standards that are appropriate for savings and loan holding companies that are predominantly engaged in insurance activities. We also agree with and support the comments made by the Financial Services Roundtable and the American Bankers Association in their joint letter to the Agencies.

Prudential’s comments are presented in two sections. The first section of this letter discusses the reasons we believe the Federal Reserve Board should not adopt the Proposed Rules for savings and loan holding companies that are predominantly engaged in insurance activities. Second, we discuss an approach and a capital model that we believe are appropriate for savings and loan holding companies that are predominantly insurance businesses, and the reasons for our views.

The Board Should Not Adopt the Proposed Rules for Savings and Loan Holding Companies Predominantly Engaged in Insurance

Prudential believes that the Proposed Rules are not the right capital standards for savings and loan holding companies predominantly engaged in insurance activities. It is very likely that these capital standards, applied to insurance groups, will cause harm that the Board does not intend, including harm to consumers and credit markets.

There appears to be no dispute that the banking and insurance businesses are very different. Thus, there is little reason to believe that a capital framework designed for banks would be adequate and appropriate for insurance companies. In fact, a joint working group of the Federal Reserve System and the National Association of Insurance Commissioners reached just such a conclusion in 2002. It recognized that “the BHC capital framework requires capital only against assets, while a significant share of capital of insurers covers risks that are not directly related to their assets.”¹ In its report, the working group said this about the banking and insurance risk based capital frameworks:

...the two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors. As a result, the effective regulatory capital requirements for assets, liabilities, and various business risks for insurers are not the same as those for banks. Moreover, the effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets.²

This is not an academic issue. If the wrong capital standards are applied to insurance groups, and the capital standards do not accurately reflect the risks and the safety and soundness needs of the operating companies, there is real potential to create risk. There are other market and consumer impacts as well. Applying the wrong capital model to insurance company assets will incent companies to change their portfolios to decrease the capital charges. As a result, those companies will necessarily modify their product offerings, or exit markets entirely, to avoid products that require them to hold long dated assets supporting long dated liabilities.

For consumers, this means that their access to long term insurance products that are designed to provide stability, including retirement products, will dwindle. This will occur at the same time the Federal government is encouraging financial services firms to make available products that can give consumers more stability and certainty in their retirements than 401k and similar products are capable of providing. This “unintended consequence” of ill-designed capital standards may have profound, long-enduring public policy consequences.

There are implications for credit markets as well. The September 2012 Chicago Fed Letter, in an article discussing United States life insurance companies, reports that they held \$5.3 trillion in assets, and that more than half of those assets are “invested in corporate, foreign, and government bonds; and another 6% of assets are invested in commercial mortgages. Most of those fixed-income investments have long durations, reflecting the long duration of insurance liabilities.”³ The article points out that life insurance companies have important roles in financing corporations, and that they hold 18 percent of all outstanding corporate and foreign bonds in the United States.⁴ Another “unintended consequence” of applying the

¹ Report of the National Association of Insurance Commissioners and the Federal Reserve System Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage, May 24, 2002, page 10.

² Id., page 1.

³ “How Liquid Are U.S. Life Insurance Liabilities?”, Anna Paulson, Richard Rosen, Zain Mohey-Deen, Robert McMenamin, Chicago Fed Letter, September 2012, published by the Federal Reserve Bank of Chicago, pages 1 and 2.

⁴ Id., page 1.

Proposals to savings and loan holding companies that are predominantly insurance businesses will be the contraction of the credit that their investments in these markets creates, in order to reduce the impact of the capital charges that the Proposals impose.

For these reasons, we respectfully urge the Board not to adopt the Proposed Rules for savings and loan holding companies that are predominantly engaged in insurance activities. As the ACLI letter discusses in detail, there is no statutory requirement for the Board to adopt the Basel capital standards for these businesses now.

The Board Should Study the Insurance Industry and Develop an Appropriate Capital Model for Savings and Loan Holding Companies Predominantly Engaged in Insurance

The Proposed Rules, which implement the Basel capital standards, were developed for banks and bank holding companies. Savings and loan holding companies that are predominantly engaged in insurance activities have business models, risks, and capital needs that differ substantially from those of banking institutions. Prudential urges the Board to adopt rules that are appropriate for these insurance organizations.

Prudential's comment letter dated April 27, 2012, to the Board regarding the proposed rule for establishing enhanced prudential standards and early remediation requirements for covered companies proposed that the Board study the insurance industry, together with federal and state agencies and regulators, affected insurers, and other experts.⁵ We believe that developing appropriate capital standards for those companies requires extensive empirical work, analysis, and modeling. After the study, the Board would understand the industry and the issues sufficiently to propose a capital model that would be appropriate.

That letter also proposed a capital model for those institutions, and it is one that we believe could be used for savings and loan holding companies that are predominantly engaged in insurance activities as well.⁶ It describes the capital model in detail, and the supporting reasoning for it. We will not repeat the entirety of that discussion in this letter, which includes only a summary of the fundamental principles we propose. We urge the Board to study the insurance industry, and to give serious consideration to adopting the capital model described in Appendix A.

The capital model we propose measures the capital adequacy of the insurance subsidiaries on a stand-alone basis, relying on existing insurance regulatory capital requirements. That model has been well tested by recent events, including the financial crisis, and it has performed well.⁷ The capital

⁵ Prudential's April 27, 2012 letter to the Federal Reserve Board is attached as Appendix A.

⁶ Appendix A, at pages 2 through 16, discusses Prudential's proposal regarding the appropriate capital framework, and the reasons we think it is an appropriate standard.

⁷ The National Organization of Life and Health Insurance Guaranty Associations ("NOLHGA") reported: "Only 13 life and health insurers (eight life and five health) were placed in liquidation from January 1, 2008, through November 6, 2011, with aggregate liabilities to policyholders of \$900 million." NOLHGA compared this number with the initial bank and bond debt of Lehman Brothers, as reported on the first day of its bankruptcy, of \$765 billion. Testimony for the Record of the National Organization of Life and Health Insurance Guaranty Associations Before the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity, Insurance Oversight and Legislative Proposals Hearing, November 16, 2011, page 2, footnote 2 and accompanying text.

adequacy of the non-insurance businesses should be determined using capital standards that have been appropriately tailored to the nature of those businesses.⁸ The top tier holding companies do not generally engage in activities requiring capital, and therefore, assuming they play this typical role as intermediaries between funding sources and regulated entities, no capital requirement should be imposed on them.⁹

Capital should be held where it is useful, for example, to respond to insurance claims as they come due. Capital models should allocate capital consistently with this need, and should perform “in the tails,” that is, produce capital requirements that respond effectively to financial bubbles and crashes that lie outside the normal financial events. The insurance risk-based capital standards, coupled with robust and conservative reserving practices that are required by state insurance law and adhered to by insurance companies and their actuaries, are entirely adequate to these tasks for operating insurance companies.

This subject is discussed in detail in both Appendix A of this letter, and in the ACLI comment letter submitted regarding the Proposed Rules, and we will not belabor the points in this letter. By way of contrast, the mark-to-market framework of the Proposed Rules fails this test for insurance groups. In long duration businesses, for example, life insurance and annuities, small changes in market conditions and values can generate large changes in the calculations for required capital. The impact is pro-cyclical, that is, the apparent change is amplified such that capital looks either better than it really is, or worse than it really is. The insurance capital model does not mark long term assets to market, which is appropriate because they are held against long term liabilities, and there is no need for short-term liquidity. Therefore, short-term changes in value are irrelevant to the liabilities held by insurance companies.

In this letter, in Appendix A, and in the comments submitted by the American Council of Life Insurers, the Financial Services Roundtable, and the American Bankers Association, numerous reasons for the Board to reconsider the Proposed Rules and their application to savings and loan holding companies that are predominantly insurance groups have been advanced. We respectfully urge the Board to take the time needed to study the insurance industry, and then propose capital standards that are appropriate for savings and loan holding companies predominantly engaged in the business of insurance. We would be pleased to participate in such a study.

⁸ Obviously, for insured depository institution subsidiaries, the capital rules adopted by the relevant Federal banking agency would be the appropriate capital standard.

⁹ We recognize that savings and loan holding companies are required to be sources of financial strength for their subsidiary insured depository institutions. For nearly all savings and loan holding companies that are predominantly engaged in insurance activities, the insured depository institution subsidiary is of such a comparatively small size that this obligation could be discharged with a capital requirement of relatively small size, held by the parent holding company or a downstream corporate parent of the depository institution.

Conclusion

Thank you for your consideration of our comments. We would be pleased to discuss our comments further, address any questions the Board may have, and participate in a study that the Board may elect to conduct.

Respectfully submitted,

A handwritten signature in cursive script that reads "Mark B. Quinn". The signature is written in black ink and is positioned below the text "Respectfully submitted,".

Appendix A



The Prudential Insurance Company of America
751 Broad Street, Newark, NJ 07102

Via Email and U.S. Mail

April 27, 2012

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

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

File Number: Regulation YY; Docket No. 1438; RIN 7100-AD-86

Dear Ms. Johnson:

Prudential Financial, Inc. ("Prudential") appreciates the opportunity to comment to the Board of Governors of the Federal Reserve System (the "Board") on its proposed rules (the "Proposed Rules") implementing section 165 and section 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Prudential is committed to supporting the objectives of the Dodd-Frank Act. Consequently, it is focusing its comments on the potential application of certain sections of the Proposed Rules should a company doing business predominantly through life insurance operating subsidiaries be determined by the Financial Stability Oversight Council ("Council") to be supervised by the Board, and subject to enhanced standards set by the Board, as provided by section 113 of the Dodd-Frank Act.

Prudential does not assume that any company predominately engaged in the life insurance business would appropriately be so designated by the Council. To the contrary, for the reasons explained later and in comment letters submitted by the American Council of Life Insurers and the Geneva Association, Prudential does not view the traditional core activities of life insurance companies to present a systemic risk to the financial stability of the United States. Prudential does not believe that it presents a risk or threat to the financial stability of the United States.

Prudential is a financial services company with major operations in the United States and Japan. Prudential offers life insurance and other products and services to individual and institutional customers, through proprietary and third party distribution networks. The vast majority of Prudential's business is conducted through insurance company operating subsidiaries, which are comprehensively regulated by governmental supervisory agencies in the

domestic and international jurisdictions in which they reside and operate. Our comments are primarily focused on the activities of life insurance companies.¹

The Board acknowledges in its preamble, that the Proposed Rules were “largely developed with large, complex bank holding companies in mind. It then states that the Proposed Rules will also be applied to other nonbank financial companies designated for supervision by the Board (“Covered Companies”), perhaps – at the Board’s discretion – tailored to different Covered Companies.² Prudential urges the Board to adopt a rule that is tailored to Covered Insurance Groups, as described in more detail below. Such a rulemaking would facilitate the intent of the Dodd-Frank Act as articulated in section 165(b)(3), in prescribing prudential standards for Covered Companies, to “take into account differences among [them] ... [and] adapt the required standards as appropriate 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.”³ Such customized treatment is particularly appropriate for Covered Insurance Groups, given the relevant distinctions between insurance and banking, and Congress’ repeated recognition in the Dodd-Frank Act that insurance should be treated differently.

EXECUTIVE SUMMARY OF PRUDENTIAL’S SUGGESTED CHANGES TO PROPOSED RULES

For the reasons discussed in this letter, we believe the bank regulatory model reflected in the Proposed Rules is not designed for insurance holding companies or their insurance subsidiaries. In particular, the bank capital model fails to capture some of the risks insurance companies face, and for that reason may fail to achieve the Dodd-Frank Act goals of protecting the financial stability of the United States.⁴ The stress testing and counterparty exposure limits standards in the Proposed Rules also are not well-suited to mitigating or preventing risks that insurance companies or their holding companies may pose to the U.S. financial system.

The current U.S. state insurance regulatory regime, based on a risk-based capital (“RBC”) and reserving model and stress testing utilized for many years, better measures the risk in life insurance subsidiaries than the bank regulatory regime. The RBC model comprehensively measures the same asset risks as the bank capital model but, in addition, measures insurance liability risk – which the bank capital model fails to measure.

A summary list of the amendments we propose is below. Our reasoning and a detailed discussion of the recommendations are in the remainder of this letter. We believe the Board

¹ We refer to life insurance companies designated by the Council for enhanced supervision as “Covered Insurance Groups.” We use “Covered Company” to refer to nonbank financial companies designated by the Council for enhanced supervision.

² 77 Federal Register 594, at 597 (January 5, 2012).

³ Dodd-Frank Act, Subsections 165(b)(3)(A) and (D).

⁴ Failure to capture relevant risks of Covered Companies means the failure to prevent or mitigate them – which is the very purpose of enhanced supervision under the Dodd-Frank Act. Subsection 165 (a)(1) of the Dodd-Frank Act provides that “...to prevent or mitigate risks to the financial stability of the United States...the Board of Governors shall...establish prudential standards for nonbank financial companies supervised by the Board...”

should amend the Proposed Rules to provide the following enhanced regulatory regime to a Covered Insurance Group if any are so designated under Section 165:

Capital, Leverage, Liquidity and Stress Testing Recommendations

- Where the predominance of a Covered Insurance Group's consolidated assets are in domestic and foreign regulated life insurance subsidiaries, such subsidiaries and the group's insurance holding company should be exempt from the application of the Proposed Rules' capital, liquidity and stress requirements until such time as the Board determines, after study, that some other regulatory regime would better achieve the purposes of Section 165 than the combined federal/state regulatory approach proposed in this letter.
- The Board would study this issue in consultation with potentially designated Covered Insurance Groups, the Federal Insurance Office, State insurance regulators and other experts to develop a model for supervising insurance subsidiaries of Covered Insurance Groups, and specifically to determine whether another regime is a better model than the RBC/reserving model. Prudential would be pleased to participate in that process.
- During this study period, the capital, liquidity and stress requirements currently applicable to the regulated insurance subsidiaries under U.S. and foreign insurance laws would continue to apply. Stress testing would be effected reflecting the stress scenarios mandated by the Board, so as to provide uniformity with other Covered Companies. In addition, to better accomplish the goals of the Dodd-Frank Act, we recommend that the stress tests be supplemented by tests that are specific to insurance companies, such as mortality and morbidity events.⁵
- Notwithstanding the exemption described above from the capital, leverage and stress testing requirements of the Proposed Rules, the insurance holding company of a Covered Insurance Group with the predominance of its assets in domestic and foreign regulated insurance subsidiaries would become subject to Board regulation as to both liquidity (on a stand-alone basis) and as to leverage (on a consolidated basis) together with stress testing thereof. It would not be subject to the capital requirements of the Proposed Rules.
- The capital adequacy and liquidity of non-insurance subsidiaries would be subject to Board regulation on a collective basis using capital, liquidity and stress testing requirements developed to the nature of the business being conducted. In particular, the asset management subsidiaries of a Covered Insurance Group would be subject to any enhanced standards the Board developed for asset management companies which are designated under Section 165.
- At a minimum, the Board should tailor its liquidity risk management rules, if applied to Covered Insurance Groups, to reflect the liquidity profile of insurance companies. Specifically, the Board should amend the Proposed Rules to reduce the frequency of

⁵ Mortality risk is the risk that death claims are higher than predicted, which is influenced by epidemics, natural disasters, or other unanticipated events. Morbidity risk relates to adverse claim experience related to reimbursements for loss of income or for medical expenses, due to illness, accident or disability.

cash flow projections; modify the responsibilities imposed upon the company's Board of Directors; and expand the definition of highly liquid assets to include highly rated sovereign and agency debt and publicly-traded corporate bonds.

This recommendation recognizes that existing insurance regulatory frameworks, both in the U.S. and overseas, are well developed and have performed well in normal and in stressed markets. Moreover, it recognizes the limited capital mobility between individual insurance entities, and between insurance companies and other parts of the Covered Insurance Group.

We believe the foregoing proposal, building upon existing state and foreign regulation of insurance subsidiaries, and imposing regulation of insurance holding company liquidity and consolidated leverage, would create a basis for the enhanced regulation of any Covered Insurance Group that would be more protective to our financial system than both the regulation contemplated by the Proposed Rules and existing state insurance regulation.

In addition, for the reasons discussed in this letter, we propose the following additional amendments to the Proposed Rules:

Single Counterparty Credit Limits

- *"Sovereign Entity"* The proposed standard that includes non-U.S. sovereigns in the counterparty exposure limit will impede Covered Insurance Groups from growing and competing globally and should be amended to exclude instruments issued by foreign "sovereign entities" from the single counterparty exposure limits when those investments support local insurance and similar liabilities.
- *"Major Covered Company"* The proposed "Major Covered Company" limitation is overbroad, and its application to Covered Insurance Groups would be harmful to their cash management operations. One potential way to modify the proposed standard would be the exclusion of certain transactions by Covered Insurance Groups from the limit, as discussed in more detail below.
- We recommend that the Board amend the Proposed Rules to exclude deposits with the central clearinghouses and exchanges from the single counterparty limits or to impose substantially higher allowable limits with respect to those categories of exposures.

Risk Management and Risk Committee

- The Proposed Rules are highly prescriptive and should be amended to reflect a more flexible standard that would permit Covered Companies to organize their board committees and risk management functions as they deem appropriate, so long as the Board's standards for effective board of director oversight and effective management of risk are achieved.

Early Remediation

- The early remediation standard limits the ability of Covered Companies' supervisors to exercise supervisory judgment in matters where judgment and discretion are appropriate. The early remediation standards should be modified to reflect the underlying capital and liquidity requirements proposed above.

Phase-In

- To the extent that any standard in the final rules applies to Covered Insurance Groups, we recommend that there be an appropriate phase-in period of not less than one year. This will allow Covered Insurance Groups to understand the new requirements, and seek any clarifications that might be necessary. Also, if changes in existing processes or operations or to management information systems would be required, time will be needed to develop, test and implement the changes to ensure they do not disrupt operations, and that the changes are effective.

SUBSTANTIVE COMMENTS

I. Capital and Leverage

A. Summary

We believe that the application of consolidated bank holding company capital adequacy rules to Covered Insurance Groups where the predominance of their consolidated assets are in regulated domestic or foreign insurance subsidiaries would inaccurately measure capital and fall short of the objectives of the Dodd-Frank Act. Instead, we recommend that the Proposed Rules be revised in light of the particular risks of those Covered Insurance Groups. One approach we believe would achieve the Dodd-Frank Act's objectives entails:

- Determining the capital adequacy of the insurance subsidiaries of a Covered Insurance Group on a stand-alone basis by relying on existing insurance regulatory capital requirements;
- Not imposing capital requirements on the top tier holding company of a Covered Insurance Group;
- Regulating the Covered Insurance Group through the imposition of a total leverage limit that is measured and applied on a consolidated basis; and
- Regulating the capital adequacy of the non-insurance portions of a Covered Insurance Group's business on a collective basis using capital standards that have been appropriately tailored to the nature of the non-insurance businesses being conducted.

The proposed application of bank holding company standards to measure the capital adequacy of a Covered Insurance Group would not recognize important aspects of life insurers' balance sheets and the particular types of risks they undertake. Among other things, bank-oriented risk metrics do not properly capture insurance-specific risks, for example, mortality and morbidity risk. Additionally, certain categories of assets are fundamental to life insurers and would not be properly evaluated in a bank-oriented model, including, but not limited to, separate accounts, "closed blocks," and policy loans. Finally, the bank holding company capital standards involve measuring capital adequacy on a consolidated basis; we believe this consolidated approach for Covered Insurance Groups is inadequate due to the regulatory capital mobility constraints, as described below, that exist with respect to insurance subsidiaries of the company.

For the reasons discussed below, we believe that the Board can prudently rely on a subsidiary insurance company's compliance with the capital adequacy rules imposed by existing U.S. and foreign insurance regulatory standards following the designation of a Covered Insurance Group.⁶

B. General Principles

In establishing standards with respect to capital adequacy requirements for covered insurance groups, we recommend that the Board be guided by the following general principles:

- a) Capital is a resource, and capital should not be presumed to be fungible. Capital adequacy rules need to be designed to recognize the limits on capital mobility across different parts of the Covered Company. In particular, the capital adequacy rules should recognize that each insurance company within a Covered Company is: (i) housed within a separate legal entity; (ii) subject to separate, stand-alone capital requirements under specified statutory accounting principles; (iii) separately and appropriately regulated; and (iv) effectively protected from all other companies within the Covered Company due to limitations on capital mobility and capital distributions.
- b) A strong capital position in any single insurance subsidiary should not mask weaknesses in other parts of a Covered Insurance Group.
- c) The rules need to address all parts of the Covered Insurance Group, including insurance regulated subsidiaries, non-insurance subsidiaries and the holding company.
- d) Capital adequacy rules need to be designed such that each part of the Covered Insurance Group is able to withstand appropriate stress testing and still remain appropriately capitalized.

⁶ While the Dodd-Frank Act directs the Board to tailor enhanced standards for Covered Companies on an individual basis or by category, the Act singles out the capital requirements for particular tailoring to the company's activities or structure. Dodd-Frank Act Section 165 (b)(1)(A)(i). The regime we propose would impose "similarly stringent risk controls" as compared to those in the Proposed Rules.

- e) Capital adequacy rules need to be appropriately tailored to address the different types of businesses being conducted and the risks assumed as part of those businesses.
- f) The framework and resulting rules should avoid unintended consequences that may harm insurers' abilities to meet customers' needs or other regulatory and public policy objectives, and should not cause unnecessary distortions in the insurance sector.

C. Recommendations

With these general principles in mind, we believe that the Board can best meet the objectives of the Dodd-Frank Act and thereby prevent or mitigate risks to the financial stability of the United States, as required by section 165(a)(1) of the Act, by revising the capital adequacy rules as to Covered Insurance Groups in the following four ways:

1. Determine the Capital Adequacy of Operating Insurance Companies by Relying on Existing Capital Requirements.

As noted earlier, for Covered Insurance Groups whose consolidated assets are predominately in regulated domestic or foreign life insurance subsidiaries, the existing U.S. and foreign insurance regulatory regimes for capital and liquidity should continue to apply to such subsidiaries unless and until such time as the Board determines that another regulatory regime applied to those subsidiaries would better accomplish the objectives of the Dodd-Frank Act. We believe that this approach will be more effective than applying the bank holding company capital rules. Insurance capital rules and requirements were specifically designed to ensure the safety and soundness of insurance businesses, just as the bank capital rules were developed for banks. The existing insurance regulatory framework has been tested over many years, and it has been proven adequate to ensure the continued safety and soundness of insurance companies through both distressed and normal markets.

The nature of an insurance company's business and its risk profile is materially different from that of a bank. Among other things, both the risk and supporting reserve/capital structure of insurance companies are strongly liability-centric, with a heavy focus on asset-liability management and conservatism (especially in the establishment of liabilities).

The capital adequacy requirements for Covered Insurance Groups should recognize and reflect these important differences. Applying bank-centric capital requirements to the insurance operations of a Covered Insurance Group will provide a misleading and inaccurate picture of the enterprise's capital condition. Relying on the current regulatory framework and requirements for U.S.-domiciled insurance companies as the basis for setting the capital adequacy requirements for these companies is the appropriate approach because of the strong protections built into that

framework and its specific applicability for the unique products, businesses, and risk profiles of insurance companies, as further explained:

(a) Appropriateness of Standards for U.S.-Domiciled Companies.

Importantly, the current regulatory framework and requirements for U.S.-domiciled insurance companies have the following major components designed to ensure that these companies are well-capitalized and able to meet their future obligations:

- Financial statement preparation and public reporting under U.S. Statutory Accounting Principles (“SAP”), whether or not financial statements are also prepared and filed under U.S. Generally Accepted Accounting Principles (“U.S. GAAP”);
- Regulatory separation of the insurance holding company from the insurance subsidiary;
- Stringent regulatory requirements for determining insurance reserves, including an annual actuarial opinion on the adequacy of reserves, as more fully described below;
- Calculation and reporting of risk-based capital (“RBC”) and a risk-based capital ratio (“RBC Ratio”) under specific rules set by the National Association of Insurance Commissioners (“NAIC”), as more fully described below;⁷ and
- Strong regulatory oversight by the various state insurance regulators, including the limitations on distributions from the insurance company to the holding company and the statutory authority to seize and liquidate companies.

Each of these elements combine to provide an appropriate and conservative framework that has functioned well through both normal and stressed markets. The few limited major insurance company failures over the last thirty years did not reflect an underlying weakness in the capital solvency measurement for U.S.-domiciled insurance companies, and they had no material impact on the United States financial system.⁸

The significance of each of these elements in terms of protecting the safety and financial soundness of U.S.-domiciled insurance companies is discussed further below.

(b) SAP vs. GAAP Differences.

Different business models have different intrinsic risks, and generally require distinct and appropriate tools to portray and understand the income statement and the balance sheet, as well

⁷ In the case of the RBC framework and other similar insurance regulation, the NAIC has proposed model legislation that has been adopted (in generally consistent form) by all 50 states and the District of Columbia. The specific enforcement of those rules and the balance of state insurance regulation is overseen by the various individual state insurance regulators.

⁸ For example, the issues with AIG during 2008-09 primarily stemmed from failures outside their regulated insurance entities. The failures at Confederation Life Insurance Company in 1994 and at Executive Life Insurance Company and Mutual Benefit Life in 1991 can all be traced to issues primarily relating to poor asset/liability management, especially with respect to the high degree of illiquidity in their invested asset portfolios relative to the duration of their liabilities. Regulations have since been enhanced to better address such risks.

as risks and capital needs. The measurement of the solvency and capital adequacy of U.S.-domiciled insurance companies begins with the use of statutory financial statements, as opposed to GAAP financials. Financial statements prepared under U.S. SAP differ from U.S. GAAP financials primarily in the following ways:

- The U.S. SAP framework is unique to U.S. insurance companies and designed exclusively for U.S. insurance companies. SAP financials are primarily focused on the strength and soundness of the balance sheet and the ability of the insurance company to satisfy all of its obligations on a timely basis even under adverse scenarios. Its principal users are insurance company regulators, policyholders, creditors, rating agencies, and others concerned with the solvency and safety/soundness of the company. In contrast, GAAP is primarily focused on measuring the going-concern value and period earnings of the general universe of companies and has, as its primary users, equity investors and equity analysts. Said another way, SAP is primarily focused on capital adequacy and the insurer's ability to pay its obligations. U.S. GAAP for life insurance companies is primarily focused on measuring the emergence of earnings.⁹
- The methods and assumptions used to determine formula insurance reserves on the statutory balance sheet are intended to be conservative as described below. For insurance companies, insurance reserves calculated under SAP perform part of the function that capital performs for banks and bank holding companies – insurance reserves are set to absorb moderately adverse financial experience, which is typically the purpose of capital.¹⁰

Taken together, these differences generally result in a more conservative valuation of an insurance company's solvency position under U.S. SAP financials than under U.S. GAAP financials.

(c) Separation of Holding Company from Insurance Subsidiary.

State insurance regulation focuses on each insurance subsidiary of an insurance holding company on a separate and unconsolidated basis, and its basic framework for capital regulation is a Risk Based Capital ("RBC") model (discussed below) designed ultimately to monitor and protect each particular insurance subsidiary's satisfaction of all its liabilities to policyholders over the long duration of life insurance policies.

- Regulated insurance subsidiaries are clearly separated from their insurance holding companies, including in times of financial distress. As discussed below, RBC regulation monitors the strength of the insurance subsidiary on a stand-alone basis and takes into account essentially the same risks considered in the bank regulatory model but also risks not reflected in the bank regulatory model – i.e., insurance risk. The state regulation of

⁹ Accounting Practices and Procedures Manual as of March 2011, published by the National Association of Insurance Commissioners, Preamble, Section c.10. See the Preamble generally for a detailed discussion of SAP and GAAP.

¹⁰ The "capital-like" nature of certain reserves is reflected in the banking model through the add-back of the Allowance for Loan Loss Reserves in the calculation of Tier 2 capital. By analogy, most statutory reserves contain a "capital-like" margin designed to absorb adverse deviations.

insurance companies places no reliance on a holding company as a source of strength to support the insurance subsidiary.

- U.S. life insurers are subject to statutory limitations on the payment of dividends and other transfers of funds to a parent or affiliated companies. Typically, dividends within a 12-month period that exceed the lesser (or, in some states, greater) of 10% of statutory surplus or the net gain from operations for the prior year are considered “extraordinary” and must receive prior approval of the insurer’s domicile state insurance regulator. Some states (such as Prudential’s domicile state of New Jersey) also restrict payment of dividends from only earned surplus (a measure of cumulative earnings) unless prior approval is obtained. Requests for payment of extraordinary dividends typically are evaluated by the state insurance regulator on the basis of whether the insurer’s surplus after giving effect to the dividend would be reasonable in relation to its outstanding liabilities and adequate to its financial needs and, particularly, the RBC Ratio that results. Accordingly, RBC requirements, together with the foregoing dividend limitations, serve to regulate the capital of each insurance subsidiary within a consolidated group on a stand-alone basis. There is no statutory concept of a consolidated RBC for an insurance holding company that would allow a parent to conceal an RBC-deficient subsidiary behind its better capitalized affiliates.
- Importantly, unlike banks, the insolvency of an insurance holding company does not necessarily result in insolvency proceedings of insurance subsidiaries; in fact, the first response of insurance regulators to insurance holding company distress is to monitor that the wall between the holding company and the insurance subsidiary is strictly observed and to ensure the ongoing operation of the insurance subsidiary is protected to satisfy the long term obligations to life insurance policyholders. State insurance laws provide state insurance regulators authority to take remedial action against insurers when distress commences before commencing rehabilitation or insolvency proceedings based on specified action-levels of RBC Ratios. Congress itself recognized in Title II of the Dodd-Frank Act that existing state insurance insolvency laws and processes, administered by state insurance regulators, should govern the rehabilitation and/or liquidation of insurance subsidiaries of designated nonbank companies even if their holding company is subject to FDIC resolution pursuant to Article II, recognizing the appropriateness of both the state regulatory regime and the use of a dual federal/state approach.

(d) Stringent Regulatory Requirements for the Determination of Insurance Reserves.

An important component of the conservatism of the reserve and capital adequacy measurement processes for U.S.-domiciled life insurance companies is the requirement to hold life insurance reserves based on mandated methods and assumptions. In particular, the laws and regulations specify the maximum interest rates that can be used to calculate reserves for various types of policies, and they specify mortality and/or morbidity tables with explicit margins (cushions) for conservatism that must be used in the calculation of minimum reserves.

In addition, the law requires the company’s board of directors to appoint a qualified actuary to provide an opinion that: (a) the reserve calculations meet all of the legal and

regulatory requirements for the minimum level of reserves, and (b) the reserves are adequate, under moderately adverse conditions, in light of the assets backing those reserves.¹¹ The testing undertaken by insurance companies to evaluate the adequacy of reserves generally involves a full projection of the cash flows associated with both the invested assets and related insurance liabilities under multiple economic scenarios. Common practice is to use at least the seven specific economic scenarios prescribed by the New York State insurance regulators (commonly referred to as the “New York Seven”), but many insurance companies test under a significantly larger number of scenarios than the prescribed minimum.¹² The testing also considers scenarios for key insurance assumptions such as mortality or lapse rates.¹³ As a result of this testing, the appointed actuary may establish additional reserves.¹⁴

(e) The U.S. RBC Framework.

The RBC framework in use for U.S.-domiciled insurance companies results in two critical measures that are used by insurance regulators to assess the financial health of insurance companies: (a) the “Company Action Level Risk-Based Capital” (“RBC Required Capital”) determines the minimum amount of risk-based capital required by an insurance company given its investment portfolio (asset) risk, business mix, activities, and the liability risks that it assumed; and (b) the so-called “RBC Ratio” that takes the “Total Adjusted Capital” or “TAC” for an insurance company¹⁵ and divides it by the RBC Required Capital to generate a ratio of available capital to required capital. Any ratio over one hundred percent represents capital above the calculated needs. In practice, insurance companies hold capital at much higher ratios.

Insurance RBC and the Basel capital ratios are conceptually consistent, although they are expressed on a different basis (available to minimum versus available to total assets normalized for risk). Both use as a numerator a measure of available capital resources and, as a denominator, a measure of the level of risk that the insurer or bank undertakes.

For RBC, the measure of available capital resources is defined as the TAC which is comparable to the narrowest definitions of available capital -- Tier 1 Common-- under Basel. TAC is principally a measure of statutory capital and excludes other forms of on-balance sheet available financial resources, such as the additional conservatism that is built into the statutory reserve calculation. Unrealized gains or losses on bonds are also excluded from the TAC measure.

¹¹ Eligibility to serve as an appointed actuary depends upon satisfying specified education and experience requirements and obtaining an appropriate set of credentials, as well as adherence to a detailed set of principles and rules of practice.

¹² For certain products, such as variable annuities, regulatory requirements require testing under a large number of stochastic scenarios meeting specified calibration requirements.

¹³ Lapse risk is the risk arising from unanticipated (higher or lower) rates of policy termination and surrender.

¹⁴ Such additional reserves are established to assure that the total required plus additional reserves, together with future premiums and investment earnings, make adequate provision to meet the contractual obligations and related expenses of the company.

¹⁵ The TAC for an insurance company is equal to the sum of the following amounts: (i) the insurer’s statutory capital and surplus; (ii) one-half of the liability established for participating policyholder dividends (not shareholder dividends); and (iii) the “asset valuation reserve” (AVR), which is a specific provision established for future equity and credit-related losses. This figure **excludes** the statutory reserves which have a degree of conservatism built into them, as noted above.

The use of RBC information as an early warning signal has historically served insurance regulators well. The RBC rules have evolved to reflect the increased complexity and capital markets sensitivity of the insurance industry's changing business mix.¹⁶ For example, a number of changes have been made to the calculation of capital needed for potential volatility in liabilities since the original rules were established in the 1990's, including the need for stochastic scenario modeling for certain types of annuities such as variable annuities. Further changes are expected to be made to address new, emergent risks and changing risk profiles.

Finally, all major insurance companies monitor and disclose their RBC ratios to regulators and continually ensure that their ratios are well in excess of the required regulatory minimums needed to avoid triggering any regulatory intervention and maintain strong credit ratings. This imposes a high degree of market discipline upon U.S.-domiciled insurance companies in terms of their capitalization.

SAP reserving and the related RBC measurement approach is the appropriate way to evaluate capital for the insurance subsidiaries of Covered Insurance Groups.¹⁷ Application of bank holding company capital requirements that would only address the characteristics of the insurance company's invested assets and would not require any capital to be held with respect to other unique risks of an insurance entity such as mortality risk would not serve anyone well.

(f) Active Regulatory Oversight.

The regulatory standards for insurance companies are designed to allow companies to withstand significant adverse experience without becoming financially weak. Additionally, regulators receive insurers' statutory financial statements, and the opinions of their appointed actuaries, and there is an active and on-going exchange between regulators and insurance companies.

Meaningful deterioration in a company's financial strength gives insurance regulators the authority to intervene and take action, with the potential actions ranging from limiting distributions to parent or affiliate companies; requiring the submission and implementation of a plan to correct the weakness; to seizing the company to protect its assets from further dissipation. In the most extreme cases, the insurance regulator would sell the troubled insurer to a stronger company, which would assume the insurance liabilities and maintain the policies in force, or if that were not feasible, would oversee the orderly liquidation of the company. The winding down of insurance companies in those cases takes years, or even decades.

(g) Appropriateness of Standards for Non U.S.-Domiciled Companies.

Though the particulars are different, the general approach to reporting, solvency measurement, capital adequacy assessment, controls over shareholder dividends, and liquidation of troubled insurers for non U.S.-domiciled insurance companies, is similar to the U.S. insurance regulatory framework for major Organization for Economic Co-operation and Development

¹⁶ For a summary of RBC results, see NAIC Staff Report, Life RBC Results for 2010, available on the internet at the following URL: http://www.naic.org/documents/research_stats_rbc_results_life.pdf.

¹⁷ Insurance regulators may, in limited specific circumstances, approve the use of a modified RBC or substitute approach, when justified by particular facts and circumstances.

(“OECD”) countries, such as Japan. Insurance reporting rules and capital measurement frameworks under international solvency standards have also been developed with the unique nature of insurance companies in mind.

For example, the risks considered in the solvency margin formula required by the Financial Supervisory Authority in Japan include asset risk (default and market), insurance or underwriting (*e.g.*, mortality and morbidity) risk, interest rate risk, and risks associated with minimum guarantees on annuity products, among other risks. These rules are periodically updated and revised to reflect the emergence of new types of products and new risks. There is also active involvement by trained and experienced actuaries overseas that is designed to ensure rigor in the establishment of reserves and measurement of regulatory capital.

Use of the existing international rules and standards for measuring capital adequacy of non U.S.-domiciled insurance companies is similarly warranted for many of the same reasons noted above. To do otherwise would be to risk presenting a misleading picture of the capital adequacy of non U.S.-domiciled insurance companies in much the same way as the U.S.-domiciled insurance companies.

2. Impose No Consolidated Capital Requirements on Covered Insurance Groups and No Obligation on the Top Tier Holding Company.

To our knowledge, holding companies of insured depository institutions are unique in their obligations to be sources of strength, including financial strength, to their subsidiaries. This is not the case for insurance holding companies. The reserve and capital requirements imposed by the applicable insurance laws on insurance companies are designed such that insurers can sustain significant unanticipated losses on a stand-alone basis without the support of the holding company.

Life insurance holding companies typically limit their activities to certain general corporate expenses that do not relate to particular operating businesses and issuing debt on behalf of subsidiaries.¹⁸ As a result, the holding company is typically not a source of strength for its subsidiaries and is instead reliant upon the cash distributions from its operating subsidiaries to meet its ongoing cash flow and liquidity needs. Therefore, liquidity is the primary remaining risk of a Covered Insurance Group holding company.

For these reasons, it is not appropriate to measure or impose a separate capital adequacy requirement at the holding company level.

3. Impose a Total Leverage Limit on the Covered Insurance Group.

To help prevent undue leverage from being undertaken within the Covered Insurance Group, and to provide a consolidated measure that can be compared across all Covered Companies, the imposition of a total leverage limit to be applied to the consolidated entity may be helpful. While a consolidated leverage measure does not fully measure the risk of excessive leverage at the legal entity level (due to capital mobility constraints), excessive leverage on a

¹⁸ Of course, if the Covered Company were to undertake activities that the Board concluded posed a material systemic risk, the Dodd-Frank Act would provide an appropriate basis upon which to impose additional constraints on those activities.

consolidated level can indicate the need for further analysis. Also, unlike capital measures which may not be comparable across various types of financial services companies, making it difficult to develop a meaningful, consolidated measure of capital adequacy, we believe there are fewer issues involved in developing a meaningful, consolidated measure of leverage.

4. Regulate the Capital Adequacy of Non-Insurance-Company Subsidiaries on a Collective Basis.

All other entities within the Covered Insurance Group (*i.e.*, the non-insurance businesses) should be analyzed and measured on a combined basis using rules tailored to the specific nature of those non-insurance operations and their attendant risks, including any systemic risk they may present. Measuring the other parts of the Covered Insurance Group on a combined basis is appropriate, given the absence of material capital mobility constraints across the different, non-insurance parts of the company. This would require all of the non-insurance parts of the Covered Insurance Group, taken together, to remain appropriately capitalized after application of Board-proposed capital market stress tests tailored to their particular activities and risks. The nature of the activities and risks assumed in the non-insurance parts of the Covered Insurance Group should drive the determination of the appropriate amount of capital for these entities.

We recommend that the Board measure the capital adequacy of all non-insurance entities within a Covered Insurance Group on a collective basis using standards tailored to the types of business and risks undertaken in those entities. This standard, in conjunction with the Board's supervisory authority to obtain information about the activities and operations of Covered Companies and all of their affiliates, enables the Board to identify activities or businesses in unregulated entities that may give rise to systemic risk.

D. Concerns Raised by the Proposed Rules Capital Model

There are a number of issues with applying bank holding company rules to Covered Insurance Groups that would inappropriately reflect their risk profile and capital adequacy. If the Board were to impose bank capital standards on Covered Insurance Groups, at a minimum these issues would need to be addressed.

(a) Consolidated Approach. The current bank holding company model measures capital adequacy using consolidated financial information. This likely works well in the operation of a bank holding company structure. However, this is not the case for life insurance companies.

For life insurance companies, cash distributions to the holding company are subject to specific statutory limitations or, in certain cases, require the explicit approval of the state regulator, as previously described. As to Covered Insurance Groups, using a consolidated approach would not provide a true picture, because any excess capital in a regulated insurance company may not be available to satisfy the needs that may exist elsewhere within the group – whether in a regulated or unregulated entity. As noted above, the current insurance regulatory framework recognizes these constraints and therefore provides for the regulation of insurance companies on a standalone basis, rather than looking at the entire company on a consolidated basis.

(b) *Separate Accounts.* In the Guidance published as an appendix to its regulation setting forth the criteria for the designation of nonbank financial companies for supervision by the Board, the Council excluded insurance company separate accounts from its calculation of the threshold leverage ratio of total consolidated assets to equity.¹⁹ However, the Proposed Rules do not make any accommodation for insurers' separate accounts, which are analogous to asset management activities. Typically, the insurer receives a fee for managing the assets in the separate account and does not share in the investment performance of the underlying assets. Performance (both good and bad) inures to the customer.

Under both U.S. GAAP and SAP, separate account assets are reported separately as a summary total with an equivalent summary total reflected as separate account liabilities.²⁰ By the terms of the contract with the policy owner, an insurer may guarantee a minimum return on the separate account assets or may guarantee the payment of insurance benefits, the value of which depends on the performance of the separate account. In such instances the insurer is required to determine (each quarter under GAAP accounting) whether it has a distinct liability for these guarantees, and if so, to establish such a liability within its General Account (*i.e.*, outside of the separate account), which, by its nature, serves as a reduction to equity. Any liability required to be so established does not alter the legal separation of the separate account assets.

Accordingly, separate accounts, which are unique to insurers, need to be specifically considered in any analysis of a Covered Insurance Group's capital and leverage.

In addition, there are other insurance products that are analogous to separate accounts, but which, for regulatory and/or contractual reasons, do not technically meet the U.S. GAAP requirements as separate accounts. These need to be considered as well.

(c) *"Closed Block" Assets.* The bank holding company model does not give any consideration to the unique regulatory apparatus created upon demutualization of life insurance

¹⁹ 12 CFR Part 1310, Appendix A, Subsection III(a), published at 77 Federal Register 21637, at 21661 (April 11, 2012). The Guidance reads in relevant part as follows: "Leverage Ratio. The Council intends to apply a threshold ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1. The Council intends to exclude separate accounts from this calculation because separate accounts are not available to claims by general creditors of a nonbank financial company."

²⁰ Under U.S. GAAP, in order to qualify for separate accounts treatment, certain other requirements must be met:

- The separate account is recognized legally and regulated under state, federal or foreign law;
- The assets are legally insulated from General Account assets and liabilities as well as default of the insurer;
- The assets are invested according to contract holder selected options or in accordance with predetermined investment objectives; and
- All investment performance, excluding fees and assessments, must pass back to the contract holder by contractual, statutory, or regulatory requirement. There may be minimum guarantees but no ceiling on performance passed to the contract holder.

companies in order to protect the interests of the “participating” policyholders at the time of such demutualization - - often referred to as the creation of a “Closed Block.”

For example, in establishing Prudential’s Closed Block, a substantial amount of assets was “walled off” at inception to discharge future policyholder claims and to satisfy a reasonable expectation of participating policyholder dividends over time, all under vigilant regulatory scrutiny and with the benefit of expert actuarial opinions. The amount of Closed Block assets, together with future premium and investment income, was determined so as to provide for all future benefits and expenses as well as for the reasonable dividend expectations of the participating policyholders at the time of demutualization.²¹ In substance, the assets contributed to the Closed Block serve to satisfy the liability to the Closed Block policyholders.

The Closed Block structure protects the participating policyholders from potential conflicts of interest that otherwise may arise from other ongoing activities of the insurer, as there are strict rules governing any interaction of the Closed Block with the rest of the company’s operating activities. All cash flows to/from the Closed Block must follow the specific procedures documented at the time of demutualization. Furthermore, there is a dividend mechanism in place to ensure that the results (good and bad) of the Closed Block assets inure to the Closed Block policyholders. Since our demutualization in 2001, policyholder dividends have periodically been adjusted upward and downward, consistent with the intended purpose of the Closed Block structure. This mechanism virtually ensures the adequacy of the Closed Block assets to satisfy the Closed Block liabilities.

Given the insulated risk profile of the Closed Block assets to the insurance company, failure to differentiate the treatment of Closed Block assets, as would occur under a bank holding company model, would misrepresent the capital and risk profile of a life insurer.

(d) Policy Loans. Policy loans are unique to life insurers and represent a common feature within life insurance contracts. Although reflected as assets on an insurer’s balance sheet, they are, in substance, advances against the life insurance liability, i.e., contra-liabilities, and not assets. Such assets bear no risk to an insurer. In the event of either the surrender of the policy, or the death of the policyholder, any outstanding loan balance is netted against the claim liability/cash surrender value in determining the ultimate proceeds. Accordingly, it would be inappropriate to consider policy loans as assets or to risk weight them in the context of the bank holding company capital ratio calculations.

II. Stress Testing

Overall, we agree with the Board that it is necessary to test the adequacy of capital and liquidity of Covered Companies under adverse scenarios. In addition to macroeconomic and capital markets stresses, the scenarios should be augmented, if applied to Covered Insurance Groups, to include insurance-specific stresses, such as stresses on mortality, morbidity, and lapse behavior for covered life insurance companies.

²¹ For some companies (like Prudential), the Closed Block may be in the same legal entity as other ongoing operations.

Stress testing is a routine part of the insurance industry's reserving regime and these stress tests are being extended as a part of the Own Risk and Solvency Assessment ("ORSA") requirements of the NAIC's Solvency Modernization Initiative. Life insurance companies are currently required to perform annual asset adequacy tests, which apply a broad range of stressed actuarial and capital markets assumptions to determine the adequacy of reserves. A deficiency under these tests results in a requirement to post additional statutory reserves. ORSA will require large insurance companies to conduct stress tests that incorporate additional variables not included in the Board-prescribed supervisory stress test. These stresses would be applied to the entire company, not only to its insurance subsidiaries. We recommend that the Board review and coordinate its stress tests for Covered Insurance Groups with these existing and future planned stress testing requirements so that life insurance companies are not subject to significant, competing obligations that fundamentally are intended to serve the same purpose.

We further recommend that stress tests be applied to Covered Insurance Groups to gauge the impact separately on (1) the regulatory capital of each life insurance subsidiary, (2) the capital and liquidity in the combined group of non-insurance subsidiaries, (3) the liquidity in the insurance holding company, and (4) leverage on a consolidated basis.

- *Life Insurance Businesses:* As discussed earlier in the section on Capital and Leverage, we recommend that the Board require each insurance subsidiary to remain appropriately capitalized after applying the stress scenarios, designed to include insurance-specific stresses. Appropriately capitalized in this context means maintaining an RBC ratio or solvency margin ratio in excess of the minimum required by the insurance regulator.
- *Non-Insurance Businesses:* The combined non-insurance businesses should be required to have adequate liquidity and to remain appropriately capitalized after applying stress tests that have been tailored to their activities.
- *Holding Company:* Insurance holding companies should be required to maintain adequate liquidity after the application of macroeconomic and capital markets-related stresses.²² As noted in the section on Capital and Leverage, life insurance holding companies have certain corporate expenses and may issue debt on behalf of their subsidiaries. To the extent they issue debt and are primarily reliant on cash flows from subsidiaries to service that debt, the critical metric for a holding company would be whether it retains sufficient liquidity following a stress.
- *Total Leverage:* Recognizing that leverage can exist at either the operating or holding company, Covered Insurance Groups should be subject to a total leverage limit.

We request the Board to adapt the Proposed Rules so that information requested from Covered Insurance Groups is relevant to the activities of these companies and how different risks manifest themselves for them. More specifically, we recommend that the data requests be revised to be consistent with the stress testing framework proposed above.

²² The liquidity stress testing described in Section 252.56 of the Proposed Rules would appear to be workable in the context of Covered Insurance Groups as applied to the holding company.

Finally, we are concerned that, under the Proposed Rules, a Covered Insurance Group would be subject to supervisory stress testing only 180 days after it is designated by the Council. As explained above, we question the efficacy and utility of subjecting a Covered Insurance Group to a bank-centric stress testing framework. If the Board disagrees and decides to proceed with the stress testing portion of the Proposed Rules as currently worded, we believe that requiring compliance with bank-centric tests only six months after designation would be very onerous. We urge the Board to consider the significant amount of time it will take Covered Insurance Groups to develop appropriate management information systems and processes to comply with the Proposed Rules, given the differences between how life insurance companies and banks currently conduct stress testing. The implementation period would need to be extended considerably.

III. Liquidity

Effective management of liquidity of financial institutions in general and Covered Companies in particular is critical to the safety and soundness of the U.S. financial system. We support the use of stress tests to evaluate liquidity risk. However, rules that take into consideration the characteristic activities and risk profile of Covered Insurance Groups will be more effective in accurately identifying the liquidity risk posed by these companies. To meet the objectives of the Dodd-Frank Act, we recommend that the Proposed Rules be amended to better reflect the nature of liquidity risk in insurance companies.

There are important differences that are relevant in designing appropriate liquidity stress tests for Covered Insurance Groups. Unlike bank liabilities, which are predominantly short-term in nature, are susceptible to immediate withdrawal, and represent borrowed money, life insurance company liabilities are most typically longer-dated and more illiquid, and, for the most part, do not represent borrowed money. In many cases, policyholders cannot realize any surrender value for their policies, and for many other contracts, policyholders can surrender only after paying a meaningful surrender charge during the early years of the contract, or by giving up valuable guarantees. These factors make life insurance a relatively illiquid investment by the policyholder. This is in sharp contrast to the liquidity risk that arises from bank demand deposits or borrowed money. Equally important, the typical intent of the life insurance customer—to purchase a protection or retirement income product—reduces the propensity for early surrender, since replacing the contract may require reunderwriting for which the customer may no longer qualify. Moreover, insurance companies typically hold a meaningful portion of their investment portfolios in government and agency securities. These investments, whose value typically increases in times of stress due to a flight to quality, can generally be liquidated to meet any unforeseen liquidity needs. For these reasons, life insurance companies are significantly less susceptible to liquidity stresses with respect to a majority of their liabilities, than are banks.

We propose the following framework, which is tailored to the particular liquidity risks faced by Covered Insurance Groups:

- Exclude life insurance subsidiaries from the proposed liquidity rules. The Board should use the regulation of liquidity risk in life insurance subsidiaries by current regulators both in the U.S. and overseas as the foundation of the Board's assessment. These regulators regularly review the results of company liquidity stress tests and the asset

adequacy tests mentioned previously in this letter. In some cases, the regulators may also prescribe specific liquidity stress tests.

- Use Board mandated stress tests for non-regulated subsidiaries of a Covered Insurance Group, giving consideration to the nature of their respective activities. These subsidiaries, taken as a whole, should be expected to have sufficient liquidity to withstand Board-prescribed capital markets stresses.
- Subject the top tier holding company of a Covered Insurance Group to stress testing to ensure it has adequate liquidity after stress.²³
- Require the Board of Directors to approve the Covered Insurance Group's liquidity plan on an annual basis and review its status at regular intervals.

However the Board decides to approach liquidity risk management for Covered Insurance Groups, it should, at a minimum, tailor the rules to recognize the fact that an insurance company's liquidity profile does not change as frequently as that of a bank. This has implications for the frequency of liquidity testing and the governance process, among other factors.

- *Reduce Frequency of Cash Flow Projections:* The requirements for monthly liquidity stress tests and daily updates of short-term cash flow projections are unnecessary, because, unlike a bank, a life insurer's liability profile and corresponding asset profile generally do not change materially in composition on a monthly or even on a quarterly basis.
- *Modify Governance Requirements:* The Proposed Rules currently require: (1) a risk committee of the Board of Directors to review and approve the liquidity costs, benefits and risks of each significant new business line and each significant new product before implementation; and (2) an annual review of previously approved significant business lines and products. While it is appropriate for the Board of Directors of a Covered Insurance Group to review the company's liquidity plan annually, along with periodic updates, the level of Board involvement in the Proposed Rules seems unwarranted given a life insurer's much more modest liquidity risk profile. We suggest that such a detailed review is more properly left to management.
- *Expand Definition of Highly Liquid Assets:* The definition of highly liquid assets should include a variety of assets that are important to the prudent operation of an insurance company, for example sovereign or agency debt. Highly rated sovereign and agency debt used to back insurance liabilities in countries such as Japan are some of the safest and most liquid forms of investment and should be included in the definition of "highly liquid assets." Publicly-traded corporate bonds that are rated as "high" or of "highest quality" by the NAIC's Securities Valuation Office should also be included in the definition, reflecting the liquid nature of these assets. Not doing so could have unintended consequences, such as causing Covered Insurance Groups to take on other forms of risk such as more foreign exchange risk by purchasing U.S. sovereign and agency debt to match non-U.S. liabilities.

²³ See page 17 and note 22 *supra*.

IV. Single-Counterparty Credit Limits

We support the Board's position that having a limit on single counterparty exposure is an important element in an overall risk management framework. We also agree that the definition of credit exposure should be broad in order to encompass all of the meaningful relationships between the Covered Company and its different counterparties. However, the Proposed Rules, as currently worded, create a number of serious issues for Covered Insurance Groups. As discussed below, giving effect to the Dodd-Frank Act objectives can be fully accomplished with a standard that does not raise these concerns.

A. Non-U.S. Sovereigns

The recent turmoil in Europe has understandably heightened sensitivity to the issue of counterparty exposure to non-U.S. sovereigns. However, the inclusion of non-U.S. sovereign governments and non-U.S. agencies within the definition of counterparty (and therefore subject to the single counterparty exposure limit) will unduly restrict the ability of Covered Insurance Groups to compete globally. The aggregation of all the agencies, instrumentalities, and political subdivisions of a foreign sovereign into a single counterparty,²⁴ and thus subject to the single counterparty exposure limit, exacerbates this problem

This outcome would create a very difficult hurdle for Covered Insurance Group foreign operations. Like many major insurers operating globally, our non-U.S. insurance operations rely heavily upon local government and agency bonds ("foreign sovereign investments") to back our foreign-issued insurance liabilities. For example, our Japanese operations hold substantial Japanese foreign sovereign investments as invested assets to support their Yen-denominated insurance policies.

This limitation will be counter-productive to the Dodd-Frank Act's risk mitigation objective for Covered Insurance Groups that have non-U.S. insurance subsidiaries. Those insurance subsidiaries hold a substantial amount of foreign sovereign investments for a number of reasons, including complying with local regulatory requirements, better cash flow matching, interest rate risk management, and foreign exchange (FX) risk management. Local regulators normally require a minimum amount of local investments by foreign insurance subsidiaries. The corporate bond markets are less well developed in certain of the foreign countries in which U.S. insurers operate, and therefore offer fewer investment options. As a result, insurance companies turn to foreign sovereign investments to satisfy these requirements. Without access to these investments, we would be challenged to put to work all of the money associated with our international businesses without assuming substantially more risk.

Global insurance companies (like Prudential) may also issue significant insurance liabilities denominated in non-local currencies. For example, our Japanese operations currently issue U.S. dollar-denominated, Australian dollar-denominated, and Euro-denominated insurance policies, where premium payments to the company and benefit payments to the policy owner are all made in these same currencies. For those liabilities, investing in similarly-denominated

²⁴ Proposed Rule Section 252.92(k)(5), 77 Federal Register 594, at 650.

foreign sovereign investments effectively supports those insurance liabilities with greater liquidity and less credit and foreign exchange risks than potential alternatives.

For these reasons, we propose that the Board amend the Proposed Rules to exclude from the single issuer counterparty limits foreign sovereign investments, under whatever safety and soundness criteria that the Board articulates, that support local insurance and like-denominated liabilities. (This would be more consistent with existing statutory insurance regulations.)

In imposing this limit, that would cripple the foreign growth and operations of Covered Insurance Groups, the Board goes beyond the Dodd-Frank Act standard to limit credit exposure, which directs the Board to establish standards that prohibit companies subject to enhanced supervision from having credit exposures in excess of 25 percent of their capital stock and surplus to “any unaffiliated company.”²⁵ Foreign sovereigns are not “companies”, and the Board certainly has ample authority to amend the final rule as we propose.

B. “Major Covered Company”

The imposition of a 10% limit on “major covered companies” that, by definition, would include most major banks would impair the cash management operations of Covered Insurance Groups who depend upon large banks to hold their operating, clearing and over-the-counter (“OTC”) collateral deposits, as well as to provide investment and derivative hedging activities. Most major insurance companies generate significant operating cash. Not surprisingly, their operating, clearing and OTC collateral deposits are held in some of the same major covered banks through which they also direct investing and hedging activities. These liquidity and general cash management arrangements, by their very nature, require the use of banks as counterparties. However, it is difficult to diversify across many different banks and still maintain an efficient cash management structure.

For this reason, we recommend that the Board amend the Proposed Rules to provide that insurance company operating cash, clearing and OTC collateral deposits be excluded from the single issuer counterparty limit or be measured separately from other credit exposures. We note that operating cash, clearing and OTC collateral deposits sometimes may be large, but are temporary and short-term in nature.

The definition of “major covered company” in the Proposed Rule includes bank holding companies with total consolidated assets of \$500 billion or more, and all Covered Companies. Major covered companies would be prohibited by the Proposed Rule from having an aggregate net credit exposure to any other major covered company that exceeds ten percent of consolidated capital stock and surplus. The Dodd-Frank Act does not require a ten percent limit; it requires the 25 percent limit that would be applicable to bank holding companies with total consolidated assets of \$50 billion or more and Covered Companies.²⁶ Thus the objective of the Dodd-Frank Act could be easily achieved with the limited revisions we propose.

²⁵ Dodd-Frank Act Section 165(e)(2).

²⁶ Dodd-Frank Act Section 165(e)(2).

C. Exchange-Traded Clearing Deposits

The inclusion of clearing deposits at the exchanges and central clearinghouses might unduly limit the hedging activities of Covered Insurance Groups, especially with respect to derivatives, because of the shift away from OTC markets required under the Dodd-Frank Act. The shift away from OTC trading will necessarily increase Covered Insurance Groups' exposure to the central clearinghouses. An example might be CME Clearing, a part of CME Group, Inc. The CME Group includes four designated contract markets for derivatives trading: Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), New York Mercantile Exchange (NYMEX), and Commodity Exchange, Inc. (COMEX). The single counterparty limits could unduly restrict hedging activities placed with these exchanges and central clearinghouses.

We recommend that the Board amend the Proposed Rules to exclude deposits with the central clearinghouses and exchanges from the single counterparty limits or to impose substantially higher allowable limits with respect to those categories of exposures. Assuming effective oversight, we expect that increased use of these intermediaries will serve to reduce systemic risk and, therefore, should not require inclusion in counterparty compliance testing.

D. Implementation Timing

The change to existing processes and potential systems and data gathering enhancements needed to comply with the counterparty exposure measurement specifics will require greater transition time to implement than is contemplated by the Proposed Rules. The shift in emphasis from "net" counterparty exposure to "gross" counterparty exposure and the use of different factors for determining potential counterparty exposure will require changes in processes and enhancements to systems and data gathering. This will take time to properly implement and test. The same is true for the collateral requirements.

E. Eligibility of Risk Mitigants

The Board requested comments regarding the use and eligibility of risk mitigants in gross and net credit exposure calculations. We propose recognizing the impact of both single name and portfolio hedges and support the use of internal models, as needed, for this purpose and for calculating net credit exposure for derivatives, securities lending, repo, and other similarly structured credit transactions.

For consistency with economics, we propose including in gross counterparty exposure any single name credit replications (long positions) in credit derivatives. Similarly, single name credit hedge positions (short credit positions) should offset gross positions in the calculation of net credit exposure.

A large portion of hedges are implemented at the portfolio level for interest rate, equity and currency risk management. We support recognizing the risk mitigation benefits of such instruments. In lieu of specific transaction-based hedge effectiveness measures for portfolio hedges, we recommend a standardized approach to discounting gross exposure or recognizing netting benefits across all counterparty types.

Finally, we support and encourage use of internal models for calculation of a covered entity's single issuer net credit amounts for OTC derivatives, securities lending, repurchase transactions, certain guarantees and letters of credit.

V. Risk Management and Risk Committee

Prudential appreciates the unequivocal need for robust risk management. Our principle concern with the Proposed Rules on these topics is the lack of flexibility in terms of how Board of Directors oversight and management responsibilities are structured to address the specific risk environment of the Covered Companies.

For example, there may be little, or no, benefit from forcing a well-functioning company to restructure its Board of Directors such that it cannot utilize existing committees with developed expertise and procedures relating to particular risks facing the company.²⁷ We appreciate that the Dodd-Frank Act requires a Covered Company to have a risk committee, but this requirement should not preclude that committee from delegating responsibility for particular risks to other committees. This structure would provide the risk committee with visibility to all risks and the flexibility to direct review of individual risks to the appropriate board committee, where expertise resides. The Board should expressly allow such delegation of responsibility.

Similarly, we see no particular benefit from forcing the Chief Risk Officer ("CRO") to report to the Chief Executive Officer or mandating dual reporting to the risk committee. Such requirements elevate form over function and create an atmosphere in which the CRO can lose valuable insights from well informed senior members of management. The important guiding principles should be that the CRO report to a very senior officer, be part of senior executive management, have direct access to the risk expert(s) on the Board of Directors, and have private sessions with the risk committee and other committees of the Board of Directors, as appropriate.

Finally, in fashioning requirements for the CRO, the Board should recognize that educational or expertise standards are not well-developed in the enterprise-risk area, in contrast to, for example, a CPA qualifying as the financial expert on an audit committee. There is no widely-accepted credential and, indeed, no similar talent pool of seasoned professionals with broad enterprise-risk oversight or management experience.

VI. Early Remediation

Section 166 of the Dodd-Frank Act directs the Board to adopt regulations to provide for the early remediation of Covered Companies in financial distress. The proposed regulations go far beyond that statutory charge. We believe that the early remediation process requires more flexibility than would be permitted under the Proposed Rule. Specifically, the triggers should permit supervisory judgment and discretion when the weakness(es) identified is/(are) not related to capital adequacy. This is particularly true for Covered Companies that are not bank holding companies and therefore will be new to the Board supervisory model.

²⁷ Currently, risk oversight responsibilities at Prudential, not unlike many major insurance companies, are divided among several committees, because each committee possesses real experience and expertise in the areas for which it is responsible, and devotes substantial time and energy in overseeing the particular risks for which it is responsible.

In addition, as to Covered Insurance Groups, the early remediation triggers relating to capital and leverage, liquidity, and stress testing are flawed, because the capital and liquidity calculation methodologies on which they are based are not appropriate for those companies, as discussed above. Therefore, for those companies, early remediation based on the proposed triggers would be required at the wrong times and could subject financially strong companies to unwarranted restrictions on their growth, new product or business development, and capital deployment. The unintended result in those cases could be to harm financially strong companies and even alter their product and service offerings, with no apparent benefit to the financial system, the company itself, or consumers.

We respectfully submit that, as part of a separate rulemaking, the Board should propose an early remediation methodology that is tailored to nonbank financial companies, including triggers tailored to their capital structure and business.

CONCLUSION

The Dodd-Frank Act affords the Board substantial discretion as to how it will adopt rules under Sections 165 and 166 and to properly study the application of such rules to Covered Insurance Groups. We believe the Board should proceed with measured steps in achieving the appropriate enhanced regulation for any Covered Insurance Groups and must thoroughly analyze the shortcomings discussed herein of the application of the bank holding company standards before a decision to wholesale impose them. The stakes in getting it right are high: the rule ultimately imposed must appropriately capture the actual risks of insurers (as opposed to banks) so as both to protect the U.S. financial system and to not injure any designated Covered Insurance Group's global competitiveness.

We thank the Board for its serious consideration of our comments. We would be pleased to discuss these comments further or address any questions the Board may have.

Respectfully submitted,



Richard J. Carbone
Chief Financial Officer