Principal Financial Group

October 22, 2012

VIA E-MAIL

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

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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Washington, D.C. 20429

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250 E Street, S.W.
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Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions (the "Basel III NPR"); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (the "Standardized Approach NPR") and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Capital Rule (the "Advanced Approaches and Market Risk NPR" and collectively with the Basel III NPR and the Standardized Approach NPR, the "Proposals")

Federal Reserve: Docket No. R-1442, RIN No. 7100- AD 87
OCC: Docket ID OCC-2012-0008; Docket ID OCC-2012-0009; and Docket ID OCC-2012-0010
FDIC: RIN 3064-AD95; RIN 3064-AD 96; and RIN 3064-D97

Ladies and Gentlemen:

The Principal Financial Group recognizes the work of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively, the "Agencies") in crafting the Proposals, the purpose of which is to establish an integrated regulatory framework for nearly all banking organizations within the United States and improve their ability to withstand periods of stress. We note that the Proposals would, for the first time, impose minimum capital requirements on savings and loan holding companies ("SLHCs") such as Principal Financial Group, Inc. ("Principal") We appreciate the Agencies' recognition that SLHCs with substantial insurance operations ("SLHC-SIOs") present unique issues that require accommodation under the Proposals.

Principal offers businesses, individuals and institutional clients a wide range of financial products and services, including retirement, asset management and insurance through its diverse family of financial services companies. As of June 30, 2012 the Principal Financial Group had $152.1 billion in assets, with operations in Asia, Australia, Europe, Latin America and the United States. In contrast, Principal Bank, which is a wholly-owned subsidiary of the Principal Financial Group, has $2.4 billion in assets and provides direct banking services in the United States. Principal Bank represents 1.6% of our organization's total assets.

In this letter, our comments reflect the perspective of a SLHC-SIO with substantial retirement, asset management and insurance operations. While our comments may focus primarily on how the Proposals uniquely impact SLHC-SIOs, we fully support the other comments you have or will receive from financial trade organizations such as the American Council of Life Insurers, the American Bankers Association and the Financial Services Roundtable.

The Proposals are designed in part to implement changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and are an important step towards achieving the important goals of Dodd-Frank. However, there are several aspects of the Proposals that we find troubling from a SLHC-SIO perspective. Before discussing our specific concerns with the Proposals, we wish to highlight two major areas of concern:

- **A Bank-Centric Framework is Inappropriate for SLHC-SIOs:** The Proposals apply a bank-centric framework to insurance organizations. We are substantially different from most bank holding companies ("BHCs"), both due to our insurance operations and because our federal savings bank represents less than two percent of our operations. By failing to recognize these differences, the Proposals would create disincentives for us and other insurers and otherwise impair our ability to appropriately manage risk. The Agencies should avail themselves of the flexibility granted to them by Dodd-Frank to create a capital framework that reflects the unique risk characteristics of SLHC-SIOs. The Collins Amendment does not require that the capital regimes be identical, just equally rigorous.
- **The Proposals should Build upon the State-Based Regulatory Framework:** The Proposals do not adequately recognize the rigorous regulatory requirements that

already exist within the state-based insurance regulatory systems. In fact, the Proposals appear to disregard those requirements rather than recognize the value they could provide in establishing consolidated capital requirements for a SLHC-SIO. These state-based regulatory systems are designed to address the unique asset and liability characteristics of insurance companies. This includes annual deterministic and stochastic asset adequacy analysis for life insurers as well as conservative reserve and capital requirements. These state-based regulatory systems, which have a strong solvency track record, should be given a more prominent role within the final Proposals.

Our comments and suggestions will be framed within the bank-centric framework currently employed by the Proposals. However, we believe an approach that relies upon the existing state-based regulatory capital framework would provide a stronger, more suitable and appropriate capital framework for SLHC-SIOs.

We ask that the Agencies consider the following recommendations concerning the Proposals, which we address more fully below:

1) **Effective Date**: The effective date of the Proposals should be deferred until July 21, 2015, as is clearly intended by Dodd-Frank.
2) **Quantitative Impact Study:** The Agencies should use the time until the deferred effective date to conduct a quantitative impact study on SLHCs, and SLHC-SIOs in particular, before finalizing the requirements for SLHCs.
3) **Transitional Issues for SLHC-SIOs:** The Proposals need to clarify many of the requirements newly imposed upon SLHC-SIOs during the transition period prior to the 2015 effective date of the Standardized Approach rules.
4) **Unrealized Gain & Loss Treatment**: The Proposals should continue the current neutralization of unrealized gains and losses on "available for sale" debt securities and rely upon stress testing for assessing whether unrealized gains and losses would ever become realized and present an insolvency or liquidity risk to the organization.
5) **Treatment of Non-Guaranteed Separate Accounts**: The Proposals should exclude non-guaranteed separate accounts from the tier1 leverage ratio, consistent with the Agencies' recognition that these assets are properly excluded from each of the other capital ratios (i.e. they have been allocated a risk weight of zero).
6) **Treatment of Guaranteed Separate Accounts**: The definition of "non-guaranteed separate accounts" should be expanded to include inconsequential separate account guarantees as well as those portions of separate accounts that are linked to non-

guaranteed products. In addition, the capital requirements for a guaranteed separate account should be based upon the existing GAAP reserves for those guarantees.

7) **Insurance Underwriting Subsidiary Deductions**: Revise the deduction of minimum required regulatory capital of insurance underwriting subsidiaries (generally 200 percent of the insurer's authorized control level) such that only that portion of the insurer's required capital that is related to insurance risks are deducted.

8) **Interest-only ("IO") Classes of Commercial Mortgage Backed Securities ("CMBS")**: The risk-weights for CMBS-IOs should be revised to 100% which more accurately reflects their risk characteristics.

9) **Mortgage Loan Risk-Weights:** The risk-weights for mortgage loans, including High Volatility Commercial Real Estate, should be modified to be less severe.

10) **Small Thrift Exemption**: SLHC-SIOs with small banking operations should be exempted from the rules imposed under the Advanced Approaches and Market Risk NPR.

Defer SLHC Implementation until July 21, 2015

The Proposals represent a significant change for SLHCs in general and for SLHC-SIOs in particular. Logistically, SLHCs will need sufficient time to understand the Proposals once they are finalized, to work with the Federal Reserve Board (the "FRB") on interpretations, and build the processes, systems, and data access and collection necessary for complying with the new regulations. In addition, for SLHC-SIOs, the Proposals contain new minimum capital requirements that are in addition to their existing insurance regulatory capital requirements. SLHC-SIOs may need to develop or modify their capital deployment plans, market risk models, capital forecasting tools or investment strategies needed to comply and manage the business to the requirements imposed by the Proposals. It is possible that the Proposals would trigger significant and unexpected increases in capital requirements as early as 2013 for some companies, which would be unnecessarily disruptive.

The FRB has the authority to grant a transition period, both under Dodd-Frank and as part of its supervisory authority under the Home Owners' Loan Act. We and many others note that the FRB did not establish for SLHCs the same implementation timeline given to U.S. subsidiaries of foreign banking organizations that rely on the Board's Supervision and Regulation Letter 01-1 ("SR 01-1 Holding Companies"). In this instance, the FRB has elected to exercise its authority by specifically citing Section 171(b)(4)(E) of the Collins Amendment to defer implementation on SR 01-1 Holding Companies until July 21, 2015.

The Congressional intent of the Collins amendment was to defer the effective date for SLHCs as well. Section 171(b)(4)(D), which provides that SLHCs are not subject to the Collins Amendment until July 21, 2015, is substantially identical to Section 171(b)(4)(E) and reads as follows:

> "(D) DEPOSITORY INSTITUTION HOLDING COMPANIES NOT PREVIOUSLY SUPERVISED BY THE BOARD OF GOVERNORS. – For any depository institution holding company that was not supervised by the Board of Governors as of May 19, 2010, the requirements of this section, except as set forth in subparagraphs (A) and (B), shall be effective 5 years after the date of enactment of this Act."

Recommendation: We urge the FRB to defer the effective date of the final capital rules for SLHCs until July 21, 2015, which is consistent with the congressional intent as well as the treatment granted to SR 01-1 Holding Companies. Since both the banking and the insurance operations of SLHC-SIOs are already subject to functional regulation, in addition to the FRB's existing supervision of the SLHC, there is no financial or regulatory reason to pursue a rapid implementation date. A delay of implementation for SLHCs is particularly important in recognition of the compliance challenges faced by them, and specifically SLHC-SIOs.

Quantitative Impact Study

The Proposals, which would impose capital requirements on SLHCs for the first time, are untested. Bank-centric capital requirements may unintentionally trigger significant and unexpected financial impacts on SLHCs, the insurance industry and the financial markets as a whole. The Proposals may also interfere with or otherwise impair the objectives of the state-based regulation of insurance operations. During the delayed implementation period, we encourage the Agencies to conduct an impact study in order to determine the potential repercussions the Proposals could have on these elements of the economy. We note that significant studies of this type were undertaken and completed by the Basel Committee on Banking Supervision prior to its promulgation of Basel III.

The impact study should capture quantitative data that reflects the financial impacts on SLHCs, the insurance industry (and in particular SLHC-SIOs) and the economy. SLHCs are not able to submit on a confidential basis their quantitative information or analysis through this public federal comment process. In addition to quantitative analysis, the study should seek to understand the extent to which the Proposals will impair the investment and capital management strategies of the banks, insurance companies and other companies to which they apply. Later in this letter, we describe some aspects of the Proposals that we believe will create incentives for insurers and banks to pursue riskier business strategies in order to manage the costs of increased capital requirements, thus impairing their ability to function within their existing regulatory scheme.

Recommendation: The Agencies have the authority to conduct a confidential quantitative impact study and issue a report describing the impacts of the Proposals. This study would be valuable to the Agencies in finalizing the Proposals for SLHCs, particularly in light of the legitimate and longstanding concern of the Board of Governors of the Federal Reserve System that the final rules recognize the "unique characteristics of SLHCs".[1] We believe that SLHC-SIOs are perhaps the best example of the need for this sensitivity. By delaying the implementation date, the Agencies would have the time to conduct the study and ensure the Proposals are not impairing the long-standing and appropriate risk management strategies for SLHCs and SLHC-SIOs in particular. A quantitative impact study is an appropriate step for the Agencies to take in order to avoid unintentional harm to SLHCs, insurers and the economy.

Transitional Issues for SLHC-SIOs

The Standardized Approach NPR effective date is described within the commentary of the Proposal as follows:

> *"This NPR proposes that, beginning on January 1, 2015, a banking organization would be required to calculate risk-weighted assets using the methodologies described herein. Until then, the banking organization may calculate risk-weighted assets using the methodologies in the current general risk-based capital rules."*

Unless a SLHC-SIO chooses to early adopt this NPR, there are several asset related items whose treatment is unclear, or potentially inappropriate, within current general risk-based capital rules. Those items include policy loans, separate accounts (both guaranteed and non-guaranteed), deferred acquisition costs and surplus notes.

For example, the current general risk-based capital rules do not adequately address the treatment of non-guaranteed separate accounts. If these assets were included in all of the capital ratios, this could be an extreme and unnecessary hardship on SLHC-SIOs until the Standardized Approach NPR is effective.

[1] 76 Fed. Reg. 22662-01 (April 22, 2011)

In addition, we note that we were unable to find any reference to surplus notes within the Proposals, even though the treatment was described within the Standardized Approach NPR commentary.

Recommendation: The Proposals should clarify the treatment of all capital and asset related SLHC-SIO items for the period of time between the Basel III rules' effective date and the Standardized Approach rules' effective date. Alternatively, SLHC-SIOs could be given the option to selectively adopt portions of the Standardized Approach rules to address those areas where current general risk-based capital rules are unclear or inappropriate for SLHC-SIOs.

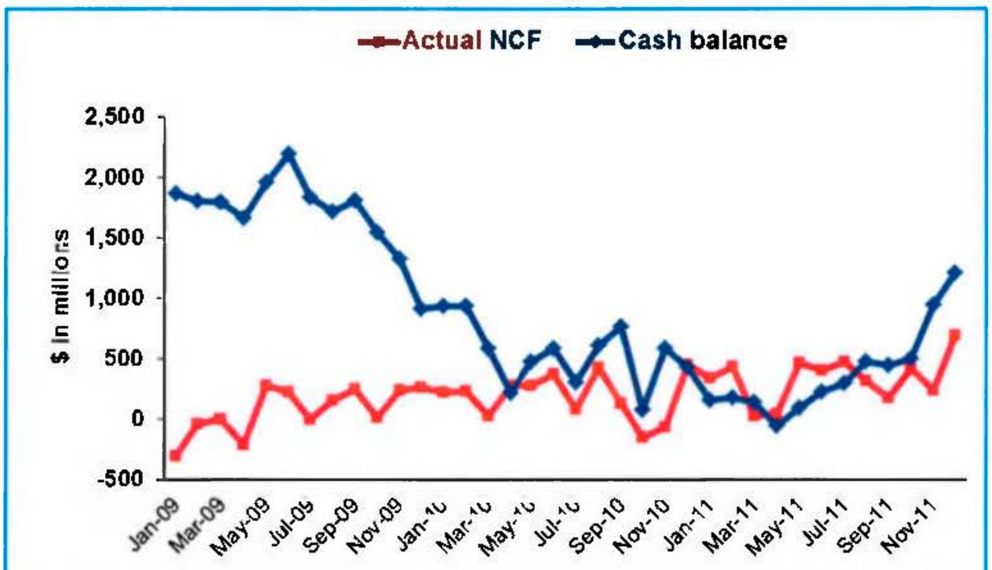
Capital Treatment of Unrealized Gains and Losses

Under the Basel III NPR, unrealized gains and losses on all debt securities held as "available for sale" ("AFS") are included for the purpose of calculating Common Equity Tier 1 capital ("CET1"), subject to a five-year phase-in. This treatment creates harmful and extraordinary capital volatility risks to SLHC-SIOs, and impairs their ability to successfully manage their asset/liability condition, as is required by their respective state-based regulatory systems. The current neutralization of unrealized gains and losses on AFS debt securities relative to the calculation of regulatory capital should be continued. As a more meaningful option, the Agencies should rely upon stress tests as the best approach for understanding the extent to which unrealized gains and losses would ever become realized and present an insolvency or liquidity risk.

Insurers are in the business of managing risk, under the oversight of the state-based insurance regulatory system. Insurers hold a significant portion of their general account portfolios in AFS securities in order to effectively manage their credit risk. This allows, and is necessary for, insurers to manage their credit risks by selling troubled assets in anticipation of credit risk events. Insurers also use complex asset-liability management ("ALM") strategies to cover their long-dated liabilities – which can and do extend 30 or more years into the future. These long liabilities are a distinct and fundamental difference between insurance companies and traditional banking entities. This is of paramount importance in the context of understanding the impact of the Proposals on SLHC-SIOs. In order to ensure sufficient cash flows to cover the future obligations represented by these long-term liabilities, insurers will typically invest in long-dated assets or derivative equivalents. Thus, even though the market value of these assets may fluctuate with interest rate movements, the asset cash flows will continue on target to cover those future liabilities. In addition to asset-oriented ALM practices, insurers will often design their contractual liabilities to discourage or disallow early withdrawals (e.g., scheduled benefits under payout annuities, early surrender charges, market value adjustment charges, linkages to benefit events such as death or disability and so forth). These features both make it more likely that these liabilities continue to be long-term (thus requiring matching long-term assets) and minimize the risk that general account assets will need to be sold at an inopportune time.

During the financial crisis, our ALM strategies proved to be very effective, consistent with the certifications we are required to give to our state insurance regulator on a regular basis. The following chart shows a comparison of Principal Life Insurance Company's ("PLIC") cash balances and its net cash flows from January of 2009 through December of 2011. Like many financial institutions, PLIC prudently maintained large cash balances during the financial crisis from late 2008 to mid-2010. That precaution proved to be unnecessary as actual net cash flows remained fairly steady, consistent with expectations, and predictable. Our asset and liability cash flows performed as expected in a "normal" economic environment, and this was far from a "normal" environment. Our ALM practices allowed us to avoid being forced sellers within that "stressed" and "panicked" environment.

PRINCIPAL LIFE INSURANCE COMPANY ASSET & LIABILITY CASH FLOWS*



* Cash balance does not reflect any cash at the Principal Financial Group holding company.

At year-end 2008, Principal had an after-tax and after-DAC unrealized loss position on AFS debt securities of $4.2 billion dollars. Since then, only a small fraction of that amount has emerged as an actual realized loss. Actual after-tax realized losses on AFS debt securities from 2009 through 2011 have totaled only $507 million, which represents approximately 12% of the original unrealized loss position on these investments.

If the Proposals in their present form had been effective in 2008, all of Principal's capital ratios would have been less than zero because of the unrealized gain and loss adjustments. These artificially stressed ratios could have triggered not only severe actions from our federal regulator, but they could have also created additional consumer and shareholder panic, which would have been unnecessarily detrimental to Principal, to our customers and to the economy. In stark contrast, however, PLIC maintained state insurance regulatory capital levels at the end of 2008 that were approximately 440% of the minimum state insurance regulatory capital requirements[2]. As history proved, the state insurance regulatory capital requirements, which reflect the values of ALM as well as the liability characteristics of the insurer, were a far more appropriate assessment of PLIC's true financial position. Principal's financial strength was evidenced by our ability to issue $750 million of debt and $1.1 billion of common equity stock in May of 2009. Principal did not participate in the Troubled Asset Relief Program.

Section 616 of Dodd-Frank states: "*In establishing regulations pursuant to this subsection, the appropriate Federal banking agency shall seek to make such requirements countercyclical so that the amount of capital required to be maintained by such company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company.*" As you see from our example, the Proposals' treatment of unrealized gains and losses on AFS debt securities would not have resulted in this mandated countercyclical capital effect during the financial crisis. Had the Proposals been in effect, they would have increased Principal's capital requirements during the financial crisis, rather than effectively decreasing them during those "times of economic contraction" as Congress, in Section 616, intended. At the end of 2011, Principal had an unrealized gain of $728 million, which is arguably providing capital relief under the Proposals in a manner that is also not countercyclical.

The Proposals would impair the state-based insurance regulatory system by creating significant incentives for insurers to pursue shorter-term investment strategies (or to inappropriately hold a much smaller portion of their significant debt securities portfolio in AFS, reducing credit risk management flexibility.) While these strategies would reduce the insurer's exposure to unrealized gains and losses (and thereby to the resulting wildly volatile capital requirements), it would increase the insurer's exposure to reinvestment risk. A shorter investment strategy, in response to the federal capital requirements, would jeopardize the insurer's ability to satisfy their annual state regulatory asset adequacy testing requirements. Insurers would no longer have the ALM benefits of investing in assets with returns that are designed to satisfy their long-dated liabilities. These incentives driven by the Proposals could inadvertently increase the risk of insolvency for insurers, negatively impacting customers and the economy.

[2] State minimum regulatory capital requirements are defined as 200% of the state authorized control level.

By shortening their investment portfolios, insurers by definition would invest less in long-term investments such as municipal bonds, high-quality corporate debt securities and other long-dated securities. Life insurers are a major investor in long-term debt, which helps to finance the infrastructure projects within the U.S. economy. The Proposals would discourage long-term investments, which could have a detrimental impact on the economy.

The volatility of capital requirements would create a business hardship for SLHC-SIOs. To demonstrate this troubling fact, consider the following simple example.

Hypothetical SLHC-SIO

Item	Baseline	With 2% rise in interest rates
Total Capital	$ 10 billion	$5.5 billion
Total Assets	$100 billion	$93 billion
Percent of assets in AFS	50%	50%
Unrealized Gain / (Loss)	$ 0 billion	($ 7 billion)
Capital Ratio	10%	5.9%
Liability Duration	7 years	7 years
Asset Duration	7 years	7 years

This hypothetical company is holding capital levels that are consistent with the Proposal's requirements. However, if interest rates were to rise by only 2% over a short period of time, this company would see its strong federal regulatory capital position erode quickly under the Proposals (this hypothetical assumes no credit losses). Using a simple rule of thumb, sudden unrealized pre-tax losses of $7 billion would decrease this insurer's capital ratio from 10% to 5.7%[3], all conceivably without the occurrence of any negative credit event. This scenario would create a radical negative change in capital position for the SLHC-SIO, severely impacting its capital and business plans, entirely as the result of unrealized loss positions on portfolios the insurer will continue to hold consistent with its long-term cash flow needs. Customer and shareholder confidence would be negatively impacted. Yet, this insurer follows ALM practices that align its asset and liability durations. This low ratio resulting from the Proposals would be entirely unwarranted and not even remotely indicative of the true financial strength of the insurer.

An unrealized loss may never, and typically does not, become realized and result in any kind of insolvency or liquidity risk to the SLHC-SIO. However, this does not mean, nor are we suggesting, that unrealized losses should be ignored by the regulator. Stress testing is the best

[3] The market value change in an asset is approximated by the change in interest rate times the duration of the asset. Thus, the pre-tax unrealized loss is (100 x 50% x 2% x 7) = 7. With a tax adjustment, the ratio becomes (10-(7 x 65%)) / (100-(7 x 65%)) = 5.71%. This example assumes the deferred tax asset is included in capital and included in assets with a risk weight of 100%.

tool for regulators to use in understanding the potential risks to a SLHC-SIO with an unrealized loss position. Insolvency is fundamentally the inability of a company to cover its obligations. A variety of plausible stress scenarios over a short and long time horizon can be used to determine whether SLHC-SIOs are at any risk of defaulting on their obligations. This path would avoid the unnecessary and extreme result made possible and, given the current interest rate environment, probably inevitable by the Proposals in their present form.

Recommendation: The current neutralization of unrealized gain and loss positions relative to AFS debt securities should continue, with reliance upon stress testing for determining whether unrealized gain or loss positions require any adjustments to the SLHC-SIO's capital requirements. If, in the future, the Agencies still have a concern about the impact of unrealized losses on the solvency of banking organizations, we believe this issue would be better addressed in conjunction with the consideration of future federal liquidity rules.

Capital Treatment of Non-Guaranteed Separate Accounts

Capital requirements should be driven by the risk characteristics of a SLHC-SIO's underlying assets and liabilities. Non-guaranteed separate accounts, for which SLHC-SIOs have no asset or liability risks, should not be included within the tier 1 leverage ratio, consistent with the Agencies' recognition that these assets receive a risk weighting of zero for purposes of the other capital ratios.

The Proposals define a non-guaranteed separate account with a two-part test:

> *"Non-guaranteed separate account means a separate account where the insurance company: (1) Does not contractually guarantee a minimum return or account value to the contract holder, and (2) Is not required to hold reserves (in the general account) pursuant to its contractual obligations to a policyholder."*

Under this definition, non-guaranteed separate accounts would be limited to those separate accounts in which the insurance company has no asset or liability risk. PLIC's non-guaranteed separate accounts primarily consist of those assets that support retirement savings plans such as 401(k) qualified defined contribution plans. The asset and liability risks of these separate account products are passed through to the underlying plan participants; thus the insurance company retains none of the risk. These assets accounted for 40% to 45% of Principal's total assets at the end of 2011.

When these non-guaranteed separate account assets are included within the leverage ratio, as is currently the effect of the Proposals, it creates a minimum capital requirement equal to 4% of assets on a significant portion of our business. We believe this treatment is particularly inappropriate as PLIC retains none of the risk on these separate accounts. The cost of capital on these assets, resulting from this inclusion in the leverage ratio, would ultimately be passed through to the underlying participants, reducing the size of their retirement savings, and creating a market disadvantage for PLIC.

Recommendation: We believe the **denominator** of the leverage ratio should be driven by the underlying risk characteristics of those assets rather than whether those assets are included on the GAAP balance sheet. Consistent with this position, non-guaranteed separate account assets should not be included in the denominator of the tier 1 leverage ratio. The propriety of this treatment has been acknowledged in related contexts.[4]

Capital Treatment of Guaranteed Separate Accounts

Guaranteed separate accounts are those separate accounts that do not satisfy the Proposals' definition of a "non-guaranteed separate account." The guarantees associated with guaranteed separate accounts, however, come in many different forms and sizes. Notwithstanding that variety, the Proposals treat all of these fundamentally different guarantees as if they all have the same risk characteristics as ordinary general account liabilities. This assumption is not correct, and we believe the capital requirements for guaranteed separate accounts should be adjusted to reflect with greater sensitivity the varying nature of those underlying guarantees.

PLIC does not market or maintain any separate account product that provides a minimum return or account value guarantee to a contract holder or participant upon contract surrender.[5] However, we do offer some separate account-related guarantees that are linked to specific benefit events, such as a death benefit or a retirement income stream. With respect to these guarantees, all of the gains and losses of the relevant separate account are passed through to the participant. In addition to this pass-through, however, the guaranteed benefits are linked to specific benefit events. The value of these guaranteed benefits is held as a GAAP reserve within PLIC's general account. In addition, under statutory accounting rules, these guarantees are covered through even more conservative reserve and capital requirements.

Here is an example to illustrate our concern. PLIC markets a variable annuity product that includes a guaranteed minimum death benefit, which is determined with reference to premiums

[4] The Financial Stability Oversight Counsel determined that separate accounts are "not available to claims by general creditors of a nonbank financial company" and, therefore, should be excluded from the calculation of the leverage ratio used in the Dodd Frank Section 113 determination process. Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 F.R. 21,637, 21,661 (Apr. 11, 2012).
[5] This excludes any statutory separate accounts that do not meet the definition of a separate account under the Proposals.

paid and historical separate account and general account values. It is not, however, a guarantee of those values. Upon the death of the annuitant, the death benefit is payable to the beneficiary in an amount equal to the greater of (i) the current contract account value[6], (ii) the premiums paid into the contract less withdrawals, and (iii) the contract account values that existed on every seventh contract anniversary less withdrawals. PLIC only has liability under the guarantee if the current account value is less than the current death benefit when the annuitant dies (i.e., (i) is less than either (ii) or (iii)). PLIC's current GAAP reserve value for this benefit is 0.04% of the total separate account assets that support contracts that have this benefit. This GAAP reserve is based upon a stochastic model that determines the present value of the projected benefits. As you can see, the value of this benefit is significantly smaller than the asset size of the separate account. Yet, under the Proposals, the entire separate account would be subject to capital requirements that are at least 100 times greater than the GAAP reserve value of the guarantees![7] Capital requirements of this magnitude are unnecessary, punitive and excessive relative to the actual liability of the insurer with respect to the underlying guarantees. The cost to customers would have to rise, which might be untenable when competing with insurers who are not affiliated with banks, creating an unlevel playing field in the insurance industry.

In addition, there are several interpretational issues that need to be resolved concerning the Proposals' definition of a "non-guaranteed separate account." The Standardized Approach NPR definition refers to a requirement "*... to hold reserves (in the general account) pursuant to its contractual obligations to a policyholder.*" The Standardized Approach NPR text discussing the definition refers to a requirement "*...to hold reserves for these separate account assets pursuant to its contractual obligations on an associated policy.*" These slightly different references raise a few questions:

- As noted in our previous example, these variable annuity death benefit guarantees are contractual guarantees made by the insurance company, the value of which is determined by reference to the entire insurance contractual arrangement – which involves assets within both the general account and the separate account. The reserves for these guarantees are not reserves for the separate account assets. Any benefits paid under this

[6] Variable annuity account values are the sum of the assets retained for the annuitant within the general account and separate account. In our experience, around 90% to 95% of the account value is invested within a separate account.

[7] The 100 times factor assumes the separate account capital requirement are being driven by the 4% leverage ratio requirement with an average risk weighted factor of 100% (i.e. corporate bonds). The 100 = (4.0% ÷ 0.04%). Realistically, most separate account assets are invested in publicly traded equities where the risk weighted asset factor would be 300%, the equivalent capital requirement would be 12% and the guaranteed separate account capital requirements would be 300 times the GAAP reserve value of the guarantee. If the capital requirements are driven by other capital ratios, the capital impact would be even greater.

guarantee would be payable directly to the beneficiary, are an obligation of the insurance company general account, and will result in appropriate reserves being maintained by the insurer in accordance with GAAP and statutory accounting rules. The separate account assets would never be replenished or augmented by the guarantee. In a sense, the separate accounts can be viewed merely as a benchmark in determining the size of the death benefit payable by the insurer general account under the insurance contract. So from this perspective, if the excerpt above from the commentary in the Standardized Approach NPR text correctly reflects the Agencies' understanding, these variable annuity separate accounts should be considered "non-guaranteed", because the general account reserve is not relative to the separate account assets. The Proposals should clarify the nature of guarantees and reserves that are contemplated within the definition, and provide that guarantees issued by an insurer's general account, properly reserved for, do not render a separate account "guaranteed."

- A single separate account may contain assets supporting a number of different insurance or annuity products. Many of these insurance and annuity products do not contain any guarantee, while others may do so. This reality raises questions concerning the application of the Proposals' definition. If, for example, only one of the products supported by a particular separate account contained a guarantee, would the entire separate account be considered "tainted" by the guarantee, and therefore ineligible for treatment as a "non-guaranteed separate account"? Or, would only that portion of the separate account that is associated with a guarantee be considered a guaranteed separate account? We believe the proposal needs to clarify that the non-guaranteed separate account definition can include a portion of a separate account to the extent it is associated with contracts that do not include separate account guarantees.

Recommendation: We believe the treatment of guaranteed separate accounts within the Proposals does not appropriately reflect the realities of these insurance products. The capital requirements in the Proposals for guaranteed separate accounts should be modified to reflect the relative magnitude and effect of varying types of associated guarantees. To address this concern, we recommend the following revisions:

- The Proposals should clarify that inconsequential guarantees issued by an insurer's general account, properly reserved for, do not render a separate account "guaranteed." The relative value of a guarantee can be measured by the relative size of its GAAP reserve. An inconsequential separate account guarantee should be defined as any guarantee for which the GAAP reserve for the separate account related guarantee is less than 5% of the portion of the separate account related to the guarantee.

- The Proposals need to allow for a portion of a separate account to be considered non-guaranteed to the extent it supports contracts that do not include separate account guarantees.
- Since these GAAP reserves are maintained within the general account, the Agencies should acknowledge that the Proposal's capital requirements imposed on the assets associated with the reserves are sufficient to cover the guarantee risks these reserves are supporting. This is a reasonable approach to take particularly since the state-based regulatory capital requirements that are deducted from the capital amounts within the numerator of the capital ratios already include an additional provision for the guarantees associated with separate accounts.
- An alternative approach for "guaranteed separate accounts" would be to express the additional capital requirement as a percentage of the GAAP reserve supporting those guarantees. As mentioned above, the variable annuity death benefit guarantees issued by PLIC have a GAAP reserve equal to 0.04% of separate account assets. Some of our variable annuities have available a guaranteed minimum income stream in the form of an annual withdrawal benefit feature. That benefit – which has a greater likelihood of being paid than does the death benefit – has a comparable GAAP reserve that is 5% of the underlying separate account assets. We believe the capital requirements for these guarantees should vary in proportion to the underlying GAAP reserves. This could be accomplished by removing the guaranteed separate account assets from the denominator of the capital ratios and then making a capital adjustment to the numerator of the ratio which equals 4% of the GAAP general account reserves backing the separate account guarantees. A capital charge of this magnitude is far more reasonable in relation to the value of the benefits than the 100+ multiples currently within the Proposals.

Deduction of Minimum Regulatory Capital of Insurance Underwriting Subsidiaries

The Proposals reduce the numerator of the capital ratios by the minimum regulatory capital requirements of insurance underwriting subsidiaries (generally, 200 percent of the insurer's authorized control level as established by the appropriate state insurance regulator). We believe this capital reduction is exceedingly and unnecessarily punitive to SLHC-SIOs. In 2011, this provision would have excluded 23% of PLIC's capital levels or $1.1 billion. Yet for PLIC's minimum state regulatory capital requirements, the vast majority of this amount is covering the same asset-related risks that are being addressed by the Proposals. Thus, the Proposals are punitive as they unreasonably disregard significant amounts of capital already maintained for non-insurance related risks.

The Proposals provide two reasons in support of this adjustment: (1) the need to cover insurance risks, and (2) the inability of insurance regulatory capital amounts to be transferred to absorb losses in other parts of the organizations. As we will explain, we do not believe these reasons are sufficient to support the Proposal's treatment.

If the goal of the deduction is to account for insurance risk, that is easily accomplished by isolating that portion of the insurer's minimum regulatory capital requirements that relate to insurance risks. The risk-based capital requirements used by the state-based insurance regulatory system are developed from five major risk based components:

- C0 – Asset Risk – Affiliates
- C1 – Asset Risk – Other
- C2 – Insurance risk
- C3 – Interest Rate Risk, Health Credit Risk, Market Risk
- C4 – Business Risk.

The insurance risk, which is unique to SLHC-SIOs, can be captured by focusing on the C2 component. The remaining risks are all found in banks as well, so they should all be captured by the bank-centric Proposals.

The second rationale for this treatment within the Proposal has to do with the inability of an insurer to transfer minimum insurance regulatory capital within the broader organization in response to risks within the subsidiary bank or savings association. We believe this rationale is not compelling for several reasons.

The fact that the insurer's minimum regulatory capital amounts need to remain within the insurance company does not mean that this capital is not providing substantial value to the insurer's consolidated organization. If the insurer were to experience any financial distress, the insurer's capital requirements cover those financial stresses and prevent the associated risks from impacting the holding company or other operations. This allows the remaining operations, including in our organization Principal Bank, to focus on meeting their capital requirements based on their risk exposures and consistent with their existing regulatory requirements, as is the case with our savings association.

In addition, the Agencies' position on the inability to transfer capital amongst operations is inconsistent with existing bank capital regulations. Under current banking rules, there is no adjustment to the capital requirements at the holding company level to reflect the clear and unquestioned inability of the broker-dealer, or an entity owned in another sovereign jurisdiction, to transfer capital to the bank in times of distress. Current banking capital rules do not adjust for the existing legal restrictions on the transferability of capital within bank holding company structures. Treating SLHC-SIOs differently, and to their disadvantage, in this regard may be seen by some as arbitrary.

Secondly, even if the Agencies' rationale were to prevail, the magnitude involved makes this treatment unnecessarily and punitively extreme. As of June 30, 2012, Principal Bank had assets of $2.4 billion, including capital levels of $219 million that support a bank tier 1 leverage ratio of 8.5%. PLIC's state regulatory capital adjustment under the Proposals would amount to $1.1 billion. It is both punitive and financially unnecessary to deny PLIC credit for its minimum insurance underwriting regulatory capital, which is almost five times greater than the more-than-adequate capital requirements maintained within Principal Bank. If financial distress were isolated to Principal Bank, PLIC clearly has the financial resources to cover Principal Bank's needs. Conversely, if financial distress were to occur in PLIC as well as Principal Bank, then PLIC's existing minimum required regulatory capital provides value within PLIC and its holding company by protecting PLIC, and its affiliates, from the financial distresses it is experiencing. Under both scenarios, it is appropriate for PLIC to retain full credit for its minimum required state-based regulatory capital.

Recommendation: The Proposals need to be modified to reflect a significantly less severe treatment of the insurer's minimum required state-based regulatory capital. We recommend that the minimum required regulatory capital adjustment in the numerator be waived for SLHC-SIOs in which the assets of the savings association subsidiary(s) are less than 25% of the total assets of the SLHC-SIO. For all other SLHC-SIOs, we recommend that the minimum state-based regulatory capital requirements adjustment in the numerator be limited to that portion of the capital that is linked to insurance risks. For state-based regulatory requirements, that would be the C2 risk component.

Credit Enhancing Interest Only Strips

The NPRs apply a 1250% risk weight to securities defined to be Credit-Enhancing Interest Only (CEIO) Strips. Based on our interpretations of the NPRs, it is unclear whether this definition extends to Interest Only classes of CMBS securitizations ("CMBS IOs"). If CMBS IOs are in fact included in this definition, the risk-weight for this asset class should be re-evaluated and reset to be commensurate with the actual risk inherent in these securities. In contrast, the Standardized Approach NPR proposes a 100% risk-weight for "Non-Credit Enhancing Interest Only MBS" and a 300% risk weight for publicly-traded equity securities. While the risk associated with CMBS-IO would be between these two types of securities, it would be much closer to the risk for "Non-Credit Enhancing Interest Only MBS". Currently the 1250% proposed risk weight immensely overstates the risk by implying CMBS IOs are 12.5 times riskier than "Non-Credit Enhancing Interest Only MBS" and 4 times riskier than publicly traded equity securities.

CMBS IOs have the following features which help mitigate risk and provide generally stable and predictable cash flows.

- **Priority of Payments** – CMBS IOs share priority with the top of the CMBS capital structure and are not affected by loan coupon modifications or interest shortfalls. Additionally, investors in CMBS IO securities continue to receive their full interest payments as long as a loan stays in the pool (regardless of its status as performing or defaulted).
- **CMBS IO Cash Flows are Front-Loaded** – CMBS IO cash flows are typically front-loaded with more of the cash flows received in the first 3-5 years in the life of the CMBS IO security.
- **Yield Maintenance Provisions** – Unlike residential mortgages, commercial mortgages are typically only open to prepayment with a yield maintenance prepayment premium. This provides a disincentive for prepayment and early termination on interest payments falling to Interest Only classes of CMBS.
- **Low Probability of Default and Liquidation at New Issue** – For newly issued deals, the newly originated collateral helps minimize the risk of early prepayments and liquidations as there have been very few instances throughout the history of the CMBS universe where losses were incurred (prepayments, loan defaults, servicer forecloses, or loan is sold) within the first few years following a deal's issuance. Additionally, the relatively conservative loan terms that are currently being underwritten at initial issuance should help mitigate near-term defaults which should provide a consistent cash flow stream.
- **Upside from Extensions Creates a Two-Tailed Distribution of Potential Outcomes** – When you purchase a CMBS IO security, you are paying for a strip of interest based off of the nominal loan terms assuming the loans pay off as scheduled. Therefore, extension of the underlying loans results in the continued receipt of interest that was not paid for in the original purchase price. This limits the risk of CMBS IOs to loan liquidations during the term of the loan and makes balloon defaults a potential positive event.

Recommendation: The proposed treatment of CMBS-IOs within the rules needs to be clarified and the risk-weights for CMBS-IOs need to be revised to be more appropriate and reflective of their risk characteristics. In our experience and judgment, a 100% risk weight factor would be most appropriate and consistent with the other risk weights established by the Agencies.

High Volatility Commercial Real Estate

The Standardized Approach NPR assigns a new, 150 percent risk weight to high volatility commercial real estate ("HVCRE"). HVCRE is defined generally as "a credit facility that finances or has financed the acquisition, development, or construction ("ADC") of real property." The Proposals' well-intended recognition of risk-differentiation among different types of commercial real estate should be expanded in order to both (1) clarify that the definition of HVCRE does not include completed, income-earning properties (which present no risks different from general corporate debt exposures); and (2) include additional risk sensitivity within the HVCRE risk weighting, proportional to the ratio in which the amount of any debt secured by the property bears to the value of the property ("LTV"); this approach should exclude entirely properties with "break even" or better cash flows relative to associated debt encumbrances.

The Proposals' definition of HVCRE is so broad that it appears to include ADC loans that encumber complete and cash-flowing properties with no credit issues, a point at which the loans should be treated no differently than general corporate exposures under the rules. As a result, we believe that the final rule should make clear that HVCRE does not include completed, income-earning loans. In addition, risk weighting all HVCRE at 150 percent ignores the actual risk of the transaction and unnecessarily raises the costs of borrowing for all HVCRE borrowers, even those with low risk characteristics. We believe that, consistent with the risk-sensitive goals of the Proposals, HVCRE should not include properties with a debt service coverage ratio of at least 1.0, and that, in recognition of the variety of risks in HVCRE exposures, the final rule should allocate risk weights according to the property's LTV, such risk weights and ratios to be determined, maximizing at the 150 percent number.

Mortgage Loan Risk-Weights

We would also like to comment on one part of the Proposals that could have an unnecessarily negative effective on the mortgage loan portfolio and lending operations of our subsidiary savings association and many others, impacting credit availability to the public.

The Standardized Approach NPR adopts substantial changes in risk-weights for residential mortgage loans, and in many cases increases them substantially. While it is appropriate to increase risk weights for loans with greater risk, the Proposals categorize too many loans as higher risk, and the risk weights in some cases appear too high relative to other non-residential mortgage loans. Without modifications, some of the risk weightings set forth in the Standardized Approach NPR could negatively impact the mortgage lending markets by eliminating or making unattractive certain loan types that may be low risk. This would reduce the number of loans extended, with lending only to the most creditworthy borrowers, and substantially reduce home equity lending. These impacts would have economic repercussions to the housing market.

Recommendation: We propose the following changes:

- **Expand the definition of category 1 mortgages.** This should include all mortgages meeting the Qualified Mortgage criteria. In addition, where supported by other underwriting criteria, category 1 should include interest-only and balloon payment mortgages, and all standard, prudently underwritten adjustable and floating rate mortgages. For example, it may be appropriate to include in category 1 mortgages with an interest-only period if supported by additional underwriting factors such as LTV, debt service coverage, and level of other financial assets.

- **Reduce the risk weights for category 2 mortgages so they range from 50% to 150%.** As written, the Standardized Approach NPR would impose considerably higher risk weights on certain types of secured mortgages than would be applied to unsecured loans. Ironically, this would create an incentive not to take the property as collateral at all if it were to be a category 2 mortgage. Also, it does not make sense to assign the same 100% risk weight to a category 2 mortgage with a 60% LTV ratio as a category 1 mortgage with a 95% LTV ratio. The category 2 mortgage is less risky than the category 1 mortgage and should receive a correspondingly lower risk weight.

- **Grandfather all loans in effect as of the implementation date to be category 1, or allow them to continue to utilize current (Basel I) factors.** In many cases it will require much manual effort to determine which category a loan falls into because the data to make that determination may only be available in original underwriting files. This also gives mortgage issuers time to adjust to the new requirements.

- **Permit recognition of private mortgage insurance ("PMI") at the individual and pool-wide level for purposes of the LTV calculation.** This should be permitted if the bank can determine, based on typical investment evaluation criteria, that (i) the risk of default by the PMI provider is low, and (ii) the full and timely payment of the insured amount is expected should the referenced mortgage default.

- **All loan restructurings and modifications that meet certain sustainability criteria, whether a Home Affordable Modification Program ("HAMP") modification or not, should remain subject to the original risk weight assigned to the mortgage at origination.** The same treatment for HAMP modifications should be available for all modifications and restructurings that meet certain sustainability criteria. Certain private, non-government sponsored modifications are at least as likely to create sustainable, performing loan modifications as HAMP. The proposed exception also should include these modifications in order to promote the public policy objectives of helping banks reduce risk and borrowers remain in their homes.

- **Existence of additional guarantees from strong organizations should be considered in category definitions.** For example, a loan with repurchase guarantees in the event of default from a highly rated organization should be considered category 1.

Changes to the Advanced Approaches and the Market Risk NPR

The Proposals would apply Advanced Approaches and Market Risk NPR to SLHCs that satisfy the respective qualification levels on January 1, 2013, without any transition period. These additional requirements on these SLHCs, which are not required by Dodd-Frank, represent an entirely new regime. SLHCs need a significant transition period consistent with the July 21, 2015, effective date intended by Dodd-Frank in order to understand and prepare for the implementation of these additional requirements. Since these requirements are new for qualifying SLHC-SIOs, and very complex, it is difficult for SLHC-SIOs to understand and assess the potential impacts of these rules.

The purpose of the Advanced Approaches and Market Risk NPR appears to be to provide the Agencies a way to impose stricter standards on larger, more complex banking organizations. In the case of SLHC-SIOs, we believe these higher standards are unnecessary since the insurance company(s) within the SLHC-SIOs already comply with numerous additional state-regulatory requirements that include items such as asset adequacy analysis as well as statutory reserve and capital requirements.

Recommendation: The effective date for the application of the rules contained within the Advanced Approaches and Market Risk NPR to SLHCs should be deferred until at least July 21, 2015, if not longer. SLHC-SIOs should be exempt from the Advanced Approaches and Market Risk NPR if their subsidiary bank or savings association's assets are less than 5% or 10% of the total assets of the SLHC-SIO.

Conclusion

The effort behind the Proposals represents an important step in strengthening the U.S. financial system and implementing key provisions of Dodd-Frank. We hope our comments and recommendations assist the Agencies in improving the Proposals.

As discussed in this letter, the application of a bank-centric capital framework on SLHC-SIOs is punitive and risks causing economic harm as well as providing incentives for behaviors that increase the risk profile of SLHC-SIO. Dodd-Frank gives the Agencies the latitude to establish capital requirements for SLHC-SIOs that are quantitatively at least as rigorous as the requirements of other depository institutions without needing to be identical to those requirements.

Lastly, we encourage the Agencies to recognize the value of keeping banking operations within SLHCs. In recent years, several BHCs or SLHCs have divested their banking operations in an attempt to avoid burdensome federal regulatory requirements that are disproportionate to their banking exposure. This is unfortunate since these banking operations are losing the financial strength, stability and business opportunities that come with being part of a large financially diversified organization. In addition, this diversification benefits our customers. At Principal, our customers exiting their retirement plans are well-served by being able to invest conveniently into individual securities, funds, annuities and FDIC-insured bank IRA in appropriate combination.

We encourage the Agencies to modify the capital requirements set forth in the Proposals in the manner we have suggested to better accommodate the unique characteristics of SLHC-SIOs.

Thank you for your consideration. We would welcome the opportunity to discuss the matters contained in this letter with you.

Very truly yours,

Terrance J. Lillis
Senior Vice President
and Chief Financial Officer