NAIC National Association of Insurance Commissioners
& The Center for Insurance Policy and Research

August 17, 2016

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551

Re: Docket No. R-1540 and RIN No. 7100 AE-54: Enhanced Prudential Standards for Systemically Important Insurance Companies

Dear Mr. Frierson:

On behalf of the National Association of Insurance Commissioners (NAIC),[1] we write today regarding the Board of Governors of the Federal Reserve System (Board) proposed rule on Enhanced Prudential Standards for Systemically Important Insurance Companies (SIICs).[2] The NAIC respectfully submits the following comments to the Notice of Proposed Rulemaking and Request for Comment (NPR) published in the June 14, 2016 issue of the Federal Register.

At the outset we would note that in the wake of the 2008 financial crisis, state insurance regulators recognized the importance of enhancing effective enterprise-wide supervision, including risk management. The NAIC's Solvency Modernization Initiative (SMI)[3] and the various changes that we have enacted as a result of it, including Form Fs[4], Own Risk Solvency Assessment Summary Reports (ORSAs), a new group-wide supervision model, and enhanced efforts with affiliate examinations, are all aimed at enhancing the financial strength of insurance institutions for the purpose of protecting

[1] Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

[2] Although the SIIC's subject to the proposed rule have been designated as systemic by the Financial Stability Oversight Council (FSOC), state regulators continue to disagree with the designations. Furthermore, we also dispute the broad assertion from the proposed rule that there were "a number of insurers that experienced material financial distress" during the 2008 financial crisis, and that several of those insurers had significant deficiencies in key areas of corporate governance and risk management.

[3] The NAIC's Solvency Modernization Initiative (SMI) began in June 2008. The SMI was a critical self-examination of the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation. While the U.S. insurance solvency regulation is updated on a continuous basis, the SMI focused on five key solvency areas: capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues. For additional information, see http://www.naic.org/index_smi.htm.

[4] The Form F (Enterprise Risk Report) was designed to require holding companies of insurers to identify and report their enterprise risk to state regulators in a confidential filing.

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policyholders and thus also supporting financial stability. While we understand that the Board has a specific regulatory mission under the Dodd-Frank Act,[5] we view that role and related endeavors as supplementary to ongoing efforts state regulators have taken and are continuing to undertake.

The importance of identifying key risks, regulating for solvency, early warning or detection systems and having sufficient capital levels was illustrated dramatically by the financial crisis. Indeed, state insurance regulators' national system of conservative solvency regulation helped insurers and their consumers weather the financial crisis far better than other financial sectors. And it is the regulatory system of accounting, reporting and oversight that continues to ensure that insurer obligations to policyholders will be met both today and in the future.

Enterprise wide Risk-Management Framework

As a general matter, the NAIC supports the use of an enterprise-wide risk management (ERM) and corporate governance framework to assist in the supervision of insurance groups that are SIICs. The requirements in the proposed rule allow the Board to address many of the same risks addressed by state insurance regulators during our on-site examinations reviewing corporate governance and enterprise risk management of insurance groups. State regulators supplement our periodic on-site exams with ongoing analytical reviews of the Form F, ORSAs, and Corporate Governance Annual Disclosure (CGAD).[6]

While we support the Board's emphasis on ERM and corporate governance frameworks, the NAIC cautions against the use of an enterprise-wide risk management framework that is too standardized, specific, or rigid. We continue to believe that diversity in management styles and corporate structures enhances financial stability and a company's enterprise framework must be tailored to a firm, its structure, liabilities, lines of business, and size, among other considerations. We believe the Board must remain especially mindful of possible unintended consequences when developing more prescriptive rules, because even general governance requirements can be unworkable or overly restrictive, depending on how such standards are enforced.

We also caution the Board against over-reliance on the ERM and corporate governance frameworks, as financial difficulties are not always caused by deficiencies in those areas, and corrections to the same will not always prevent future difficulties.

The NAIC also requests that the Board, in implementing the requirements for the risk management and corporate governance frameworks, ensure that such requirements do not conflict with existing state requirements for insurers within a group, as well as consider the reporting under the NAIC Corporate Governance Annual Disclosure Model Act.[7]

Corporate Governance: Risk Committee

The NAIC agrees that it is appropriate for a SIIC to appoint a risk committee responsible for the development of company risk-management policies and oversight of the company's global risk-management framework. We also agree that the requirement for at least one member of the risk committee to have relevant experience in identifying, assessing, and managing risk exposures of large, complex financial firms is appropriate. Ideally, more than one member of the risk committee would have such experience.

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[5] Pub L. 111-203.
[6] See http://www.naic.org/cipr_topics/topic_corporate_governance.htm.
[7] NAIC Model #305, available at: http://www.naic.org/store/free/MDL-305.pdf.

While we also agree that some basic requirements should be in place for members of the risk committee, one concern we have with the Board's proposed criteria is that there is no requirement for insurance sector experience. With the great deal of diversity among large, complex financial firms, there is no guarantee that a risk committee member's experience assessing risk at a large, complex bank or other financial institution would translate well into assessing risk at a large, complex insurer. We believe SIIC Boards should review the adequacy of proposed risk committee members on a case-by-case basis, rather than establishing rigid, one-size-fits-all requirements for risk committee membership.

Corporate Governance: Chief Risk Officer and Chief Actuary

The NAIC cautions the Board against being too prescriptive in the role of a Chief Risk Officer or Chief Actuary within a SIIC's structure. It is difficult to define and implement the "appropriate" amount of stature and independence of a chief actuary from business lines and legal entities. The concept of independence raises difficult questions such as whether the Chief Actuary would need to have approval or veto power of all actuarial policies, and how involved the Chief Actuary can be in the development of individual actuarial decision making in a particular line of business or legal entity. Although reporting structures are important, the keys to an effective Chief Risk Officer or Chief Actuary are the competencies and abilities of the individuals serving in those capacities.

We agree the Board should not require a single, enterprise-wide Chief Actuary and that the position of Chief Actuary be allowed to be split between life/health and property/casualty lines. We note that it would be very rare for an actuary, let alone a Chief Actuary, to have significant experience in both areas.

Separate life/health and property/casualty Chief Actuaries is also appropriate because of the nature of the insurance reserves and the fact they are held within separate insurance legal entities. While we understand the Board's desire for an enterprise-wide view of reserve adequacy, the utility of this view is limited given that such reserves are <u>not</u> fungible within the enterprise; any such movement would require express state regulator approval or oversight.[8] Moreover, reserve adequacy at an enterprise level may not be sufficiently conservative since deficiencies in one business can be easily masked by excesses in another. Thus, we believe the prudent approach is to require reserves to be sufficient for each product line on a standalone basis, which further supports the ability to have separate life/health and property/casualty Chief Actuaries within one group.

Liquidity Risk: Cash Flow Projections

The Board's proposal would require SIICs to update short-term cash-flow projections daily and update longer-term cash-flow projections at least monthly. While these updates would not always require revisiting actuarial estimates, SIICs would need to roll the cash flows forward and revise assumptions as needed based on new data and changing market conditions. Although such testing projections may be appropriate in volatile markets, when markets stabilize, they may be overly stringent. In particular, the daily cash-flow projections may be excessive given the nature of insurance and timing of claim payments. While it may be appropriate to have daily or even intraday updates for any non-traditional insurance and more bank-like activities that are material to the firm or the market, a blanket enterprise-wide daily update of cash flows seems unnecessary. We would suggest the Board develop appropriate threshold and activity definitions to trigger daily cash-flow projection updates and consider making the short-term update requirements a weekly exercise. In addition, when doing comprehensive enterprise-

[8]Section 176 of the Dodd-Frank Act preserves the authorities of the state insurance regulators including the ability to wall off insurance legal entities. *See* 12 USC 5374 ("[Title I of the Dodd-Frank Act] and the rules, regulations, or orders prescribed pursuant to such Title do not divest any [Federal or State Agency] of any authority derived from any other applicable law").

wide cash-flow projections and establishing a methodology for making both short-term and longer-term cash-flow projections, it is imperative to recognize that insurers' assets in a group should not be considered as a source of liquidity across the group due to the significant regulatory restraints on cash-flows out of legal entity insurers.

Further, the projection methodology should include reasonable assumptions regarding future behavior of assets, liabilities, and off-balance sheet exposures. In order to achieve credible and meaningful results, it is imperative that the Board apply assumptions as to liquidity that is realistic and appropriate to the insurance business model. The rule should enable insurers to take into consideration the features and attributes of insurance products that are natural and effective disincentives to surrender/cashing out and thus liquidity demands, such as: contract provisions at the option of the insurer; surrender charges; and the intent of product purchase – long-term needs or protection against events that can cause disastrous financial impacts. Failure to understand and factor these purposes into cash-flow projections will result in flawed methodology and an inaccurate accounting of a SIIC's actual exposures.

We would note that the Board's list of cash flows for calculating liquidity projections in the proposed rule does not include all material cash inflows for SIICs – in particular, principal payments on investments and maturing assets are not listed. Thus, we suggest that "(8) investment income and proceeds from assets sales" be changed to "(8) investment income and proceeds from asset dispositions."

Liquidity Risk: Contingency Funding Plan

The NAIC believes that the assessment of liquidity risks under normal and stressed assumptions, along with appropriate contingency funding plans to address the triggering of these risks, should be a part of the SIIC's ERM system.

We would also note that one of the stress events imagined by the proposed rule involves the widening of credit default swap (CDS) spreads, presumably on the insurance entity. Given the relatively thin market in CDS of insurers, we are uncertain how appropriate its inclusion as part of evaluating contingency funding for SIICs.

As the Board develops the requirements for SIIC contingency funding plans, we encourage you to remember that any market related indicators for the insurer should be taken in the context of the overall market. For example, if the market spread for the SIIC widens by 100 basis points, but the average market spread for all financial institutions widens by 200 basis points, the Board should take that meaningful distinction into account as part of the evaluation of the contingency funding plan.

The NAIC also believes SIICs should be able to include contractual stays as part of their contingency funding plans in response to *severe* adverse liquidity scenarios. Assuming away a contractual requirement for such funding plans ignores an important tool at a firm's disposal and one that insurance regulators may insist be utilized (or alternatively invoke themselves) during a severe liquidity crunch to smooth outflows with the purpose of preserving the assets within the insurance legal entities.

We also note the proposed rule requires testing of a contingency funding plan that "in some cases, would require actual liquidation of assets in buffer periodically as part of the exercise. This can be critical in demonstrating treasury control over the assets and an ability to convert the assets into cash." This "actual liquidation" requirement should be eliminated. While the NAIC is generally supportive of contingency planning through table-top exercises, we do not believe such an actual liquidation would

serve the Board's stated goal in the absence of real world stress and liquidity needs. Showing that actual liquidation can be done without sending distress signals would not be proven by such an exercise, which would necessarily take place in a vacuum.

Liquidity Risk: Collateral, Legal Entity, and Intraday Liquidity Risk Monitoring

In the normal course of business, the NAIC does not believe that insurance activities should result in the need to engage in intraday liquidity monitoring. However, we acknowledge that some SIIC's may choose to engage in activities such as private placements, commercial mortgages, securities lending, overnight repos, borrowings, commercial paper, and similar instruments or activities. To the extent that a SIIC is engaging in these activities, intraday liquidity monitoring may be appropriate in stressed situations.

Liquidity Risk: Stress Testing

The NAIC has significant concerns regarding the potential impact of the very specific liquidity stress testing of §252.165 in the proposed rule. We believe the specified test could actually *weaken* the financial condition of the group by inappropriately failing to properly weight the probability of certain events. We believe any test should consider the probability weighting of any liquidity stress element of the test, just as most life insurers consider in their liquidity management programs. To do otherwise forces the insurer to inappropriately overweight liquidity risk compared to other risks and could actually weaken the financial condition of the company by weakening its earnings capacity, thereby reducing capital and access to future capital.

Additionally, by not probability weighting for certain events, the Board is inappropriately forcing insurers to ignore risks associated with safe havens provided elsewhere in the proposed rule. For example, although U.S. Treasuries are relatively safe, fundamentals such as ongoing negative cash outflows and increased debt suggest risks are increasing. While the NAIC agrees with the inclusion of such risks in the stress testing, we would urge the Board to consider using historical information to develop haircuts for the different asset classes, as well as the potential cash outflow events that may be very unlikely to occur based on history.

With respect to the frequency of the stress testing, the NAIC believes that annual stress testing as set forth in the Dodd-Frank Act should be the minimum requirement, along with the potential for interim requests in times of stressed environments or immediate submissions when material changes occur at the company level.[9] However, stress testing can be a resource intensive activity, so it is important to weigh the costs against the benefits of such tests. Another option for balancing costs vs benefits would be to require more frequent testing for a specific element or component within the entire set of stress tests.

Regarding stress horizons, the NAIC encourages the Board to consider how stress horizons of less than 90 days relate to the 90-day window for the overall liquidity requirement. Given that the proposed rule does not allow any assumption for delaying payments under insurance contracts, the proposed seven or even 30 day stress scenario for an insurer not only fails to account for such a contractual stays, but also fails to account for the claims verifying process, which typically takes some amount of time.

The NAIC is also concerned that there is no mention of regulatory stays in the stress testing provisions. The absence of such stays means they could not be factored into a SIIC's liquidity risk calculations. While excluding these stays may be appropriate since they are not within the company's control, they

[9] 12 USC § 5365

should at least be a viable reference point for the insurer to address for an extreme liquidity stress scenario where an insurance regulator would become involved.

Liquidity Risk: Buffer Requirements

The NAIC believes the Board's 90 day planning horizon for calculation of the buffer may be a very conservative time frame depending upon the probable liquidity stress durations in the company-specific test scenarios. However, we recognize the Board is also considering liquidity concerns that existed in the broader financial sector during the financial crisis. Certainly a minimum of a 30 day horizon should be established, as this would allow some time to see how the causes of the liquidity strain develop, giving regulators lead time to prepare for any necessary receivership actions. We encourage the Board to engage in a discussion with SIICs regarding the appropriate planning horizon, whether 45, 60, or the proposed 90 days, as they will suffer the negative impacts of the liquidity capital buffer in a challenging investment environment.

With respect to the proposed rule's definition and treatment of eligible assets in the liquidity buffer, the NAIC has several concerns. Firstly, it is unclear how assets on deposit for various reasons will be treated. The assets listed as permitted fully exclude exchange traded funds (ETFs) and mutual funds (MFs) or money market funds (MMFs). While there were instances during the financial crisis where MFs and MMFs were frozen and questions exist regarding the liquidity of ETFs, it may still be appropriate to include these funds in certain circumstances, such as in an outer layer of the buffer (similar to the tiering of capital). The Board's treatment also explicitly excludes investments in bonds from banks and insurance companies as well as bank deposits, for interconnectedness issues. That will create market issues since financial institutions have been major issuers and likely will continue to be with various bail-in structures. The exclusion of bank deposits will mean insurers likely need to change their cash management procedures away from banks.

Secondly, the Board's list of eligible assets also refers specifically to investment grade corporates, and not structured securities or municipal bonds. While the former is understandable, given the turmoil from the financial crisis, there was extensive discussion for the liquidity coverage tests for banks to include some municipal bonds. It is also our view that consideration for legal entity insurers' ability to continue receiving premium cash flow even in stressed situations should be part of liquidity buffer considerations.

Here and throughout the liquidity buffer requirements, we urge the Board to consider the incentives and impacts these requirements will have upon legal entity insurers. Just as we have fungibility of capital concerns, we are also concerned with the location of liquid assets within the SIIC structure, given the regulatory restrictions on accessing assets within a legal entity insurer. The liquidity needs of legal entity insurers should be considered as priorities to several of the other potential liquidity needs not involving contractual requirements to policyholders in these decisions.

Finally, we believe that the proposed rule's elimination of cash deposits held by a bank from the definition of highly liquid assets that should be available as a liquidity buffer is unreasonable. During the 2008 financial crisis, cash was king and even the U.S. Treasuries market – which the proposed rule treats as highly liquid – dried up. One of the Dodd-Frank Act's central tenets was an effort to make banks safer by ensuring they have enough capital in stress scenarios to meet their liquidity needs for such "on-demand" deposits. By eliminating such sources from insurers' liquidity buffers, the proposed rule indirectly protects banks from runs through the regulation of insurers subject to the rule.

Conclusion

The NAIC appreciates the opportunity to share our views on the important questions surrounding the Enhanced Prudential Standards the Board will apply to SIICs. We continue to believe that systemically risky activities are antithetical to the interests of policyholders, and that insurance consumers should not be materially exposed to such activities.

We are generally supportive of efforts to improve ERM, Corporate Governance, and Liquidity Risk management at SIICs. But, being mindful of costs to consumers and the risk of unnecessary disruptions to insurance markets, we would hope the Board's proposed standards can be implemented by leveraging the existing stated-based regulatory system of reporting and oversight. For these reasons, we look forward to working with the Board constructively on these and other issues surrounding the regulation of SIIC's.

Should you wish to discuss this comment or any other matter relating to the NAIC's views on this proposed rule, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980 or Mark Sagat, Counsel and Manager of Financial Policy and Legislation, at (202) 471-3987.

Sincerely,

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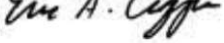

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