The Cypress Group

August 17, 2016

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551
E-mail: regs.comments@federalreserve.gov

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

Dear Mr. Frierson:

I write on behalf of The Insurance Coalition, a group of insurance companies supervised by the Federal Reserve and interested parties. We share a common interest in federal regulations that apply to insurance savings and loan holding companies ("insurance SLHCs") and insurers that have been designated as systemically important nonbank financial institutions ("insurance SIFIs.").

In this case, we write because Insurance Coalition members are either subject to or take a strong interest in the Board of Governor's of the Federal Reserve System's ("the Board's") Notice of Proposed Rulemaking ("NPR") regarding Enhanced Prudential Standards for Systemically Important Insurance Companies published in the *Federal Register* on June 14, 2016.[1] We appreciate this opportunity to comment and also support the comments of our member company trade associations, including the American Council of Life Insurers (ACLI). It is important to also note that except where otherwise indicated, our comments below are specific to the life insurance business model.

Executive Summary

We share the Board's goal of reducing systemic risk to the economy. While we have long taken the position that insurance does not pose systemic risk, we also believe that any federal regulations for insurers (whether insurance SIFIs or SLHCs) should be well tailored to the business of insurance. We appreciate that the NPR seeks to establish tailored Enhanced Prudential Standards for insurance companies that have been designated as systemically important. However, we respectfully request that the Board consider further

[1] Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610 (proposed June 14, 2016) (to be codified at 12 C.F.R. pt. 252).

tailoring the NPR to reflect significant differences in the risk profiles of large banking organizations and insurers. The Board has also recognized several times the importance and desirability of tailoring regulations for the business of insurance.[2] We applaud this sensitivity and hope to further this goal by offering specific suggestions for additional tailoring in the NPR.

I. The NPR Should be Further Tailored to the Insurance Business Model

As noted above, we appreciate that the NPR reflects some tailoring of the enhanced prudential standards applicable to bank holding companies ("Regulation YY").[3] However, we believe that the NPR should be further tailored to adequately reflect the fundamental differences between the banking and insurance business models.

Further Tailoring is Consistent with Congressional Intent and Board Policy

We believe that additional tailoring is consistent with congressional intent in the Wall Street Reform and Consumer Protection Act ("the Dodd-Frank")[4] and other related legislation. As noted in the NPR, section 165 of the Dodd-Frank Act specifically contemplates tailoring by company and business model, stating that the Board may "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate."[5]

Beyond the specific language in section 165, Congress has consistently indicated its intent to treat insurers differently in financial regulation. Congress recognizes that the business of insurance is highly distinct from banking, and also acknowledges the robust regulation of insurance at the state level. Congress codified the deference to states in the regulation of insurance in the McCarran-Ferguson Act[6], and has consistently sought to avoid disruption of the state regulatory regime in federal regulation.

Congress's intent to preserve the state regulatory framework and tailor federal regulations to the business of insurance is apparent throughout the Dodd-Frank Act.[7] Additionally, Congress intended for the Board to tailor its capital regulation for insurance, which was clarified in the 2014 Insurance Capital Standards Clarification Act.[8] While we appreciate the

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[2] Daniel K. Tarullo, Board Member, Fed. Reserve, Speech at the Nat'l Ass'n of Ins. Comm'r's Int'l Ins. Forum, Washington D.C. (May 20, 2016); Janet Yellen, Chairman, Fed. Reserve, Opening Statement on Ins. Capital Advanced Notice of Proposed Rulemaking and Enhanced Prudential Standards Proposed Rule for Systemically Important Ins. Firms (June 3, 2016).

[3] Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610, 38611 n.11 (proposed June 14, 2016) (to be codified at 12 C.F.R. pt. 252).

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1419-20 (2010).

[6] 15 U.S.C. §§ 1011-1015 (1945).

[7] 12 U.S.C. § 1851 (2011).

[8] The Insurance Capital Standards Clarification Act of 2014, Pub. L. No. 113-279, 128 Stat. 3017 (2014).

extent to which the NPR reflects congressional intent regarding tailoring for insurance, and respectfully suggest that additional tailoring would better fulfill Congress' intent with respect to federal regulation for insurers.

The NPR puts forward a number of liquidity risk management standards for insurance SIFIs. We support the goal of ensuring that the financial system is adequately protected against liquidity risk, and believe that this goal can best be achieved by fully reflecting the insurance business model in every aspect of liquidity risk-management standards.

Accordingly, we encourage the Board in the final rule to take account of certain key differences between banking organizations and insurers that are directly relevant to liquidity risk management. First, the balance sheets of banking organizations and insurance groups differ in critical ways. Banking organizations generally hold complex assets and have significant deposit, wholesale funding and other short-term liabilities. These liabilities are generally acquired by their holders for the specific purpose of maintaining liquidity, and therefore pose liquidity risk in times of financial stress. Unlike insurance groups, many large banking organizations also engage in payment, clearing and settlement activities, or serve as dealers or market-makers in financial instruments. These activities, create significant intraday liquidity exposure, which is reflected in the requirements of Regulation YY.[9]

By contrast, the risk profiles of insurance groups are not subject to significant change over short periods of time (*i.e.*, monthly or even yearly). Liabilities accumulate over many years, and are carefully matched with assets pursuant to sound risk management practices and state regulatory requirements. This reflects the conservative -"buy-and-hold-"strategy that is central to the insurance business model.

The products offered by insurers also generally do not give rise to significant liquidity risk, particularly as compared to banking products. Insurance products are generally acquired for protection against certain life events and/or in planning for retirement, not for liquidity purposes, and are subject to inherent and powerful economic incentives to maintain a policy. Additionally, life insurance policies that can be surrendered are often associated with legal and/or contractual protections that significantly disincent immediate surrender. With respect to property and casualty products, the claims adjustment process does not result in immediate cash flows, and these products therefore do not present liquidity risks.

Many in the regulatory community, including the Board, have recognized that federal prudential regulations for insurers, including liquidity standards, should be tailored to insurance and distinct from the rules for banks.[10] We agree and suggest that the final rule reflect this in its risk-management standards by incorporating our suggested revisions, which are detailed below.

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[9] Enhanced Prudential Standards (Regulation YY), 12 C.F.R. § 252.34-35 (2012).

[10] See Gov. Daniel K. Tarullo, Daniel K. Tarullo, Board Member, Fed. Reserve, Speech at the Nat'l Ass'n of Ins. Comm'r's Int'l Ins. Forum, Washington D.C. para 11 (May 20, 2016) (stating that "capital and liquidity requirements for insurance companies should be calibrated differently than capital and liquidity requirements for dealer banks").

In addition to specific tailoring suggestions outlined below, we also note that the NPR is heavily focused on enterprise-wide implementation. We believe that this approach, increases regulatory cost exponentially versus materiality-based regulation. We therefore suggest that the final rule include clear materiality thresholds that cover: (1) the frequency, granularity and degree of management oversight/review of cash flow projections; (2) the frequency, granularity and degree of management oversight/review of liquidity stress testing results; (3), the frequency and granularity of management and independent reviews of stress testing assumptions and methodologies, and (4) the granularity of required documentation.

We believe that the projection, testing, reporting and review requirements listed above should be limited to liquidity-intensive activities, including asset-backed financing and derivatives collateral within material legal entities rather than being applied globally on an enterprise-wide basis. It should be noted that global application of these standards would create "very significant" rather than the "modest" additional regulatory costs cited in the NPR. In other words, our approach would appropriately tailor additional requirements to liquidity-intensive insurance SIFI activities and ensure that the costs of the additional regulations are commensurate with the scope of such activities at insurers subject to their requirements. We appreciate your consideration of this materiality-based approach, in addition to the specific suggestion changed outlined below.

II. Corporate Governance and Risk Management

The NPR includes a number of requirements related to corporate governance and risk management.[11] These provision mirror the requirements of Regulation YY for bank holding companies.[12]

In our view, the corporate governance provisions in the NPR are overly prescriptive. Insurance SIFIs are subject to state insurance law, the Securities Exchange Act of 1934, Sarbanes Oxley, and NASD-NYSE listing standards (depending on listed exchange).[13] In our view, in light of the robust corporate governance regulatory framework already in place, NPR's additional, prescriptive standards are unnecessary. This is especially true regarding the NPR's requirements with respect to which Board of Directors committee addresses particular risk issues, and to whom the chief risk officer and chief actuary report.

We believe that instead of the prescriptive approach in the NPR, the Board should adopt a principles-based approach in the final rule. Such an approach would permit insurance SIFIs to keep governance and risk-management policies that have worked and that are consistent with the aim of the NPR.

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[11] Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610, 38611-24 (proposed June 14, 2016) (to be codified at 12 C.F.R. pt. 252).

[12] Enhanced Prudential Standards (Regulation YY), 12 C.F.R. § 252.22, 252.33, 252.153, & 252.155 (2012).

[13] Existing U.S. Corporate Governance Requirements 14-16 (2012) (unnumbered working paper) (on file with the National Association of Insurance Commissioners).

If the Board declines to adopt a principles-based approach, we would request a change regarding senior management approval and review for new products. Specificially, we belive that requiring a separate senior management approval and review process for new products/activities with liquidity risk is unduly burdensome. New product/activity approval and review processes covering a variety of asset-liability risks (including interest rate, equity, FX and liquidity risks) should qualify under the final NPR. Lastly, we recommend that senior management review/approval of liquidity stress testing practices, methodologies, and assumptions be required on no more frequently than annually, absent a material development requiring a special review. We believe that this is sufficient to meet the goals of the NPR, and that the quarterly basis outlined in the NPR is unduly burdensome. As noted above, our preferred approach is a principles-based approach to corporate governance standards, but if such an approach is not incorporated in the final rule we respectfully request that these specific changes are adopted.

III. Specific Comments Regarding Liquidity Risk Management Standards

The NPR would require insurance SIFIs to conduct liquidity stress testing monthly, or more frequently if required by the Board.[14] The NPR also provides for a 7-day time horizon when conducting a stress test for an insurance SIFI. We greatly appreciate that the Board tailored the rule by providing a 7-day time horizon, as opposed to the overnight stress test required by Regulation YY for bank holding companies.[15]

In addition to the 7-day time horizon, we believe that it is important to further tailor this rule to reflect the stable nature of the insurance risk profile. Specifically, a quarterly liquidity stress testing schedule would reflect insurers' stable risk profile while not imposing a burden out of proportion with the benefits of the requirement. In addition to the stress testing schedule, we believe that the liquidity stress testing should focus on the legal entity level.

We also request that the Board consider further evaluation and study to determine whether certain activities conducted by insurance SIFIs should be subject to more frequent liquidity stress testing. Lastly, we suggest that the requirement to conduct liquidity stress tests over a 7-day planning horizon should be focused on only those activities that could generate short-term liquidity risks.

IV. Cash flow projections

The NPR would require insurance SIFIs to update short-term cash-flow projections daily and long-term cash flow projections monthly.[16] We respectfully suggest that these requirements do not adequately account for the insurance business model. Given the stability over time of

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[14] Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610, 38618-20 (proposed June 14, 2016) (to be codified at 12 C.F.R. pt. 252).
[15] *Id.*, at 38618.
[16] *Id.*, at 38616.

insurers' assets and liabilities, in our view requiring the production and updating of cash-flow projections with the frequency contemplated by the NPR would not be particularly useful to supervisors or the companies themselves, and would be costly and burdensome to implement. In the alternative, we suggest that it would be sufficient for short-term and long-term cash-flow projections to be updated quarterly. Additionally, we suggest that short-term cash-flow projections focus on specific activities that pose short-term liquidity risk, and only to the extent that the insurance SIFI engages in such activities to a material extent.

In addition, we believe that the final rule should clarify that the cash flow projection requirements are for normal, business-as-usual environments only. Cash flows under stress scenarios are an input into liquidity stress testing requirements. We feel that projecting cash flow mismatches greater than one year is a highly assumption-driven process that does not add significant value, and thus should not be required under the final rule.

V. Inclusion of Borrowing Sources

The NPR does not permit insurance SIFIs to include proceeds from certain committed future borrowing sources (such as credit lines) in either the liquidity buffer and stress tests for the 90-day time horizon. We urge the Board to include such proceeds as cash-flow sources in the final rule. Excluding these proceeds, as the NPR does, would treat insurance SIFIs differently from banking organizations when applying the same liquidity stress test time horizons to both classes of firms. As we note throughout this comment letter, in many cases there are important reasons related to the insurance business model to distinguish insurers from complex banking organizations. However, that is not the case here – there is no difference in an insurer's potential use of such proceeds in a stress event vis-à-vis a bank's. Thus, the final rule should treat both types of institutions similarly and permit inclusion of such borrowing sources in the liquidity buffer and liquidity stress tests for the 90-day horizon.

Relatedly, we believe that insurance SIFIs should be permitted to treat pre-funded liquidity sources that present no material counterparty or systemic risks as available sources of funding and liquid assets for purposes of liquidity stress testing and the liquidity buffer. In our view, inclusion of proceeds from borrowing sources and pre-funded liquidity sources is also appropriate, given the requirement that such stress-test assets be diversified."[17] The inclusion of such assets, in addition to being consistent with the treatment of bank holding companies, would permit an insurance SIFI to diversify its sources of funding during a stressed scenario and reflect the economic reality of the likely reliance on such assets in the event of such stress.

Federal Home Loan Bank (FLHB) advances, in particular, speak to this as a source of funding diversification, and insurance SIFIs should not be required to assume that they could not be utilized during a time of stress. The recent financial crisis provides evidence of the FHLB

[17] See Enhanced Prudential Standards for Systemically Important Insurance Companies, 81. Fed. Reg. 38610, 38629 (proposed June 14, 2016) (to be codified at 12 C.F.R. pt. 252) (outlining § 252.165(a)(5)(ii)).

System serving as a resilient source of liquidity in support of its housing mission. Any determination regarding the ability to obtain new funding or roll over existing funding should instead be part of the assessment of each individual stress scenario. Particularly during a short-term financial crisis, when financial markets can become chaotic, accessing FHLB funding provides reliable liquidity while avoiding turning a short-term situation into a permanent value detriment. Unlike commercial lenders that tend to restrict advances when faced with tight liquidity markets, the FHLBs, as government-sponsored enterprises, maintain access to global capital markets and are able to continue making advances to their members across business cycles. For these reasons, we believe that it is appropriate that the final rule to treat FLHB advances as an available source of funding for purposes of the liquidity stress tests and liquidity buffer.

VI. Certain Contractual Stays Should be Included in Liquidity Stress Testing

The NPR would not allow insurance SIFIs to take into consideration contractual rights to defer payments as a source of liquidity in stress testing, and questions whether such stays should be permissible within contingency funding plans.[18] We urge the Board to reconsider this broad exclusion of all contractual stays from all liquidity stress testing results, and believe that they should be recognized in contingency funding plans.

Contractual stays are an important method to mitigate risk in certain stress events. We believe that insurance SIFIs should not be required to exclude policy or contract features that reduce credit or market risk by providing an insurance company with the option to choose among alternative policy payment arrangements.

While we acknowledge that it may be appropriate to exclude certain stays from liquidity stress testing results(notably, stays that require regulatory action outside the insurer's control), we request that the Board not categorically exclude contractual stays that should be permitted to be included in liquidity stress testing, if based on appropriate assumptions, and credit- and market risk-mitigating product features, particularly with respect to institutional products that are an integral part of the products themselves, and which should be permitted to be used in stress testing in all cases. Additionally, while we agree that the traditional 6-month contractual delay incorporated in many traditional retail insurance products should not be incorporated in liquidity stress testing, we believe that they should be permissible in late-stage contingency funding plans as an alternative to reorganization.
We believe that adopting this nuanced approach to the incorporation of stays reflects the actual economic reality during a stress event and the effect of these various stays on an insurance SIFI's liquidity risks.

VII. Liquidity Buffer

The NPR sets forward liquidity buffer requirements, including the requirement that an insurance SIFI maintain a liquidity buffer sufficient to meet net cash outflows for 90 days

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[18] *Id.*, at 38619.

over the range of liquidity stress scenarios used in internal stress testing.[19] We appreciate that the Board proposed a 90-day period for the liquidity buffer to reflect differences in the insurance business model. However, we feel that further tailoring is important, specifically with respect to the assets that may be included in the liquidity buffer.

The exclusion of bank deposits from the liquidity buffer deprives insurers of the cash that they hold at banks, which is the very first line of defense against liability outflows. Similarly, investment-grade corporate debt is an extremely critical asset class for insurers, including SIFI insurers, and is relied on as a superior source of liquidity in the event of stress. We are concerned that the "high trading volume" criterion in the NPR's definition of "liquid and readily marketable" would inappropriately exclude some high quality corporate debt that is not actively traded yet could readily be sold if necessary. The exclusion of financial services obligations from the liquidity buffer reduces the universe of investment grade corporates by about 30%, which would inappropriately incease credit concentration of non-financial issuers in SIFI asset portfolios. We believe it is particularly inappropriate to exclude these three sources of liquidity.

As a general matter, whether an asset is included in the liquidity buffer can have a significant effect on capital markets and capital formation by disincenting investment in particular assets. In our view, both because of their actual level of liquidity and the effect on capital markets, we request that the Board consider expanding the universe of assets included. Specifically, we urge the Board to amend the NPR to permit the following to be included in the liquidity buffer: (1) bank deposits, (2) investment-grade corporate bonds (even if they do not have a "high trading volume"), (3) money-market fund shares, (4) investment grade structured assets, such as asset-backed and commercial mortgage-backed securities, (5) financial sector entity obligations, and (6) municipal revenue bonds. The current definition of assets that may be included is too narrow and we believe that expanding it to include the above-listed assets will reflect the liquidity of these assets, better reflect the insurance business model, and prevent unintended market dislocations.

VIII. Intraday Liquidity Risk Monitoring

The NPR requires an insurance SIFI to establish intraday liquidity monitoring only "if necessary for its business."[20] We support this approach and believe that intraday liquidity monitoring may not be useful or relevant to an Insurance SIFI's risk management framework. In our view, this reflects full tailoring to the insurance business model, and we urge the Board to preserve this approach in the final rule.

IX. Phase-in period

With respect to the phase-in period, we request that the Board to extend the generally applicable phase-in period to the first day of the thirteenth quarter following the effective

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[19] See Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610, 38629 (proposed June 14, 2016) (to be codified at 12 C.F.R. pt. 2525) (outlining § 252.165(b)).
[20] *Id.*, at 38628.

date of the final rule. This longer phase-in is necessary for all insurance SIFIs. However, we also note that any newly-designated SIFIs have a shorter lead-in period to prepare for the standards than original SIFIs prior to the Standard becoming official. The short phase-in period significantly raises the implementation cost of the standard versus the multi-year implementation schedule for most systems projects.

Alternatively, a shorter phase-in would be feasible if the Board accepts the tailoring to the NPR suggested in this comment letter and other industry comments, particularly with respect to cash flow projections and liquidity stress tests. Incorporation of these suggested changes would reduce the administrative and compliance burden to a degree that a shorter phase-in period would be appropriate. However, we would support a longer phase-in for newly designated SIFIs, even if the tailorings suggestions are accepted.

If the Board does accept our proposed changes, in our view a nine-quarter transition period strikes the appropriate balance between the need for implementation of the standards and the time and investment required by companies subject to the rule.

If the Board does not grant a general extension for the implementation of the standards in the NPR, then we request that the five-quarter transition period be extended for the cash flow projection and liquidity stress testing requirements, because those requirements will require the most significant investments in management information systems and infrastructure.

Conclusion

As described above, we appreciate the extent to which the NPR already reflects the insurance business model, and respectfully request that the Board consider our additional suggestions for tailoring. We appreciate your consideration of our comments and look forward to a continued dialogue as the rule is finalized.

Sincerely,

Bridget Hagan
Executive Director, The Insurance Coalition