AFR Americans for Financial Reform

September 28, 2016

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

RE: Capital Requirements for Supervised Institutions Significantly Engaged In Insurance Activities [Docket No. R-1539], Enhanced Prudential Standards for Systemically Important Insurance Companies [Docket No. R-1540]

To Whom It May Concern:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced Advanced Notice of Proposed Rulemaking (the "Proposal") and Request for Public Comments (the "Request") by the Federal Reserve Board (the "Board"). AFR is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. AFR includes consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

Insurance companies played a significant role in the 2008 financial crisis, both directly and indirectly. American International Group (AIG), the world's largest insurance group at the time, was at the epicenter of the crisis, and of course collapsed and required the largest government bailout in U.S. history. Monoline financial guaranty (bond) insurance companies and mortgage insurance companies also played a major role in the crisis and in some cases also collapsed.[2] While these links between the financial crisis and the insurance industry were well publicized, it is less well known that life insurance companies offering large amounts of variable annuities also took heavy losses and came under enormous financial pressure due to market-linked liabilities and the failure of their hedging strategies in stressed markets.[3] In some cases these pressures, and their intersection with regulatory capital requirements, led to fire sales that increased losses in

[1] A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Schich, Sebastian, "Insurance Companies and the Financial Crisis", OECD Journal, Financial Market Trends, Volume 2009, Issue 2, Organization for European Cooperation and Development, October, 2009. Available at http://www.oecd.org/finance/financial-markets/44260382.pdf
[3] McKinsey Consulting, "Responding to the Variable Annuity Crisis", McKinsey Working Papers on Risk, April, 2009; Du David Fengchen and Cynthia Martin, "Variable Annuities – Recent Trends and the Use of Captives", Federal Reserve Bank of Boston, October 7, 2014.

distressed markets.[4] Major life insurance companies also participated in TARP and various Federal Reserve emergency lending programs such as the commercial paper program.

This Proposal and the accompanying Request represent an important step in responding to the experience of the financial crisis and what it demonstrated concerning the systemic risks that can be posed by insurance companies. The Proposal lays out a broad and general approach to determining capital standards for insurance companies, while the Request lays out new risk management requirements for insurance companies designated as Systemically Important Financial Institutions (SIFIs) by the Financial Stability Oversight Council (FSOC). The broad and general nature of these releases indicates that they are only the first step in the Board's effort to lay out prudential requirements for insurance companies. We look forward to continued engagement with the Board on these issues.

The Liability Structures of Insurance Companies And Banks

A frequent issue raised in discussing the appropriate regulation of insurance companies as opposed to banks is the claimed difference between the liability structures of insurance companies as opposed to banks. Classically, banks fund long-term assets using short-term liabilities such as demand deposits. Furthermore, particularly since the end of Glass-Steagall and the increase in trading liabilities at banks, bank liabilities are often closely correlated with the risks of the broader financial system. In contrast, in the traditional insurance business, such as casualty insurance or classical forms of life insurance, liabilities would be expected to be long term and uncorrelated with broader financial system risks.

Where it actually holds, this distinction has important implications for appropriate regulation. When financial liabilities are genuinely long-term and their timing is unrelated to financial system stress, it can be appropriate to use them to finance investments in illiquid assets whose short-term value may be volatile or uncertain. Indeed, such a pattern can be beneficial to financial stability. As holders of long-dated liabilities that are naturally diversified, insurance companies may be the safest and most natural purchaser of assets in illiquid markets, and their investment activities would complement those of other financial entities that are more natural

[4] Acharya, Vidal and Matthew Richardson, "Is The Insurance Industry Systemically Risky?", Conference Paper for Brookings Institution Conference On Insurance Regulation, October 14, 2014, available at http://www.brookings.edu/~/media/events/2014/10/14-insurance-regulation/acharya_richardson_paper.pdf; Merrill, Craig B. and Nadauld, Taylor and Stulz, René M. and Sherlund, Shane M., Were There Fire Sales in the RMBS Market? (May 6, 2014). Charles A. Dice Center Working Paper No. 2014-09; Fisher College of Business Working Paper No. 2014-03-09. Available at SSRN: http://ssrn.com/abstract=2436887

purchasers of liquid assets.[5] It is appropriate for liquidity and capital requirements for insurance companies to reflect the long-term and diversified nature of traditional insurance liabilities.

However, this simplified picture of "traditional" insurance company liabilities is frequently inaccurate, and growing more so in the modern financial system. Business models at major insurance companies today often resemble business models at other financial intermediaries, in ways that can generate short-term, bank-like, liabilities and also create significant correlations with the rest of the financial system.

Some elements of these business models include:

1) Financial guarantees: Clearly, providing guarantees for the value of other financial or investment products creates a liability that is highly correlated with general systemic risk and likely to be drawn upon when the financial system is under stress. Financial guaranty products ranging from bond insurance to credit default swaps played a significant role in the financial crisis. The shift of life insurance business from traditional death benefits to annuity products that frequently link life insurance with investment products that guarantee returns linked to financial indices constitutes another form of financial guaranty product. Over two-thirds of life insurance reserves now support annuity products.[6] Other types of financial guarantees include Guaranteed Investment Contracts (GICs) sold to institutional investors and pension funds.

2) Other insurance products with high liquidity: Many insurance policies provide generous surrender conditions which can be used to cash out a policy, or permit cash value in a policy to be used as collateral for a loan. Such policies bear clear resemblances to deposit or checking accounts, which can provide on-demand liquidity. The use of life insurance as a savings and investment product which can provide short-term credit has a long history through a wide range of cash value products.

3) Securities lending and repurchase agreement transactions: Insurance companies of course hold massive inventories of tradeable securities, including some $4 trillion in bonds, which can be used as collateral in securities lending programs. Collateral received in securities lending can be reinvested in risky assets. Such collateral creates short-term liabilities, since in most cases counterparties have the right to reclaim their collateral on demand. If securities lending collateral is reinvested poorly, as occurred in the AIG case, then an insurance

[5] Persaud, Avinash, "How Not to Regulate Insurance Markets: The Risks and Dangers of Solvency II", April 14, 2015.
[6] American Council of Life Insurers, "Life Insurance Fact Book, 2015", American Council of Life Insurers, 2015.

company may find itself unable to meet counterparty demands for collateral. Indeed, the economics of securities lending, which permits the use of demand liabilities similar to deposits to invest in a wide variety of assets, enables a kind of financial intermediation strikingly similar to banking.[7]

4) Derivatives activities: While securities lending activity in U.S. insurers has not shown unusual growth, this is not true of derivatives exposures. Since 2010, derivatives notional value at U.S. insurers has grown at a 17% annual growth rate, and now exceeds $2 trillion.[8] Almost all of this exposure is concentrated at life insurance companies. The short-term liability exposure created by derivatives varies depending on the credit terms of the derivative and its relationship to other exposures at the company, but it can clearly be significant. Although most insurance company derivatives use is for the claimed purpose of hedging risk, these hedges tend to be imperfectly correlated with other company exposures and thus create independent risk.[9] Derivatives values are closely correlated with broader financial market volatility, and the heavy use of derivatives by insurance companies also creates interconnectedness with the largest banks that act as derivatives dealers.

5) Liabilities connected to risk transfers: In recent years insurance companies have made increasing use of so-called "captive reinsurance" as a mechanism of transferring liability risk to other jurisdictions, usually jurisdictions which offered more lenient reserve requirements that resulted in significant declines in reserves backing transactions.[10] In 2015, the National Association of Insurance Commissioners (NAIC) acted to increase regulation of these transfers somewhat and there is an expectation that a reduction in required reserves under "principles based reserving" will reduce the incentive for the use of captive reinsurance subsidiaries. However, the presence of possibly under-reserved liabilities that are guaranteed by the parent or by a letter of credit with a third party bank could create unexpected liquidity demands on the parent.

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[7] Cetorelli, Nicola, "Hybrid Intermediaries", Federal Reserve Bank of New York Staff Report 75, December, 2014.

[8] National Association of Insurance Commissioners, "Derivatives", NAIC and the Center for Insurance Policy and Research, September 7, 2016. However, this $2 trillion figure is a lower-bound estimate because it only includes derivatives held by U.S. licensed insurance subsidiaries and does not include derivatives held by overseas subsidiaries and non-insurance subsidiaries.

[9] Less than 10 percent of insurance company derivatives are classified as "effective" hedges according to NAIC accounting principles. National Association of Insurance Commissioners and the Center for Insurance Policy and Research, "Update on Insurance Industry's Use of Derivatives", Capital Markets Special Report, August, 2015.

[10] Vo, Lily D., "Issue Brief: Captive Reinsurance", August 12, 2016.

Finally, emerging forms of alternative risk transfer such as Insurance Linked Securities, Industry Loss Warranties, and Longevity Swaps, create even closer links between the capital market and derivatives markets and core insurance underwriting.

These and other examples show that it is a misleading oversimplification to simply assert that the liability structures of insurance companies differ fundamentally and necessarily from those of banks. It is true that 'traditional' insurance activities are quite different than banking, present different kinds of risks, and can appropriately be regulated differently. But insurance companies in the modern financial system can engage in many forms of intermediation that create risks much more similar to investment or deposit banking, and are deeply interconnected with the rest of the financial system. These facts, combined with the sheer size and scale of insurance company activities and the demonstration during the financial crisis that insurance companies can be major contributors to systemic risk, underline the importance of careful and nuanced regulation of insurance activities. As discussed below, the Federal Reserve's role as an entity that can provide oversight of insurance company activities on a consolidated basis can and should be an important part of this regulatory framework.

Capital Requirements for Supervised Institutions Significantly Engaged In Insurance Activities [Docket No. R-1539]

In this Proposal, the Board lays out two broad approaches to capital requirements for supervised insurance entities, the "building block approach" (BBA) and the "consolidated approach" (CA). The BBA relies on aggregating the capital and/or reserve requirements for each separate legal entity, as set by regulators in each separate jurisdiction, to arrive at an additive total of required capital. The CA calculates exposures on a consolidated basis and assigns multiplicative risk weights. We strongly support the Board's development of consolidated capital requirements for insurance companies, and would also support the use of these capital metrics as a basis for some form of stress testing. In the absence of the Board's initiatives in this area, major insurers do not otherwise have effective consolidated supervision.

But we are also concerned that proper implementation of the BBA is likely to be complex, challenging, and non-transparent when applied to larger insurance firms, including both larger insurance depository holding companies and firms designated as systemically important (SIFIs). Due to this complexity, we suggest that the Board consider using a simpler and more transparent method, such as the use of a floor based on the CA capital method, for all firms above a certain size, including larger insurance depository holding companies.

As the Board points out in the Proposal, there is significant variance between the treatment of insurance risk exposures in different jurisdictions, both internationally and within the United

States. For example, Iowa's decision to diverge from both Statutory Accounting Principles (SAP) and Generally Accepted Accounting Principles (GAAP) in its accounting for insurance reserves has led to insurance companies relocating operations to that state in order to take advantage of rules that permit massive reductions in reserves.[11] Iowa is just one example, as since 2002 there has been an apparent race to the bottom between different state regulators regarding regulatory rules governing risk transfer to 'captive insurance' subsidiaries, with over two dozen states adapting more permissive rules regarding such subsidiaries.[12]

Beyond these current explicit cross-jurisdictional divergences, the movement of U.S. insurance capital regulation to a "principal based reserving" (PBR) model indicates that divergence will only grow, and will also become less transparent and more difficult to oversee. Much like the Basel II system of internal model based capital charges, the PBR model relies on internal assessments of risk made by each company.[13] This self-regulatory approach carries significant dangers. As demonstrated by the findings of the Basel Regulatory Consistency Assessment Program (RCAP), internal model based methodologies vary widely depending on the implementation by each regulator, for reasons that can be complex and opaque.[14] So the move to a PBR system will make it still more difficult to ensure consistency across jurisdictions, or even across companies within a single jurisdiction.

The Proposal suggests that differences across jurisdictions in the stringency of capital requirements and the accompanying regulatory arbitrage will be addressed through the selection of appropriate "baseline" capital measures in each jurisdiction and then the application of "scalar" multipliers to account for differences in supervisory stringency. Furthermore, the Proposal contemplates using a consolidated definition of aggregated capital even as an input into the BBA, to account for cases where equity investments in subsidiaries are funded through borrowing in other areas of the holding company.[15] This would appear to blur the distinctions between the BBA and CA approaches.

Given the potential opportunities for arbitrage offered by a simple aggregated BBA we strongly favor these adjustments to subsidiary-level capital metrics in order to address arbitrage concerns.

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[11] Foley, Ryan, "Iowa At Center of Debate Over 'Shadow Insurance' Deals", Des Moines Register, August 30, 2016.

[12] Koijen, Ralph and Motohiro Yogo, "Shadow Insurance" Federal Reserve Bank of Minneapolis, Staff Report 505, May, 2016.

[13] Weber, Robert F, "Combatting the Teleological Drift of Life Insurance Solvency Regulation: The Case for a Meta-Risk Management Approach to Principles Based Reserving", 8 Berkeley Business Law Journal 35, 2011.

[14] Basel Committee on Banking Supervision, "Regulatory Consistency Assessment Program – Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book", April 2016.

[15] "To address the limitations of a simple BBA, the Board is considering adopting a version of the BBA that would determine an institution's aggregate qualifying capital position on a uniform consolidated basis" – CFR 38635

Indeed, the BBA would not be a good guide to the overall risk of an insurance organization without such adjustment.

However, the extensive use of jurisdiction-specific scalars and other adjustments will tend to make the BBA at least as complex as the CA and possibly much less transparent. An approach that follows recent practice in bank capital regulation by flooring the BBA capital at the level of capital determined under the CA approach would seem to be simpler and offer more transparent safeguards against levels of capital that are too low. An approach in which capital estimated using the BBA approach could not fall below capital estimated using the CA approach, particularly for larger and more complex insurance firms, would mirror the structural role of the standardized approaches in bank capital regulation, even as the specific capital metrics used would be tailored to the specific risks of insurance companies.

We would also strongly oppose using any capital approach that uses a simplified BBA which is vulnerable to regulatory arbitrage on the basis of limiting the use of the BBA to insurance depository holding companies that have not been designated as SIFIs. Especially since only a few of the very largest insurers are designated as SIFIs, the collective activities of non-SIFI insurers can pose significant risks.[16] The Board's jurisdiction over insurance depository holding companies is not an accidental or insignificant adjunct to state regulation, but is instead based on the importance of proper consolidated regulation of large holding companies that combine a wide range of financial activities. While it would be reasonable to scale the complexity or of the capital approach to the size of the firm, drawing a sharp line between SIFIs and all other insurance depository holding companies would be inappropriate.

In terms of the use of the CA, we support the following general recommendations:

- The CA should clearly reflect and incorporate the risks of derivatives and other off balance sheet exposures, either through capital add-ons or consolidation of exposures. Reduction in derivatives exposures due to hedging should be carefully controlled.

- The CA should segment risks based on distinctions between conventional insurance risks, which have genuinely long-dated liabilities less correlated with general financial system stress, and other types of financial risks, including insurance risks connected with financial guarantees. So long as the actual nature of liabilities is fully understood, aligning capital regulation with the nature of liabilities can be conducive to financial stability by matching less liquid assets with less liquid liabilities. It would be appropriate to explore forms of capital regulation which encouraged such matching, as suggested by

[16] Schwarcz, Daniel and Schwarcz, Steven L., "Regulating Systemic Risk in Insurance", University of Chicago Law Review, Vol. 81, No. 4, 2014; Minnesota Legal Studies Research Paper No. 14-18, December 30, 2014.

scholars such as Avinash Persaud.[17]

The CA approach should preserve the principle that accounting practices for insurance companies should be inherently conservative.. Statutory accounting for insurance companies is designed to be more conservative than GAAP accounting, in order to reflect the primacy given to solvency concerns in insurance regulation.[18] While it may be reasonable to diverge from the SAP approach in particular cases, the fundamental principle that insurance company accounting should be more conservative and less aggressive than GAAP accounting should be preserved.

Enhanced Prudential Standards for Systemically Important Insurance Companies (SIFIs)

This Request for Public Comment lays out the application of a number of risk management requirements to designated insurance SIFIs, defined as companies designated as systemically important by the Financial Stability Oversight Committee which have over 40 percent of their total consolidated assets related to insurance activities. These risk management requirements include an independent risk committee, liquidity risk management including regular liquidity stress testing, collateral monitoring, and legal entity level liquidity monitoring.

We support all of these requirements. With regard to the specific requirements for liquidity stress testing and management, we support the restriction that companies cannot assume that mandated payments to consumers can be delayed for the purposes of liquidity stress testing, even if such the insurance contract or the state regulator permits such stays. We agree that the reputational harm from such stays is such that they should not be assumed in a stress test.

The 90 day liquidity buffer outlined in the Request is considerably looser than the total liquidity requirements applying to banks, both in terms of the absence of longer-term liquidity requirements such as the Net Stable Funding Ratio and in terms of the range of assets permitted in liquidity buffer holdings. We agree with the Request that this is generally appropriate due to the nature of overall insurance company liabilities. However, given the relatively small number of insurance SIFIs and the extensive liquidity information generated through the multiple scenarios required as part of risk management, we hope that regulators will address any need for stronger liquidity buffer requirements as part of the supervisory process.

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[17] Persaud, Avinash, "How Not to Regulate Insurance Markets: The Risks and Dangers of Solvency II", April 14, 2015.

[18] National Association of Insurance Commissioners and Center for Insurance Research and Policy, "Statutory Accounting Principles", CIRP Brief, May 5, 2016. http://www.iii.org/publications/commercial-insurance/how-it-functions/financial-reporting

Thank you for the opportunity to comment on this Proposal. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,
Americans for Financial Reform