The Cypress Group

September 16, 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: Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (RIN 7100-AE 53; Docket No. R-1539)

Dear Mr. Frierson:

I write on behalf of The Insurance Coalition, a group of federally supervised insurance companies 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 as insurance SLHCs or insurance SIFIs, many Insurance Coalition members would be directly affected by the capital rules for insurance companies supervised by the Federal Reserve Board ("the Board")[1] that are the subject of the advanced notice of proposed rulemaking ("ANPR") issued by the Board in June. We also support the comments of our member company trade associations, including the American Council of Life Insurers ("ACLI") and the Financial Services Roundtable ("FSR").

We greatly appreciate the open, deliberative process conducted by the Board in advance of the release of the ANPR. Given the long history of state supervision of insurance companies, and the fact that the Board is developing the first-ever federal capital framework for insurers, this thoughtful process is critical to ensuring that federal rules complement rather than disrupt the state regulatory system.

General Principles

While our more detailed comments follow below, we also believe that any federal capital framework should adhere to certain core principles, reflecting the congressional intent in the Wall Street Reform and Consumer Protection Act[2] and the Insurance Capital Standards Clarification Act ("ICSCA"),[3] as well as sound regulatory policy principles more broadly.

First and foremost, we support robust capital standards that reflect the insurance business model and serve the primary goal of protecting our customers. Because insurance companies provide American families with protection from financial risks, financial strength is the core of our business model.

[1] Capital Requirements for Supervised Institutions Engaged in Insurance Activities, 81 Fed. Reg. 38631 (June 14, 2016).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[3] Insurance Capital Standards Clarification Act of 2014, Pub. L. No. 113-279, 12 U.S.C. § 5371 (2014).

We also agree with and appreciate the Board's analysis of other international capital frameworks, including Solvency II. We support the principle that the federal capital framework should be designed to avoid artificial volatility and pro-cyclicality.[4] We also appreciate the Board's desire to ensure that any federal capital framework is tailored to the US insurance business model. Given that international conversations on global capital standards are ongoing, it is important to note that we believe that the right outcome for US insurers and our customers is for the capital framework ultimately adopted by the Board to fully reflect the domestic US insurance business model. Of the frameworks considered by the Board, we believe that the BBA best achieves this goal.[5]

Another core principle that we believe should inform the final capital framework adopted by the Board is that the state regulatory regime should not be disrupted. This is consistent with the preservation of the state regulation of insurance in the Dodd-Frank Act, and with the intent of Congress in enacting the ICSCA. We believe strongly in the efficacy of state insurance regulation, including the state risk-based capital ("RBC") regime. The state RBC system has proven effective in preserving the safety and soundness of insurance companies while at the same time achieving policyholder protection. Moreover, the RBC regime is constantly being updated to take appropriate account of changes in insurance products and markets. We believe that incorporating the state RBC system serves the Board's insurance supervisory goals and avoids disruption of the competitive landscape. Relatedly, we feel that any federal capital framework should reflect the ICSCA mandate to preserve the state accounting regime for ISLHCs, and we appreciate that the ANPR does so.

These principles inform our more detailed comments on the ANPR, which are laid out below.

I. The BBA is Appropriate for All Federally Supervised Insurers

The ANPR sets forth two distinct capital frameworks for federally supervised insurers: the Building Blocks Approach ("BBA") and the Consolidated Approach ("CA"). The BBA would aggregate available and required capital for legal entities within an insurance enterprise (subject to certain adjustments) to determine an insurance group's aggregated qualifying and required capital. The CA, by contrast, would apply risk weights to segmented insurance assets and liabilities to determine required capital for a consolidated insurance enterprise, which would be compared to a consolidated definition of qualifying capital.[6]

The ANPR asks for input on the appropriateness of these frameworks for insurance SLHCs and insurance SIFIs, and suggests that the BBA is appropriate for insurance SLHCs and the CA is more appropriate for insurance SIFIs.

We respectfully suggest that the BBA is an appropriate framework for both insurance SLHCs and insurance SIFIs on a permanent basis. Through a well-defined aggregation

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[4] See Daniel K. Tarullo, Governor, Fed. Reserve Sys., Speech at the National Association of Insurance Commissioner's International Insurance Forum, Washington, D.C.: Insurance Companies and the Role of the Federal Reserve para. 18 (May 20, 2016) (showing Governor Tarullo's comments on Solvency II).

[5] While not all Insurance Coalition companies would be directly subject to international group capital standards, we believe this strongly as a matter of public policy and it reflects a common principle of the group.

[6] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (proposed June 14, 2016) (to be codified at 12 C.F.R. ch. 2).

process with appropriate adjustments and scalars, the BBA framework can be appropriately applied to any institution regardless of size, ownership type (e.g., mutual or stock), corporate structure, breadth of business, countries of operation or any other distinguishing attributes. Even if a CA is developed, the Board should have discretion to determine that the institution could proceed to calculate its group capital requirements under the BBA.

As noted above, the BBA avoids disruption of the state insurance regulatory regime, which has long been the basis for insurance regulation, an approach that is enshrined by Congress in the McCarran-Ferguson Act.[7] In enacting the ICSCA, Congress sought to ensure that federal rules for insurers complement rather than disrupt the state regulatory regime.

In addition, the Board's stated supervisory objectives in establishing a capital framework for insurance SIFIs include ensuring "that the institution has sufficient capital…to absorb losses and continue operations as a going concern..." and "to substantially mitigate any threats to financial stability that the institution might pose."[8] While we disagree that insurance SIFIs pose systemic risk, we believe that the BBA, as applied to SIFIs, meets the Board's stated policy goal.

The BBA relies on the solvency regimes in place for each legal entity in a federally supervised insurance enterprise, and includes the use of adjustments and scalars to ensure consistency and comparability of capital across regimes. We believe that the combination of appropriate adjustments and scalars in the BBA will effectively mitigate the potential for regulatory arbitrage noted in the ANPR, because the Board can address any observed arbitrage through additional adjustments or through recalibration of scalars. Additionally, we believe that the BBA should also be considered in the context of the full panoply of the Board's supervisory tools under the Dodd-Frank Act. Those other tools provide mechanisms, in addition to the capital requirements, that the Board can employ to ensure the solvency of companies under its supervision.

We further support the BBA because it addresses all material non-insurance subsidiaries through reliance on existing capital regimes (e.g., Basel III for depository institutions) or by assigning an appropriate capital regime based on the nature of the entities operational purpose.

The BBA Reflects the Intent of Congress in Enacting the Insurance Capital Standards Clarification Act

In addition to the policy reasons for supporting the BBA, the framework has the benefit of fully reflecting the intent of Congress. In 2014, Congress enacted ICSCA to make it clear that the Board had the flexibility to and should tailor capital standards to the business of insurance. The intent of Congress is clear from the plain language of the statute and the legislative history. As an original sponsor of the Senate legislation noted before the bill's enactment:

> The bill clarifies that, in establishing the minimum leverage capital and risk-based capital standards under section 171, the Federal Reserve Board is not required to include activities or companies that are engaged in the

[7] 15 U.S.C. §§ 1011-1015 (1945).

[8] 12 C.F.R. ch. 11, p. 38631, Vol. 81, No. 114, June 14, 2016.

> business of insurance and are subject to State insurance regulation, including State insurance capital requirements. Similarly, regulated foreign affiliates or subsidiaries engaged in the business of insurance and subject to foreign insurance regulation and foreign insurance capital requirements that have not been deemed to be inadequate also may be excluded from section 171 capital standards. We believe it is worth noting that the Government Accountability Office found that the State risk-based capital rules performed well during the financial crisis.
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> The bill allows the insurance capital requirements that have been effective [State risk-based capital] to continue to determine the capital requirements for the activities of insurance companies and groups that are supervised by the Federal Reserve Board.[9]

It is also noteworthy that House sponsors expressed similar views regarding the aims of the ICSCA, further emphasizing the legislative unanimity around the bill.[10] We believe that the BBA best reflects the intent of Congress because it incorporates a well-tested capital framework that is tailored to the business of insurance – the state RBC system. The state RBC framework was designed specifically for insurers and is risk-sensitive. Importantly, it also reflects differences among different types of insurers and product lines, including separate frameworks for life and property / casualty companies.[11]

Only the BBA Can be Implemented in the Short- to Medium-Term

In describing the principles underlying the ANPR, the Board notes that "the [capital] framework also should be executable in the short-to-medium term."[12] We agree with this conclusion, because, among other reasons, long-term lack of clarity regarding capital requirements does not serve the interests of the insurance industry or policyholders. To that end, we support the BBA over the CA, because only the BBA can be implemented in the short- to medium-term. The CA is an entirely new capital framework not based on any existing framework. As such, it would require the development of detailed and sophisticated risk weights for assets and liabilities, and significant and complicated adjustments to GAAP, to adequately reflect the true risks in insurance companies. Such a framework would either be insufficiently risk-sensitive if adopted in the short-term, or if adequately detailed and risk-sensitive, would likely take too long to develop to meet the goal of being adopted on a reasonable time frame. In our view, the BBA could be adopted in the short-term.

The BBA is Preferable to Other Capital Frameworks

We also appreciate that the BBA reflects the policy goal of establishing a federal domestic capital standard for insurers before international agreements are finalized. This is critical from a policy perspective, because it will ensure that international agreements do not inappropriately tie the Board's hands in its development of an appropriate federal capital standard for insurers. We also agree with and appreciate the Board's sensitivity to the fact that

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[9] 160 Cong. Rec. 6530 (2014) (joint statement of Sen. Collins, Sen. Brown and Sen. Johanns).
[10] 160 Cong. Rec. 1796 (2014) (statement of Rep. Gary Miller); *see also* 160 Cong. Rec. 7512 (2014) (statement of Rep. Carolyn McCarthy) (showing Rep. McCarthy's support for the legislation).
[11] NAT'L ASS'N OF INS. COMM'RS' & THE CTR FOR INS. POLICY AND RESEARCH, RISK-BASED Capital para. 4 (2016).
[12] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631, 38633 (proposed June 14, 2016) (to be codified at 12 C.F.R. ch. 2).

there are significant issues with international standards in development that must be addressed before they are finalized. Specifically, we agree with Governor Tarullo that Solvency II would create volatility by reliance on mark-to-market accounting standards. To the extent that international capital standards rely on mark-to-market accounting, like Solvency II, they will create significant volatility that does not reflect the true capital condition of supervised insurers; also such standards do not reflect the long term nature of insurance liabilities and the reality that many assets are held to maturity.

II. The Building Blocks Approach – Additional Comments

The 25 % of Assets Test is Appropriate but Should be Clarified

The ANPR asks whether the appropriate test for the application of the insurance-centric capital framework is whether the supervised entity is "significantly engaged in insurance activities" as defined in Regulation Q. This approach would subject a supervised entity to insurance-centric capital requirements if it holds 25 percent or more of its total consolidated assets in insurance underwriting subsidiaries (other than assets associated with insurance underwriting for credit risk).[13] We believe that the Regulation Q test is appropriate to determine application of an insurance-centric capital framework to both insurance SLHCs and insurance SIFIs.

We note that Regulation Q also includes "a top-tier SLHC that is an insurance underwriting company" in its explanation of institutions that are excluded from application of Regulation Q because they are insurance SLHCs. Certain insurance SLHCs have their largest insurance underwriting company as the top-tier entity in organization. Therefore, we would recommend that the Board clarify that the BBA would apply to Insurance SLHCs where (1) the top-tier holding company is an insurance underwriting company, or (2) the top-tier holding company holds 25% or more of its total consolidated assets in subsidiaries that are insurance underwriting companies (other than assets associated with insurance for credit risk). In the alternative, the 25% threshold should not be limited to assets held in "subsidiaries." Rather, it should indicate the following: the top-tier holding company holds 25% or more of its total consolidated assets in insurance underwriting companies.

The above test is an appropriate method of distinguishing between supervised entities whose insurance operations are incidental to other operations, versus those for whom insurance is a core function.

Consolidation of Qualifying Capital

The ANPR describes two versions of a BBA framework, one in which the definition of qualifying capital varies according to local solvency regimes, and one in which the Board would apply a single, uniform definition of qualifying capital. The Board identifies a concern with "double leverage" as animating consideration of a uniform definition of qualifying capital.[14]

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[13] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (proposed June 14, 2016) (to be codified at 12 C.F.R. ch. 2).

[14] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631, 38635 (proposed June 14, 2016) (to be codified at 12 C.F.R. ch. 2) (showing Senator Miller's support for and urging of Congress to pass the ICSCA).

A key virtue of the BBA is its reliance on local solvency regimes. As discussed above, we believe that in doing so, the BBA reflects the will of Congress and meets the Board's supervisory goals. We believe use of a uniform definition of qualifying capital would be problematic because it would not adequately address the differences in asset valuation or liability conservatism in the varying underlying accounting regimes. We believe that summing and scaling as appropriate available capital for each legal entity is the most appropriate approach to ensure alignment with the required capital component of the BBA and a coherent group solvency ratio. In our view, the appropriate course is to sum and appropriately scale qualifying capital, and we strongly agree with the comments of the ACLI in this regard.

Compliance Date and Reporting

As detailed above, one of many reasons we support the BBA is its ability to be implemented relatively quickly. We also believe that pursuant to sound supervisory practices generally and Section 10(b)(2)(B) of HOLA, in implementing the BBA the Board should rely to the fullest extent possible on existing supervisory reports and readily accessible data.[15] However, certain aspects of the BBA will necessarily require some time for companies to adapt to, including, inter alia, the identification of legal entities, the local capital regime that applies to such entities, and calculation of qualifying capital, required capital, and application of scalars. We recommend a minimum of twelve months for companies to comply with the BBA after the rule is made final. Additionally, we recommend that the aggregated group solvency ratio be calculated and reported to the Board on an annual basis, to be coordinated with other related regulatory reporting, including RBC required reporting.

III. The Consolidated Approach – Additional Comments

For the reasons described above, we believe that the BBA is appropriate for both insurance SLHCs and insurance SIFIs. Because it relies on legal-entity-level solvency regimes already in place, the BBA could be developed relatively quickly. We believe that the CA should not and cannot be developed quickly, because of the complexity of the task of developing a capital framework "from scratch" and the need to adequately tailor the CA to the business of insurance. Thus, we urge the Board to consider adopting the BBA for all federally supervised insurers

If the Board nevertheless chooses to adopt the CA for insurance SIFIs, we urge that sufficient time be taken to fully understand the operation of the framework. In addition to continuing the open, transparent process of engagement with all stakeholders, we urge the Board to consider a quantitative impact study ("QIS") or some other appropriate mechanism to gather additional data regarding the operation of the CA before the framework is finalized.

Fungibility of Capital

We also have concerns that the CA framework may assume full and free fungibility of capital among parent, subsidiaries and affiliates of regulated groups. As the Board is aware, state insurance regulation is legal-entity-focused with strict oversight and required regulatory review of all material inter-affiliate transactions. We acknowledge the Board's mandate to ensure that savings and loan holding companies can act as a

[15] *See* 12 U.S.C. 1467a(b)(2)(B).

source of strength to depository institutions within an enterprise, and the Board's mandate to address systemic risk within nonbank SIFIs. However, these mandates must be implemented in a manner consistent with the state legal-entity-based, policyholder-protection-focused system. In the case of ISLHCs, Congress has acknowledged this, and by upholding McCarran-Ferguson Act as the controlling federal law, reaffirms that regulation of state incorporated insurance entities remains as the primary regulatory structure for ISLHCs. Specifically, the Policyholder Protection Act[16] requires that the state insurance supervisor approve movement of capital from an insurance subsidiary to act as a source of strength to an insured depository institution within an ISLHC.

We believe that an aggregated approach is also appropriate for insurance SIFIs and the BBA best captures the true solvency picture of an insurance enterprise by recognizing and utilizing the legal entity capital for aggregation. In our view the BBA approach, which provides insights on the viability of each legal entity as well as the consolidated group, is preferable to an approach such as the CA that addresses solvency on a holding company basis without explicit reliance on the capital requirements of and available capital in operating subsidiaries. We believe that the BBA avoids any tension between the Board's supervisory goals and the state risk-based capital system, without compromising either set of objectives.

IV. Integration of Domestic Framework with International Regulatory Developments

As noted in the discussion of our core principles above, we believe that an important policy goal underpinning the ANPR and Board involvement in international conversations is the need to promote US interests in global regulatory developments. To that end, we believe that the BBA can be adopted domestically and promoted internationally as meeting stated international regulatory goals of achieving comparable outcomes across jurisdictions. We appreciate the Board's sensitivity to the need to advocate on behalf of US interests and the US regulatory framework in international insurance regulatory conversations, and we look forward to continued dialogue on how the capital framework under development can be integrated into ongoing international conversations.

V. Conclusion

Again, we strongly support robust capital standards, and greatly appreciate the open, thoughtful process that preceded the ANPR. For the reasons described above, we support the BBA as the optimum framework for federally supervised insurers, and we look forward to a continued dialogue as the Board develops their subsequent Notice of Proposed Rulemaking.

Sincerely,

Bridget Hagan

Bridget Hagan
Executive Director, The Insurance Coalition

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[16] Policyholder Protection Act of 2015, H.R. 1478, 114th Cong. (2015).