

**Meeting between Governors Powell and Stein and
Representatives of MetLife, Inc. (MetLife)
July 9, 2013**

Participants: Governor Jerome H. Powell, Governor Jeremy C. Stein, Scott Alvarez,
Connie Horsley (Federal Reserve Board)

Steven Kandarian, John Hele, Heather Wingate (MetLife)

Summary: Representatives of MetLife met with Governor Powell, Governor Stein, and Reserve Board staff to discuss the company's views on an alternative regulatory framework for assessing the capital adequacy of insurance companies in the context of insurers that could be designated by the Financial Stability Oversight Council for supervision by the Board. More specifically, as an alternative to the Basel framework, the MetLife representatives discussed their proposed aggregated activities-based approach as described in the attached document that was distributed.

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Alternative Framework to Basel for Insurance Companies

July, 2013

Preface

- This document addresses solvency frameworks for SIFI-designated insurers
- However, we continue to emphasize that traditional life insurance generally does not pose systemic risk
- Naming just a handful of companies as SIFIs is not the best approach to regulating potentially systemic activities of insurers
- Because we recognize the possibility that FSOC may designate one or more insurers as non-bank SIFIs, we have prepared this outline of a regulatory regime for insurers that could be workable
- Oliver Wyman and Promontory have helped to develop and flesh-out the proposals laid out in this document

Introduction

- Over the course of several meetings, regulators and lawmakers have requested input on capital adequacy frameworks for insurers as an alternative to the Basel framework prescribed under the US Basel III Final Rule
- To develop an alternative framework, we first laid out a set of principles for a capital regime for insurers
- We evaluated the proposed Basel approach for insurers (considering potential enhancements) against these criteria – and ultimately concluded that the Basel approach is a poor fit
- We propose an alternative framework – an “aggregated activities-based approach” – that approximates a consolidated view of capital adequacy by summing available and required capital across all activities utilizing the existing capital regimes
 - Extends and enhances the Group Supervision approach already in place in Europe

Sensible principles for an effective regulatory capital regime

- 1** Tailored and calibrated to the activities of the institution

- 2** Ensures sufficient capital to protect solvency even in severe stress

- 3** Comprehensively captures entities and risks

- 4** Provides a basis for comparison among banks, insurers and other financial institutions

- 5** Can feasibly be implemented – requires minimal adjustments, none of them complex



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Evaluation of the Basel approach for insurers

Basel framework as applied to insurers falls short of the key principles

Design principle	Assessment
1 Tailored and calibrated	<ul style="list-style-type: none">• Designed and calibrated for banks, not insurers• Insurers have different risk and liquidity profiles
2 Ensures sufficient capital, even in severe stress	<ul style="list-style-type: none">• Basel ratios do not measure current constraints<ul style="list-style-type: none">– Insurance operating entities– Insurance holding companies• Basel ratios can generate “false positive” or “false negative” solvency indicators
3 Comprehensive	<ul style="list-style-type: none">• Covers all legal entities via consolidation but fails to capture liability oriented risks
4 Comparability	<ul style="list-style-type: none">• Comparable <i>in form</i>, but <i>not in substance</i>
5 Feasible implementation	<ul style="list-style-type: none">• Significant adjustments necessary to tailor for insurers

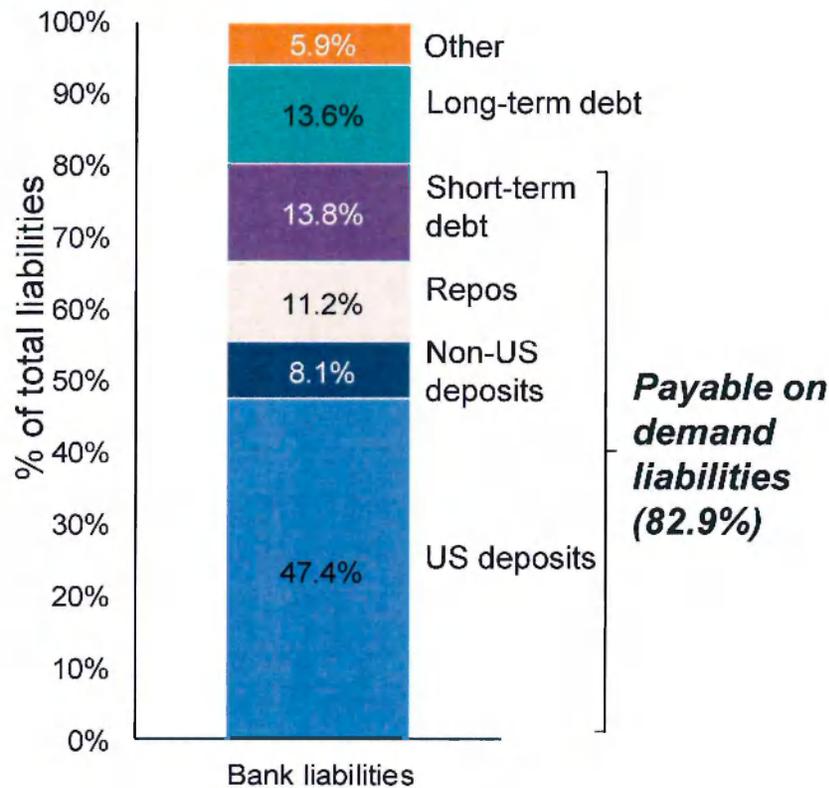
■ Critical issues; discussed in following slides

Significant differences between risk profile and solvency of banks and insurers

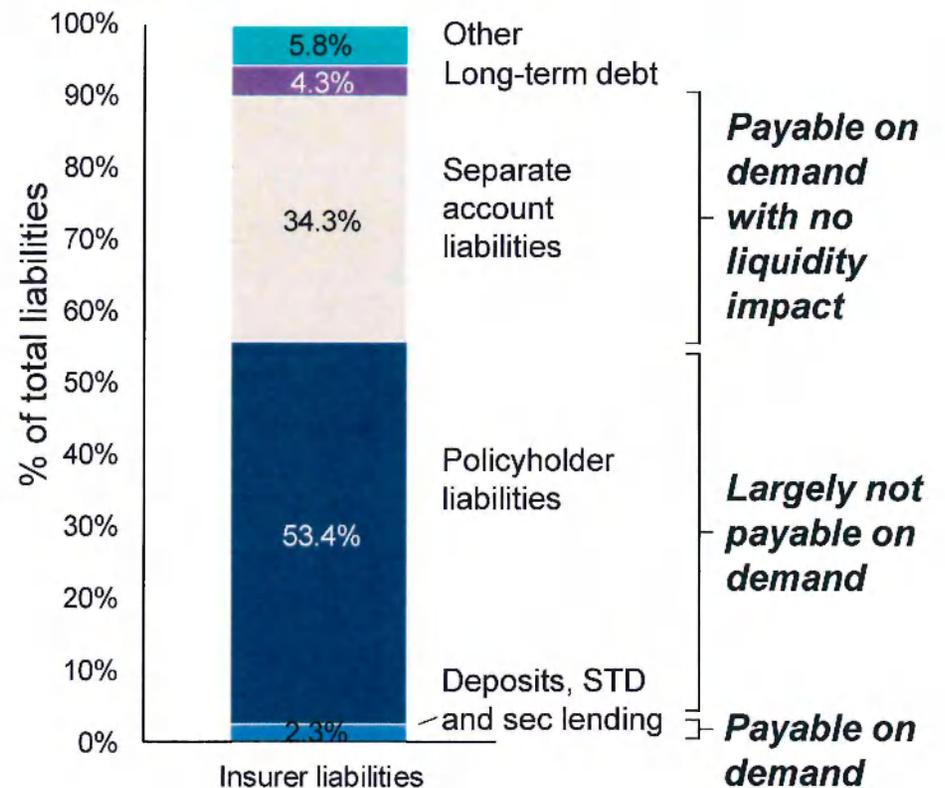
	Banks	Insurers
Liability profile	<ul style="list-style-type: none"> • Deposits and short-term debt 	<ul style="list-style-type: none"> • Insurance policies
Pattern of failure	<ul style="list-style-type: none"> • Institution fails at “tipping point” when depositors/markets lose confidence – even when capital is ultimately sufficient 	<ul style="list-style-type: none"> • Failure occurs over a protracted period due to small proportion of liabilities payable on demand • Insurers with significant non-traditional insurance activities may have bank-like failures
Regulatory accounting and capital requirements	<ul style="list-style-type: none"> • Liability par values well known • Failures driven by asset losses • Asset risk-focused capital regime 	<ul style="list-style-type: none"> • Value of liabilities difficult to measure • Failures driven by assets, liabilities, or ALM • Capital regime with broader coverage

Insurers are far less reliant on short-dated funding

Banks – sources of funding¹
Q4 2012



Insurers – sources of funding²
Q4 2012



1. Dollar-weighted average for Bank of America, Wells Fargo, Citigroup, Morgan Stanley, JP Morgan; Source: SNL, 10-K filings

2. Dollar-weighted average for AIG, MetLife, Prudential, Hartford, Lincoln and Principal; Source: SNL, 10-K filings

STAT accounting and insurance regulatory capital assess solvency in a way that GAAP/Basel for insurers do not

	GAAP (Basel) assessment "Shareholder perspective"	Statutory B/S (RBC) assessment "Policyholder/debtholder perspective"
Available capital	<p>Focus</p> <ul style="list-style-type: none"> • Timing of earnings profile <p>Example: embedded options / guarantees</p> <ul style="list-style-type: none"> • Some products: full capture of mark-to-market value • Others: guarantees reflected on an accrual basis 	<ul style="list-style-type: none"> • Solvency under conservative reserving principles • Comprehensive capture by reserves through cashflow testing – shortfalls in spread require reserve increase
Required capital	<p>Focus</p> <ul style="list-style-type: none"> • Assets <p>Example: ALM risks</p> <ul style="list-style-type: none"> • Not captured for general accounts/banking book <p>Example: P&C risks</p> <ul style="list-style-type: none"> • Not captured 	<ul style="list-style-type: none"> • Assets, Asset-Liability Matching, Mortality/Morbidity and Property and Casualty risks • Captured through extensive stress testing of ALM position • Captured through quantification of underwriting risk

Fails to comprehensively capture and tailor risks for insurers

Determines solvency and ability to operate as going concern

False negatives

Example

Scenario <i>(empirical)</i>	<ul style="list-style-type: none"> • Select leading life insurers (excluding AIG) during 2008 financial crisis
Solvency Assessment using Basel ratios	<ul style="list-style-type: none"> • <i>Result = “False negative”</i> • If Basel III was fully implemented in 2008, Tier 1 common capital ratios for life insurers would have been significantly below the pre- and post-stress minimum capital ratios
Actual financial strength and performance	<ul style="list-style-type: none"> • RBC ratios of insurance companies dipped but still indicated that the insurers were financially healthy ➤ Market focus was largely around “stressed” RBC ratios, consistent with proposed aggregated activities based approach • Insurers continued to write new business with ongoing positive net flows and continued access to markets



Insurance subsidiaries of some select leading US life insurers continued to write large volumes of new business and benefited from a “flight to quality”

False positives

Example

Scenario <i>(hypothetical)</i>	<ul style="list-style-type: none">• Insurer with a mismatched interest rate position• Persistently low and declining interest rates
Impact to Basel ratios	<ul style="list-style-type: none">• <i>Result = “False positive”</i>• Available capital can be overstated: embedded guarantees in General Account not captured under GAAP• Basel ratios improve: Fixed income assets appreciate while insurance liabilities are unaffected
Impact to RBC ratios	<ul style="list-style-type: none">• <i>Result = insurer fails test</i>• Statutory requirement to post capital and increase reserves upfront: Stochastic cashflow testing assesses the runoff profile of assets and liabilities

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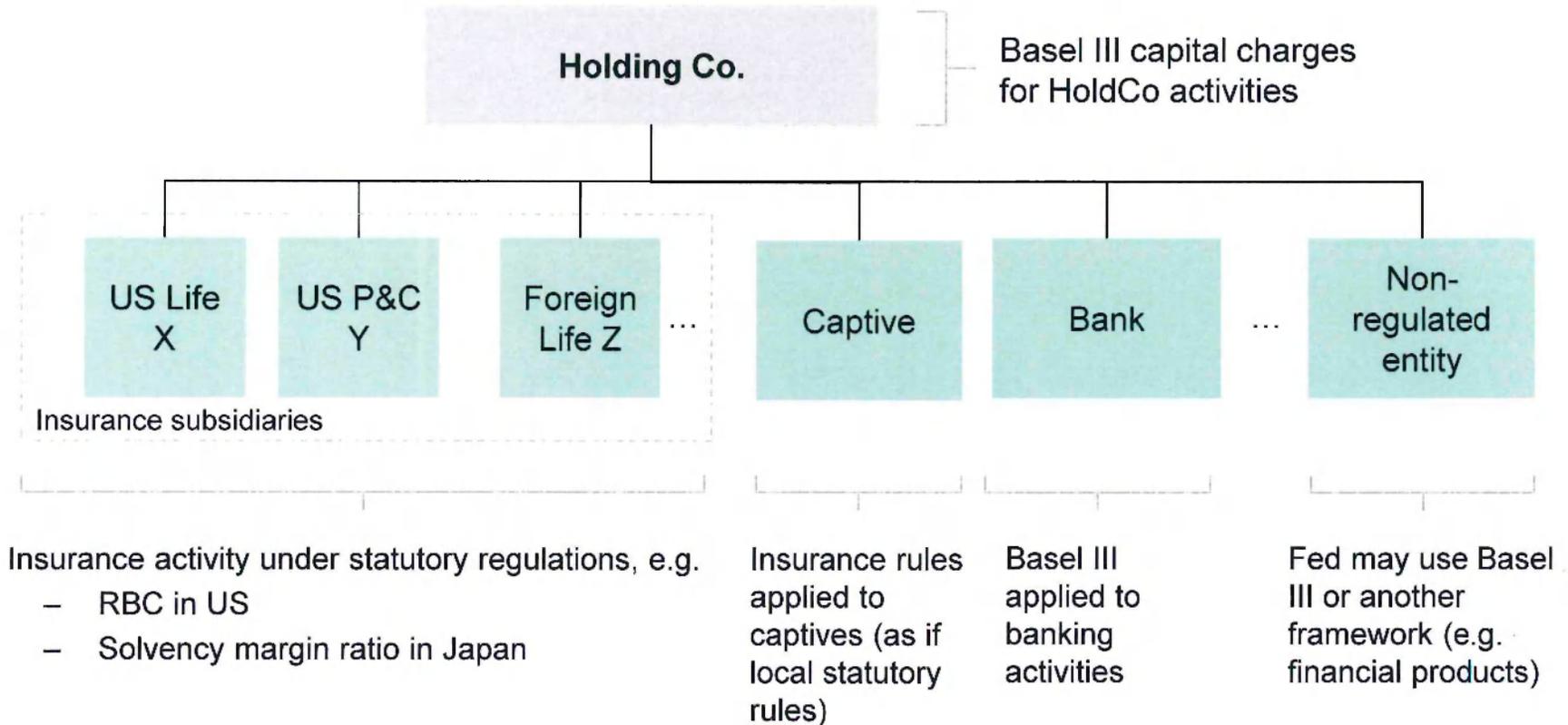
In some stress scenarios Basel capital ratios will look “good”, even in cases where impact of stress is severe and negative; RBC ratios better reflect reality

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Description of the alternative approach

Local regulatory rules are applied to each entity within the aggregated activities-based approach



Comprehensively addresses all activities using most tailored rules

Summary of proposed approach (hypothetical)

Worked example

- 1 Sum the available and required capital for each subsidiary**

US Insurance entities Required capital: 100 Available capital: 500
Non-US Ins. entities Required capital: 100 Available capital: 500
Other subs (e.g. Asset management) Required capital: 100 Available capital: 200
=
Total Required capital: 300 Available capital: 1200

- 2 Adjust for holding company double leverage and capital requirements**

Unconsolidated holding company balance sheet	
Assets	Liab. and equity
Assets: 300	Sub. debt ¹ : 200
	Other debt: 500
	Total debt: 700
	Total equity: (400)
	Preferred stock ² : 100
	Total common eq.: (500)

- 3 Determine aggregated activities based capital ratio**

Aggregated activities-based capital ratio	
Required capital: 300	
Tier 1 com: 1200 – 500 = 700	
Tier 1 total: 800	
Total capital: 1000	
Tier 1 common = 233%	
Tier 1 = 266%	
Total = 333%	

- 4 Stress test aggregated capital ratio**

Tier 1 com. = 180%
Tier 1 = 213%
Total = 280%

Challenges to implementation

- A. Equivalency of capital measures** across the regulatory regimes (e.g. US RBC vs. Japan solvency margin ratio)
- B. Calibration of capital thresholds** to ensure comparability across banking, insurance and other holding companies

1. Tier 2 instrument; 2. Tier 1 instrument

The alternative approach addresses the weaknesses of existing regulatory regimes as applied to insurers

Major weaknesses of existing frameworks

- **Basel regime as applied to insurers**
 - Measures do not align with how insurers fail
 - Basel capital rules, GAAP capital measures, and minimum ratios not tailored to insurers' risk profile
- **Existing insurance regime**
 - Capital ratios measured only at the subsidiary level
 - Capital rules ignore risk-taking within unregulated subsidiaries and the holding company



Proposed alternative approach

- Captures holding company assets and non-insurance subsidiary capital requirements
- Aggregates available and required capital based on regulatory regime tailored to financial activities and risks of all entities
 - If capital requirements do not exist or are weak for an entity, the Fed may designate the appropriate regime
- Can be applied to bank holding companies and other holding companies

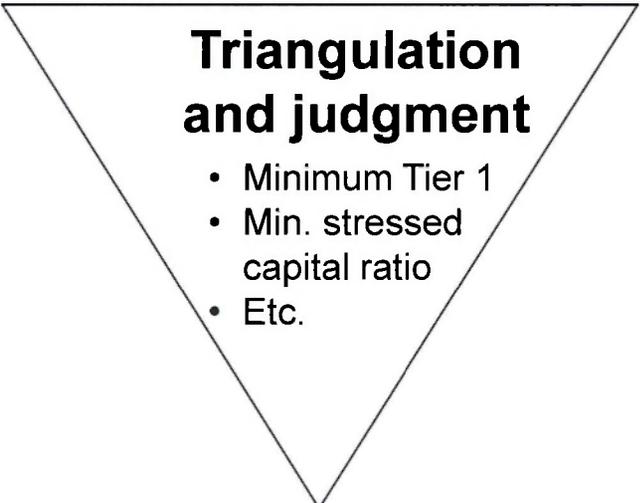
Potential approach to comparing capital levels as calculated under Basel and alternative regime

1 “Market-implied” approach

Calibrate through credit default swap spreads – similar CDS spreads imply equivalent default risk and capital levels

2 “Regulatory intervention” approach

Calibrate based on similar triggers for regulatory intervention across banking and insurance



Triangulation and judgment

- Minimum Tier 1
- Min. stressed capital ratio
- Etc.

3 Empirically

Calibrate empirically – identify levels that resulted in insurer distress / insolvencies by applying approach pro-forma to crisis

Alternative approach satisfies the design principles

Design principle	Assessment
1 Tailored and calibrated	<ul style="list-style-type: none"> • Regulated entities: Developed and calibrated over many years to fit the risk profile of the business of insurance • Non-regulated entities: Group regulator selects capital regime
2 Ensures sufficient capital, even in severe stress	<ul style="list-style-type: none"> • Proposed capital adequacy assessment regime reveals whether an insurer remains a going concern post stress • Assessment metrics are compatible with a stress testing framework
3 Comprehensive	<ul style="list-style-type: none"> • All risks are captured in the aggregated ratios
4 Comparable	<ul style="list-style-type: none"> • Ratios can be calibrated for substantive comparability with other types of financial services institutions
5 Feasible implementation	<ul style="list-style-type: none"> • Relies on existing measures, minimal need for adjustments

Summary

	Aggregated activities-based approach	Basel approach
Approach	<ul style="list-style-type: none"> • Measure capital using rules designed specifically entities / activities • Determine equivalency and aggregate capital ratios 	<ul style="list-style-type: none"> • Measure and stress consolidated capital ratio under Basel capital rules
Key challenges	<ul style="list-style-type: none"> • Determine /assess equivalency of capital measures across regulatory regimes • Calibrate capital thresholds to ensure comparability 	<ul style="list-style-type: none"> • Potential for false positives and false negatives • Risk of unintended consequences • Would require multiple complex adjustments and tailoring

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Appendix – Issues with applying proposed Basel framework to insurers

The Basel framework would require an extensive number of changes before being applied to insurers

Subset of issues with Basel framework as applied to insurers

Issue	Description
Risk weights	
Separate accounts (risk weighting)	<ul style="list-style-type: none"> Assets of the guaranteed separate accounts are assigned corresponding risk weights although the risk of the guaranteed accounts lies in its guarantee, not the notional value of the separate accounts. Furthermore, risk weight is applied independent of any actions the insurer may take to offload the exposure via hedging
Differentiation by asset quality	<ul style="list-style-type: none"> Risk weights do not distinguish between higher or lower credit quality of the holdings
Closed blocks	<ul style="list-style-type: none"> Assets supporting closed blocks are assigned full risk weights although credit risk is largely borne by policyholders
Policy loans	<ul style="list-style-type: none"> Policy loans are assigned a 20% risk weight although they pose no risk to the insurer
Capital	
Insurance subsidiary capital deduction / Liability risk	<ul style="list-style-type: none"> Capital requirements of insurance subsidiaries are deducted from total capital to account for liability risks and limited capital mobility in insurers; this deduction is punitive and is not calibrated meaningfully to either issue There is no explicit measure of insurance risk – this is especially pronounced for Property and Casualty risks
Conservatism in GAAP reserves in capital calculation (PADs)	<ul style="list-style-type: none"> PADs are treated as liabilities under GAAP; however, they provide an additional buffer for deviations away from expected loss, which is consistent with the definition of capital
Separate accounts (leverage ratio)	<ul style="list-style-type: none"> Tier 1 Leverage Ratio includes separate account assets where investment risks are borne by policyholder Assets backing reserves of guarantees on separate account are already included in the Leverage Ratio
2.5% capital buffer/minimum requirement levels	<ul style="list-style-type: none"> The 2.5% capital conservation buffer and minimum capital requirements were determined under the banking construct – a comparable analysis was not performed for the insurance sector
Stress testing	
Insurance-specific stress scenarios	<ul style="list-style-type: none"> Existing Fed scenarios are calibrated to stress the macroeconomic risk profile of a typical bank with little regard to macroeconomic sensitivity of insurers' books



Even after all specific risk weight, capital, and stress testing adjustments are completed, minimum capital requirement levels must be re-calibrated for insurers

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