

**Meeting between Federal Reserve Bank of Chicago Staff
and Representatives of American Council of Life Insurers
July 17, 2012**

Participants: Anna Paulson, Zain Mohey-Deen, and Robert McMenamain (Federal Reserve Bank of Chicago)

Julie Spiezio and Andrew Melnyk (American Council of Life Insurers)

Summary: Staff of the Federal Reserve Bank of Chicago participated in a telephonic discussion with representatives of the American Council of Life Insurers (“ACLI”). During the meeting, ACLI’s representatives discussed the potential impact of section 619 (“Volcker Rule”) and section 171 (“Collins Amendment”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act on life insurers. ACLI’s representatives also discussed the need to tailor regulation for certain non-bank institutions. Additional information regarding the issues and concerns raised by ACLI’s representatives during the meeting are reflected in the attached comment letters.



Julie A. Spiezio
Senior Vice President, Insurance Regulation & Deputy General Counsel
(202) 624-2194 t (866) 953-4083 f
juliespiezio@acli.com

July 28, 2011

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., N.W.
Washington, D.C. 20551

Re: Proposed Rule on Capital Plans (Docket No. R-1425; RIN No. 7100 AD 77)

Dear Chairman Bernanke:

These comments are submitted on behalf of the American Council of Life Insurers (“ACLI”). The ACLI is a national trade association with over 300 member companies representing more than 90 percent of the assets and premiums of the life insurance and annuity industry in the U.S. On behalf of all our members, we appreciate the opportunity to submit comments on the proposed rule for capital plans (the “Proposed Rule”) referenced above as proposed by the Board of Governors of the Federal Reserve System (the “Board”) and published at 76 Federal Register 35351 (June 17, 2011).

The Proposed Rule would require top-tier U.S. bank holding companies with total consolidated assets of \$50 billion or more to submit capital plans to the Board on an annual basis and to provide prior notice to the Board under certain circumstances before making a capital distribution. In its press release accompanying the Proposed Rule, the Board notes that the Proposed Rule builds upon and institutionalizes the Comprehensive Capital Analysis and Review conducted earlier this year at the 19 largest U.S. bank holding companies.¹ Based on the most recent available data, there are approximately 35 U.S. bank holding companies with \$50 billion or more in consolidated assets that would be covered by the Proposed Rule. In the Supplementary Information section of the Federal Register notice, the Board indicates that through separate rulemaking or by order, it expects that the requirements of the Proposed Rule would be extended to large savings and loan holding companies and nonbank financial companies supervised by the Board pursuant to section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).²

A number of ACLI member companies own insured savings associations and thus may become subject to any future extension of the Proposed Rule to large savings and loan holding companies or nonbank financial companies supervised by the Board pursuant to section 113 of the Dodd-Frank Act. Because of the implications of any possible future extension of the Proposed Rule to large savings and loan holding companies, particularly those that are predominantly engaged in insurance activities or have significant insurance operations, or

¹ Federal Reserve Press Release (June 10, 2011).

² 76 Fed. Reg. 35351, 35352 n.9 (June 17, 2011).

nonbank financial companies, the ACLI is offering its comments on the Proposed Rule. The predominant insurance nature of the ACLI member companies that own depository institution subsidiaries provides an important perspective for commenting on any possible future extension of the Proposed Rule to savings and loan holding companies or nonbank financial companies supervised by the Board pursuant to section 113 of the Dodd-Frank Act.³

1. General Observations on a Supervisory Approach to Savings and Loan Holding Companies

As the ACLI has noted in earlier comment letters to the Board,⁴ the ACLI believes that the Board should recognize as a basic principle in any supervisory approach to savings and loan holding companies that many savings and loan holding companies, particularly those that are predominantly engaged in insurance activities, have significantly different business and risk profiles than the bank holding companies that the Board has traditionally regulated. In addition, many savings and loan holding companies own savings associations that represent a very small percentage of assets or revenues of their overall corporate entity. This is particularly true of savings and loan holding companies that are predominantly insurance enterprises and distinguishes these savings and loan holding companies from virtually all bank holding companies for which the depository subsidiaries represent a predominant percentage of the assets and revenues of the overall corporate entity. In developing an appropriate supervisory approach to savings and loan holding companies and nonbank financial companies, the Board must recognize the different business models and risk profiles that distinguish many large savings and loan holding companies and other nonbank financial companies from large bank holding companies and tailor its supervisory approach to the specific business models and risk profiles of the entities to be supervised.

This approach has the clear advantage of structuring a supervisory program to the actual risk characteristics of the entities to be supervised rather than to a model that no matter how well designed or accepted does not reflect the characteristics (either in terms of diversity of activities or the relative weight of depository activities) of the entities to be supervised. This tailored approach also allows for differentiated supervision of organizations that are low-risk or noncomplex irrespective of size. This tailored approach has the additional advantage of allowing the necessary and appropriate weight to be accorded to the existing regulatory regimes that apply to particular types of financial entities such as insurance companies. These general principles guide the following comments from the ACLI with respect to the possible future extension of the Proposed Rule to large savings and loan holding companies and other nonbank financial companies that are predominantly insurance enterprises or have significant insurance operations.

³ While the comments in this letter focus primarily on the issues related to any potential extension of the Proposed Rule to savings and loan holding companies that are predominantly insurance enterprises, the comments are also relevant to the issues of the application or extension of the Proposed Rule to any entity that is predominantly an insurance enterprise or has significant insurance operations, including an entity that is a bank holding company or a nonbank financial company supervised by the Board pursuant to section 113 of the Dodd-Frank Act.

⁴ See ACLI Letter to Hon. Ben S. Bernanke (April 6, 2011); ACLI Letter to Hon. Ben S. Bernanke (May 20, 2011).

2. Savings and Loan Holding Companies Predominantly Engaged in Non-Depository Activities

As the Board has consistently noted in its supervisory guidance relating to the payment of dividends and the redemption and repurchase of stock by bank holding companies, “[a] fundamental principle underlying the Federal Reserve’s supervision and regulation of BHCs is that a BHC should serve as a source of management and financial strength to its subsidiary banks.”⁵ Indeed, much of the Bank Holding Company Act regime is focused on protecting the safety and soundness of the subsidiary banks of the holding company.⁶ A supervisory approach to capital planning at a holding company level, including a capital plan requirement, is consistent with these objectives when the depository subsidiary or subsidiaries represent a significant percentage of the overall assets or revenues of the holding company.

The supervisory approach should be modified, however, when the depository subsidiary or subsidiaries represent a relatively small percentage of the consolidated holding company entity. In such a case, the assets available to the holding company to provide additional capital or other financial support to the depository subsidiary may be many times the amount of any additional capital requirement at the depository subsidiary. In addition, in the case of a large holding company with a small depository subsidiary, there will be much reduced risk of reliance on dividends from the depository subsidiary to service the obligations at the holding company level (and much reduced risk of any problem arising from double leverage at the holding company level).⁷ As a structural matter, a large savings and loan holding company with a small depository institution is inherently better aligned with the source-of-strength doctrine than the typical large bank holding company with a large depository subsidiary or subsidiaries. To subject a large holding company with a small depository subsidiary to a regulatory requirement for a formal capital plan and for review and non-objection by the Board is thus unnecessary and disproportionate to the intended purpose and does not make the appropriate allowance for the differences between the financial profile of large bank holding companies and most large savings and loan holding companies.

As part of its supervisory responsibility over savings and loan holding companies, the Board will have the full range of other supervisory and regulatory tools to assess and monitor the capital position of savings and loan holding companies. These supervisory and regulatory tools can be more appropriately tailored to the individual situation of savings and loan holding companies than a capital plan requirement. The ACLI encourages the Board to consider the appropriate range of supervisory and regulatory tools available to it to monitor the capital positions of savings and loan holding companies and to tailor its approach to the differing situations of individual savings and loan holding companies.

The use of a tailored approach to capital monitoring for savings and loan holding companies is also consistent with another principle articulated by the Board in issuing the Proposed Rule, i.e., that the amount of capital held by a holding company should be commensurate with the

⁵ See Division of Banking Supervision and Regulation SR Letter 09-4 (Feb. 24, 2009) (revised March 27, 2009); Federal Reserve Board Policy Statement, Unsafe Banking Practices – Cash Dividends Not Fully Covered by Earnings (Nov. 14, 1985). The Dodd-Frank Act has now extended the source of strength doctrine to all holding companies of insured depository institutions. See Dodd-Frank Act § 616(d).

⁶ See Bank Holding Company Supervision Manual §1050.1 (Jan. 2009).

⁷ In the case of a savings and loan holding company, the Home Owners’ Loan Act of 1933 (“HOLA”) already provides a direct mechanism for regulatory review of all dividend payments to the holding company. See 12 U.S.C. § 1467a(f). The Office of Thrift Supervision has by regulation expanded the review process beyond dividends to all forms of capital distributions (other than dividends payable in shares) by a savings association subsidiary to its holding company. See 12 C.F.R. §§ 563.141-536.146.

company's risk profile. Many large savings and loan holding companies have risk profiles that differ significantly from large bank holding companies. For example, the largest bank holding companies are engaged in various financial activities that the Congress identified as posing significant risks to the financial system, such as acting as primary dealers, acting as derivatives dealers, managing payment and clearing systems, providing prime brokerage services, and sponsoring and underwriting structured products. Many savings and loan holding companies are not engaged in these activities at all or only to an insignificant extent in the case of individual institutions. The significant difference in the risk profiles of large bank holding companies and large savings and loan holding companies should be recognized in any supervisory approach that the Board adopts, providing for a tailored assessment of the risk profiles of individual large savings and loan holding companies.⁸ As discussed in the following section, recognition of the difference in risk profiles between large bank holding companies and large savings and loan holding companies is particularly appropriate for large savings and loan holding that are predominantly engaged in insurance activities or have significant insurance operations.

3. Special Considerations Applicable to Savings and Loan Holding Companies Predominantly Engaged in Insurance Activities

Within the set of large savings and loan holding companies, special considerations apply to those savings and loan holding companies that are predominantly engaged in insurance activities. In effect, these entities represent a unique subset of institutions because of the nature of their business and the attendant regulatory structure that flows from that business. Consistent with the underlying approach reflected in the Dodd-Frank Act, the Board in developing its supervisory approach to large savings and loan holding companies should tailor its approach to the predominant line of business of the savings and loan holding company. This is particularly appropriate for savings and loan holding companies that are predominantly engaged in insurance activities because of the longstanding and comprehensive regulatory and supervisory system that applies to entities engaged in insurance activities. The amendments made to HOLA by the Dodd-Frank Act recognize this principle as applied to savings and loan holding companies that own functionally regulated subsidiaries.⁹

As the ACLI has noted in an earlier comment letter, any supervisory capital approach developed by the Board for savings and loan holding companies that are predominantly engaged in insurance activities must take full account of the "inherent differences" between the insurance and banking businesses and the resulting differences in the risk-based capital methodology

⁸ In issuing the Proposed Rule, the Board noted that while the proposal is not mandated by the Dodd-Frank Act, the Board believes that it is appropriate to hold large bank holding companies to an elevated capital planning standard because of the elevated risk posed to the financial system by large bank holding companies. The Board also noted that the proposed asset threshold of \$50 billion for bank holding companies is consistent with the threshold established by section 165 of the Dodd-Frank Act relating to enhanced prudential supervision for large, interconnected bank holding companies. 76 Fed. Reg. at 35352. It should be noted, however, that neither section 165 nor section 166 of the Dodd-Frank Act, which is also cited by the Board in Supplementary Information section of the Proposed Rule, apply to savings and loan holding companies as such. Likewise, the related sections 115 and 116 of the Dodd-Frank Act do not apply to savings and loan companies as such, reflecting Congressional recognition that large savings and loan holdings generally present a different risk profile than large, interconnected bank holding companies.

⁹ See Dodd-Frank Act § 604(g) & (h).

adopted by the insurance and banking regulators.¹⁰ As the ACLI has further noted, the best way to address the inherent differences between the insurance and banking business would be to recognize and accept for supervisory purposes to the greatest extent possible the insurer risk-based capital requirements for savings and loan holding companies that are predominantly engaged in insurance activities.¹¹ As discussed below, the insurance regulatory system provides both for required capital levels and controls on dividend payments by insurers. These are essential elements of the insurance regulatory system for insurers. They should also be recognized as essential elements of any supervisory system that the Board implements for savings and loan holding companies that are predominantly engaged in insurance activities. The following discussion provides a high level summary of the relevant capital requirements and dividend restrictions applicable to insurance companies under state insurance law and regulation.

A. *Insurer Risk-Based Capital*

Under state law insurers are subject to conservative risk-based capital (“RBC”) requirements that take into account both investment (asset) and insurance (liability) risks as well as interest rate risk, off balance sheet items like guarantees and contingent liabilities and the risk of collectability of reinsurance. If an insurer’s RBC ratio (Total Adjusted Capital/Authorized Control Level RBC) falls below 200%, the insurer must present its domestic state insurance regulator with a plan to improve its financial position. The insurer’s domestic state insurance regulator is authorized to place an insurer in receivership if the RBC ratio falls below 100%, and is required to place the insurer into receivership if the RBC falls below 70%.¹² A well-capitalized insurer generally holds multiples of the required RBC level. It is important to note that the insurer RBC calculation is formulaic, and is not based on insurer’s own risk estimates or internal models.

While insurer RBC is important generally to the financial health of a top-tier depository institution holding company that owns both an insurer and an insured depository institution, insurer RBC takes on additional importance when an insurer itself owns, directly or indirectly, the insured depository institution. This will be the case for all top-tier depository institution holding companies that are mutual insurers. Since mutual insurers and fraternal benefit societies have no parent, they are the top-tier depository institution holding company. In addition, this will be the case for a top-tier depository institution holding company that owns a stock insurer that, in turn, directly or indirectly, owns an insured depository institution. In this case, the capital standards imposed by insurer RBC indirectly supports the continued financial health of the depository subsidiary.

B. *Stock Insurer Shareholder Dividend Limitations*

State insurance laws typically include regulation of shareholder dividends made by stock insurers. These are usually contained in state insurance holding company statutes. The typical law¹³ requires the following:

¹⁰ See ACLI Letter to Hon. Ben S. Bernanke (May 20, 2011) (quoting from the Report of the National Association of Insurance Commissioners (NAIC) and the Federal Reserve System Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage (May 24, 2002).

¹¹ *Id.*

¹² See National Association of Insurance Commissioners, Risk-Based Capital (RBC) Model Act §§ 3-5.

¹³ See, e.g., Ill. Rev. Stat. Ch. 215 §§ 5/27 (earned surplus) 5/131.20a(2) (extraordinary dividend) and 50 Ill. Adm. Code 855.30(a)(1) (ordinary dividend).

- (i) All shareholder dividends be paid only from earned surplus (accumulated earnings) and not contributed surplus (proceeds from the sale of its stock). Some states may allow shareholder dividends to be paid from other than earned surplus but only with the prior approval of the insurer's domestic state insurance regulator.¹⁴
- (ii) No "extraordinary dividend" may be paid without giving the domestic state insurance regulator at least 30 days prior notice, during which time the regulator may disapprove the proposed shareholder dividend. An "extraordinary dividend" is typically defined as one, which together with other dividends made within the prior 12 months, exceeds the greater of (i) 10% of the insurer's surplus as of the prior December 31, or (ii) the net income of the insurer for the 12-month period ending the prior December 31.
- (iii) The insurer must give its domestic state insurance regulator notice of each and every "ordinary dividend" – any dividend that is not an "extraordinary dividend." A typical state law or regulation may require notice 5 business days following declaration of the ordinary dividend and no less than 10 business days prior to payment of the ordinary dividend. This allows the regulator to review the impact of the proposed ordinary dividend on the financial condition of the insurer and, if warranted, allow the regulator to intervene and prohibit the ordinary dividend.¹⁵

These state law restrictions serve the same general purpose as the restrictions in banking law on the payments of dividends. They are used when necessary to preserve the financial strength of the insurance subsidiary; they also serve as a prophylactic matter to discourage undue reliance by a holding company on dividends or other distributions from an insurance subsidiary. If a savings association subsidiary is owned directly or indirectly by an insurance company, they can also serve indirectly to discourage undue reliance by the holding company on dividends or capital distributions from the savings association subsidiary in conjunction with the direct regulatory regime applicable under HOLA.

C. *Policyholder Dividends*

If the Proposed Rule were to be extended to savings and loan holding companies that are mutual insurance companies or mutual insurance holding companies, it could present significant problems for such entities. The Proposed Rule contains a broad definition of the term "Capital distribution" to mean:

"a redemption or repurchase of any debt or equity capital instrument, a payment of common or preferred stock dividends, a payment that may be temporarily or permanently suspended by the issuer on any instrument that is eligible for inclusion in the numerator of any minimum regulatory capital ratio, and any similar

¹⁴ See, e.g., Pa. Stat. Ann. Tit. 40, § 459.8(a), (b).

¹⁵ In addition, if an insurer's domestic state insurance regulator determines that the continued operation of the insurer may be hazardous to the policyholders or the general public, then the regulator may issue an order requiring the insurer to, among other things, suspend or limit the declaration and payment of dividend by an insurer to its stockholders or to its policyholders. See National Association of Insurance Commissioners, Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition § 4.B(5).

transaction that the Federal Reserve determines to be in substance a distribution of capital.”¹⁶

Mutual insurers and mutual insurance holding companies regularly pay “dividends” to their policyholders or members. However, these are not distributions on any capital instrument. Policyholders and members are neither shareholders nor debt holders in that capacity. Nonetheless, the ACLI is concerned that the phrase “any similar transaction that the Federal Reserve determines to be in substance a distribution of capital” could be construed as including dividends to policyholders or members of a mutual insurer or a mutual insurance holding company. In no event should any proposed capital plan requirement extend to the payment of dividends to policyholders or members of a mutual insurer or a mutual insurance holding company.¹⁷

Policyholder dividends of mutual life insurers are already subject to regulation under state insurance laws. For example, under New York law, a mutual life insurer must ascertain the surplus earned by it each calendar year. It may then set aside from that earned surplus an amount for deferred dividend policies and an amount its deems advisable for the accumulation of surplus (capital), but then must use the remainder of the earned surplus for the payment of policyholder dividends in accordance with insurance regulatory standards.¹⁸ As a general matter, current year policyholder dividends are paid from current year earnings.¹⁹

4. Phase-in for Savings and Loan Holding Companies

The Proposed Rule would apply to every top-tier bank holding company domiciled in the United States that has \$50 billion or more in total consolidated assets. However, as noted in the Supplementary Information section of the Federal Register, “[c]onsistent with the phase-in period for the imposition of minimum risk-based and leverage capital requirements established in section 171 of the Dodd-Frank Act,” the Proposed Rule by its terms would not apply until July 21, 2015 to any bank holding company subsidiary of a foreign banking organization that has relied on Supervisory and Regulatory Letter SR 01-01 issued by the Board.²⁰

We believe that this postponement for such foreign-owned bank holding companies is appropriate both as a policy matter and as a matter of statutory intent. For the reasons discussed in the previous sections of this letter, the ACLI believes that a capital plan requirement at least in the form of the Proposed Rule should not be extended to large savings and loan holding companies. If, however, the Board should decide to extend a proposed capital plan rule to large savings and loan holding companies, the ACLI submits that the Board should provide the same phase-in period for savings and loan holding companies pursuant to section 171(b)(4)(D) of the Dodd-Frank Act as the Proposed Rule provides to bank holding company subsidiaries of foreign banking organizations pursuant to section 171(b)(4)(E) of the Dodd-

¹⁶ 76 Fed. Reg. at 35359 (to be codified at 12 C.F.R. § 225.8(c)(2)).

¹⁷ This same reasoning would also apply to similar types of distributions made by other insurers such as insurers operating on a not for profit basis and fraternal benefit societies.

¹⁸ N.Y. Ins. L. § 4231(a). So that a mutual life insurer cannot accumulate an excessive amount of surplus and pay no policyholder dividends, under New York law a mutual life insurer may not maintain surplus in excess of the greater of (i) \$850,000, or (ii) 10% of its policy reserves and policy liabilities, or (iii) 10% of its policy reserves and policy liabilities plus 300% of its authorized control level RBC minus the asset valuation reserve as reported in its annual statement, or (iv) the minimum amount of capital and surplus required by law of another state in which the insurer is authorized to do business. N.Y. Ins. L. § 4219(a)(1).

¹⁹ A mutual life insurer that in good faith apportions its divisible surplus on an annual basis may pay dividends from its accumulated surplus so long as it maintains the minimum amount required by law.

²⁰ 76 Fed. Reg at 35352.

Frank Act. The provisions in section 171(b)(4)(D) and (E) of the Dodd-Frank Act reflect the legislative judgment that the institutions covered by these provisions should be provided with the same phase-in period before being subjected to new capital requirements. In addition, if the Board formally proposes extension of the Proposed Rule to savings and loan holding companies or other non-bank holding company entities, we respectfully request those entities be given an opportunity equal to that afforded to bank holding companies to comment on the specific rules that would apply to such entities prior to any final decision to expand their application.

5. The Capital Plan Submission Process

The Proposed Rule would generally require that capital plans be submitted to the Board by January 5th of each year and that the Board would provide a notice of non-objection by March 15th. Any effort to address concerns expressed by the Board would presumably further delay this timeframe and the associated completion of a capital plan for the year. This would significantly restrict a subject company's ability to address annual capital distributions by effectively disabling all subject companies from setting forth a final capital plan within at least the first quarter of each calendar year.

Use of the first quarter time frame for all bank holding companies, savings and loan holding companies and systemically significant nonbank financial companies is extremely disruptive to the corporate governance framework of the companies and is equally inefficient for the Board's use of its resources. The Proposed Rule establishes a timeline that is potentially unfair and adverse to the interests of shareholders and policyowners of subject companies and mandates a regulatory framework for capital distribution decisions that limits the flexibility of the subject company to deal with those plans in the ordinary course of its corporate governance process. The Proposed Rule also establishes a process that will require Board staff to review all capital plan submissions within a two month period at the beginning of each calendar year. There is no demonstrable regulatory need for such a timing requirement.

We recommend that the Board modify the Proposed Rule to permit subject companies to follow their regular corporate governance timeline for development of capital distribution plans and to submit those plans to the Board as appropriate over the course of the year. The Board would then have some period of time following the submission to respond to the capital plan. This would permit subject companies to continue to manage their individual capital distribution planning process and would spread the regulatory burden for review of capital plan submissions. This approach would have no adverse affect on Board review of capital plans or the Board's ability to supervise these companies.

6. Informational Requests under the Proposed Rule

The Proposed Rule permits the Board to request a broad range of data from subject companies. It is unclear why the Board would require such submissions in connection with the capital plan process when much of the information requested has already been collected in other reports required for submission by the subject companies. The scope of the capital plan submission is overbroad and very burdensome as a result.

In addition, the Proposed Rule envisions the potential for submission of data as it relates to a specific date and on a loan level basis. Again the scope of the data request has the potential to

be overbroad and extremely burdensome without consideration of whether there exist sufficient regulatory need for such submission in connection with the capital plan review.

We recommend that any final rule clarify that any data submission should first require the Board to seek the information from other sources/formats in which the information has already been collected and that any information requested should be consistent with current regulatory reporting so as not to require significant additional system expenditure in order to comply.

Thank you for your consideration of our views. We are available for further discussion on this matter at your convenience.

Respectfully submitted,



Julie A. Spiezo

CC: Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551



Julie A. Spiezio
Senior Vice President, Insurance Regulation & Deputy General Counsel
(202) 624-2194 t (866) 953-4083 f
juliespiezio@acli.com

April 25, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (FRS Docket No. 1438 & RIN 7100-AD-86)

Dear Chairman Bernanke:

These comments are submitted on behalf of the American Council of Life Insurers (the “ACLI”). The ACLI is a national trade association with over 300 member companies representing more than 90 percent of the assets and premiums of the life insurance and annuity industry in the U.S. We appreciate the opportunity to submit comments on the Board’s notice of proposed rulemaking implementing enhanced prudential standards and early remediation requirements for certain covered companies (the “Proposed Rules”).¹

I. Introduction

At the outset, we wish to reiterate our belief that the traditional core activities of life insurance companies do not present a systemic risk to the financial stability of the United States. As we have discussed in previous letters² to the Financial Stability Oversight Council (the “FSOC”), the traditional core activities of life insurers do not present a systemic risk for a number of reasons:

- The core business activity of most life insurers involves providing policyholder coverage for long-term risks, and matching these long-term, liabilities with assets appropriate to ensure that these liabilities can be met. This is a fundamentally different business model than other types of financial institutions which depend on short-term, on-demand funding, and are much more susceptible to runs on their liabilities during periods of stress.
- Core life insurance activities do not give rise to high interconnectedness with other financial institutions. Thus, life insurers do not exhibit the same levels of interconnectedness as banks.
- Life insurers are highly regulated in ways that decrease the risk they pose to the financial system. State insurance regulators have strict capital requirements, which operate not only to mandate a minimum capital buffer, but also to remove incentives to hold risky assets. Life insurers are also required to hold reserves against future losses based on prudent assumptions.

¹ Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 *Fed. Reg.* 594 (Jan. 5, 2012).

² See, e.g., Letter from the ACLI, to the Board (Dec. 19, 2011), *available at* http://www.acli.com/Newsroom/News%20Releases/Documents/ACLI_FSOC_121911.pdf.

- The insurance regulatory system provides an established process for the orderly rehabilitation or wind-down of impaired life insurers. This wind-down process, combined with the illiquid nature of insurance company liabilities, prevents “fire sale” liquidations that can spread contagion to otherwise healthy firms.

The findings of the International Association of Insurance Supervisors (IAIS) in its recent paper, “Insurance and Financial Stability,”³ also support the view that traditional insurance activities are unlikely to present systemic risks.

Other analyses have come to the conclusion that even if an insurer were to fail, the failure itself would be unlikely to cause systemic risk. For example, the Geneva Association recently published a detailed study of resolution experiences with insurance companies. Among the conclusions of the study are the following:

- The wind-down of an insurer has never caused a systemic financial crisis.
- The balance sheet of an insurer does not react to stresses in the same way as the banking balance sheet, because: (i) ongoing reserves stabilize the wind-down of the insurer; (ii) insurer reserves are held predominantly in local legal entities; and (iii) depending on local law, reserves are covered by assets specifically “tied” to those reserves.⁴

Taken together, these characteristics support the view that life insurers do not pose systemic risk. We urge the Board to remain cognizant of this view as it finalizes the Proposed Rules.

II. Required Tailoring for Nonbank Financial Companies

Our letter is prompted by an overriding concern that the Proposed Rules themselves do not appropriately distinguish between bank holding companies (“BHCs”) that are subject to the Proposed Rules by virtue of the fact that they have at least \$50 billion in total consolidated assets (“Large BHCs”) and nonbank financial companies that are designated as systemically important under section 113 of the Dodd-Frank Act (“Nonbank Covered Companies”). This concern is informed by both the preamble to and the text of the Proposed Rules. In the preamble, the Board states that the Proposed Rules were “largely developed with large, complex [BHCs] in mind.”⁵ Although the Board notes in the preamble that following designation of a Nonbank Covered Company by the FSOC, the Board would “thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the enhanced prudential standards . . . should apply to the covered company” and that it “may, by order or regulation, tailor the application of the enhanced standards to designated nonbank financial companies on an individual basis or by category, as appropriate,”⁶ nowhere in the Proposed Rules themselves does the Board draw an explicit distinction between Large BHCs and Nonbank Covered Companies. Instead, the Proposed Rules provide that both Large BHCs and Nonbank Covered Companies will be subject to the same set of enhanced standards.⁷ This is in direct conflict with the provisions of section 165(b)(3), which require the Board to take into account differences among nonbank financial companies and BHCs and to adapt the required standards as appropriate to the predominant line of business of a nonbank financial company. The Proposed Rules do neither.

³ IAIS, *Insurance and Financial Stability* (Nov. 2011), at 6, available at <http://www.iaisweb.org/Otherpapers-and-reports-46>.

⁴ See Geneva Association, *Insurance and Resolution in Light of the Systemic Risk Debate* (Feb. 2012), at 2-3, available at http://www.genevaassociation.org/PDF/BookandMonographs/GA2012-Insurance_and_Resolution_in_Light_of_the_Systemic_Risk_Debate.pdf.

⁵ 77 *Fed. Reg.* at 597.

⁶ *Id.*

⁷ *Id.*

As we discuss in detail below, the failure of the Proposed Rules to distinguish explicitly between Large BHCs and Nonbank Covered Companies, and to provide explicitly for tailored application of the enhanced prudential standards and early remediation requirements based on these distinctions is not only inconsistent with the requirements of section 165(b)(3), but also would lead to an unworkable and ineffective set of requirements for Nonbank Covered Companies⁸. Such an outcome would be contrary to the interests of the Nonbank Covered Companies and the Board itself, but more importantly, it would be contrary to the purpose of section 165, which is to mitigate risks to the financial stability of the United States.

Accordingly, we submit that the Board must revise the Proposed Rules either to (i) provide specifically for the tailoring required by section 165(b)(3) or (ii) exclude Nonbank Covered Companies from the Proposed Rules and conduct a separate rulemaking to establish a process for tailoring the standards as required by section 165(b)(3) for Nonbank Covered Companies. As part of any such rulemaking process under section 165 for Nonbank Covered Companies, the Board should request recommendations from the FSOC under section 115 as to the appropriate tailoring of the standards to Nonbank Covered Companies. Any rules issued under section 165 for Nonbank Covered Companies must also provide for consultation (as required under section 165(b)(4)) by the Board with each of the FSOC members that primarily supervises any functionally regulated subsidiary of a Nonbank Covered Company prior to the imposition of prudential standards or other requirements on a Nonbank Covered Company. Any rules proposed by the Board for Nonbank Covered Companies should provide for an appropriate opportunity for Nonbank Covered Companies (none of which has yet been designated under section 113) to comment on the proposed rules as required by the Administrative Procedure Act. Any such proposed rules should also provide for an appropriate observation period before the rules become final, particularly if the Board decides to create prudential rules that differ from, or establish new requirements beyond, those imposed by the primary financial regulatory agency for the Nonbank Covered Company or for any functionally regulated subsidiary of the Nonbank Covered Company.

III. Coordination under Section 113 and Section 165

As both a legal and a policy matter the implementation of the section 165 prudential standards for Nonbank Covered Companies must be coordinated with the designation process under section 113. More specifically, there must be a tailoring of the standards applicable to Nonbank Covered Companies by the Board under section 165 based at a minimum on general recommendations from the FSOC under section 115. The preamble to the Proposed Rules appears to contemplate that there will be a tailoring of the prudential standards to Nonbank Covered Companies, but that the tailoring will only occur *after* the designation process under section 113 has been completed with respect to a specific nonbank financial company. The preamble states that after the designation of a company, the Board will “thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the enhanced prudential standards and early remediation requirements should apply.”⁹

We submit that this thorough assessment of the business model, capital structure, and risk profile is necessarily part of the FSOC designation process itself and as a legal matter is the predicate for a designation determination. We agree with the Board’s statement in the preamble to the Proposed Rules that the tailoring of the standards and requirements to different Nonbank Covered Companies on an individual basis or by category is important,¹⁰ particularly because the types of business models, capital structures, and risk profiles could vary significantly. But we firmly believe that the FSOC designation process must be based upon the same thorough assessment of the business model, capital structure and risk profile of any company that would be subject to designation. The designation process itself necessarily involves two basic assessments: first, an assessment of the types of risks that a company

⁸ One example of the inappropriateness of this “one-size-fits-all” approach as applied to a Nonbank Covered Company that is a life insurance company is illustrated by the Proposed Rules’ suggestion that the word “debt” be defined as “total liabilities”, discussed in greater detail *infra* at pg. 14.

⁹ *Id.*

¹⁰ *Id.*

may present that could result in a threat to U.S. financial stability and second, an assessment of how the enhanced standards in section 165 as applied to the particular company will mitigate those risks. To meet the purpose of section 113, it is incumbent upon the FSOC not only to determine that a company could pose a threat to U.S. financial stability, but also to determine how the application of the prudential standards in section 165 would mitigate the perceived threat.

This two-pronged assessment process will be particularly important when the FSOC is considering for designation a nonbank financial company that is already subject to comprehensive regulation by a primary financial regulatory agency such as a state insurance authority.¹¹ The FSOC itself has provided in its final rule and interpretive guidance for designating Nonbank Covered Companies that one of the overarching categories in its analytic framework for the designation process is the extent and scope of existing state or federal regulatory scrutiny, including detailed reporting requirements, capital and liquidity requirements, enforcement actions, and resolution authority.¹² The two-pronged assessment process is equally important when the FSOC is considering for designation a foreign nonbank financial company that also is already subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority.¹³ As the FSOC itself provides in its notice of proposed rulemaking, the existence of an effective mechanism to resolve a nonbank financial company such as an insurance company will also be a factor in the designation process, and it will affect the type and extent of any additional prudential regulations that might be necessary under section 165. These considerations are directly relevant to any determination of the threat that an insurance company might pose to U.S. financial stability and to the type and extent of additional prudential regulation that might be thought necessary to address the threat.¹⁴

The FSOC assessment process, which must include these regulatory as well as all the other factors listed in section 113(a), provides the necessary basis for the FSOC to determine how the prudential standards should be applied to a Nonbank Covered Company and to make recommendations to the Board as envisioned by section 115. Section 115(a)(2) envisions that the FSOC may make recommendations to the Board on differentiating among companies on an individual basis or by category. Section 115(b)(3) envisions that the FSOC in making recommendations will take into account differences among nonbank financial companies and BHCs based *inter alia* on the factors listed in section 113(a) and will adapt its recommendations as appropriate in light of the predominant line of business of the company. Reinforcing the thrust of these provisions in section 115 is section 113(g), which requires the FSOC to consult with the primary financial regulatory agency for each nonbank financial company or subsidiary of a nonbank financial company before any final designation determination is made with respect to the company. The in-depth assessment and consultation process required by section 113 provides the natural basis for the recommendations envisioned by section 115(b)(3), the language of which parallels the language in the tailoring provisions in section 165(b)(3) itself.¹⁵ Although the FSOC has said in the preamble to its final rule on the designation of nonbank financial companies that it “does not generally intend to make company-specific regulatory recommendations to the Board,”¹⁶ we submit that the Board should request recommendations from the FSOC on how the prudential standards provided in section

¹¹ Section 113(a)(2) requires the FSOC to consider a list of considerations, including the degree to which a company is already regulated by one or more primary financial regulatory agencies. Section 2 of the Dodd-Frank Act defines “primary financial regulatory agency” to include a State insurance authority of the State in which an insurance company is domiciled with respect to the insurance activities and activities that are incidental to such insurance activities of an insurance company that is subject to supervision by the State insurance authority under State insurance law.

¹² See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 *Fed. Reg.* at 21637.

¹³ See Pub. L. No. 111-203, § 113(b)(2)(H) (codified at 12 U.S.C. § 5323(b)(2)(H)).

¹⁴ See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 *Fed. Reg.* 64264, 64282 (Oct. 18, 2011).

¹⁵ Coordination also ensures that the Board will receive the active advice and input on the appropriate treatment of insurance entities from the three FSOC members with insurance expertise.

¹⁶ See 77 *Fed. Reg.* at 21647.

165 should be applied to the designated company to mitigate the risks identified by the FSOC in its designation process. It is likewise incumbent on the FSOC to provide recommendations to the Board on how the prudential standards in section 165 should be applied to a Nonbank Covered Company to mitigate the threats that the FSOC itself has identified in the designation process with respect to that company.

IV. Application to Savings and Loan Holding Companies

As the Board itself indicates in the preamble, with the exception of section 165(i)(2), sections 165 and 166 do not apply to savings and loan holding companies (SLHCs). Nevertheless, the Board indicates in the preamble that it intends to apply the enhanced standards to certain SLHCs to “ensure their safety and soundness.”¹⁷ The Board indicates its intent to issue a separate proposal for notice and comment to initially apply the enhanced standards and early remediation requirements to all SLHCs with “substantial banking activities,” *i.e.* any SLHC that (i) has total consolidated assets of \$50 billion or more, and (ii) that (A) has savings association subsidiaries which comprise 25 percent or more of the SLHC’s total consolidated assets, or (B) controls one or more savings associations with total consolidated assets of \$50 billion or more.¹⁸ The Board indicates that it will not issue such a proposal until such time as it has established risk-based capital requirements for SLHCs.

We respectfully disagree with the suggestion that the Board may extend the proposed section 165 and section 166 requirements to SLHCs with “substantial banking activities.” Section 165 and section 166 clearly provide that the enhanced standards and early remediation requirements apply only to Large BHCs and Nonbank Covered Companies and not to SLHCs as such. Section 165(i)(2) specifically enumerates the one instance in which an enhanced standard applies to SLHCs. In seeking to apply the entire of enhanced standards to certain SLHCs, the Board obviates this carefully crafted statutory scheme. Nor does the Home Owners’ Loan Act as amended by the Dodd-Frank Act authorize the Board to impose Title I standards on SLHCs. By conflating two distinct statutory schemes, the Board contradicts Congress’s clear and deliberate intent to only apply one of the Title I requirements (namely, section 165(i)(2)) to SLHCs, rather than the enhanced prudential framework as a whole.

By proposing to apply the Title I enhanced standards and early remediation requirements to certain SLHCs, the Board has effectively made a determination expressly reserved for the FSOC. This determination is at odds with Congressional intent and the plain language of Title I itself. This determination also flies in the face of the Board’s previous statement that it would develop a regulatory and supervisory framework for SLHCs that “to the greatest extent possible [takes] into account [the] unique characteristics of SLHCs and the requirements of the Home Owners’ Loan Act.”¹⁹ We request that the Board remain cognizant of this statutory framework and of its prior previous statements, and refrain from applying sections 165 and 166 to SLHCs.

V. Phase-In

In addition to the need to tailor the prudential standards to Nonbank Covered Companies, it is essential that the Board provide for a phase-in period for the enhanced standards that recognizes the fundamentally different posture between Large BHCs that are already subject to comprehensive regulation by the Board and Nonbank Covered Companies that will become subject to such regulation for the first time upon their designation. For example, the proposed capital and leverage requirement would become applicable to a Nonbank Covered Company 180 days after designation and the stress testing requirement would become applicable to a Nonbank Covered Company in the same calendar year it is designated by the FSOC if the date of designation is more than 180 days before September 30. A Nonbank Covered Company that is designated before September 30, 2012 will become subject to the

¹⁷ 77 *Fed. Reg.* at 598.

¹⁸ *Id.*

¹⁹ Board, Supervision and Regulation Letter 11-11: Supervision of Savings and Loan Holding Companies 2 (July 21, 2011), available at <http://www.federalreserve.gov/boarddocs/srletters/2011/sr1111.htm>.

single-counterparty exposure limit beginning October 1, 2013. The other enhanced prudential requirements would become effective five calendar quarters after the Nonbank Covered Company is designated. These phase-in periods are highly unrealistic for companies that do not have the pre-existing risk infrastructure and management information systems (“MIS systems”) designed around the bank-centric requirements of the Proposed Rules. Moreover, the substantive standards such as capital will require more extended phase-in periods.

We submit that the Proposed Rules should be revised to provide for an appropriate phase-in period for Nonbank Covered Companies. As a general matter, it is clear that both Large BHCs and Nonbank Covered Companies will be required to make significant investments in risk infrastructure and MIS systems to bring themselves into compliance with the Proposed Rules. However, Nonbank Covered Companies will be required to undertake much more significant investments in risk infrastructure and MIS systems than Large BHCs. Much of the enhanced prudential requirements in the Proposed Rules represent enhancements to existing bank prudential requirements. Although Large BHCs will still need to make significant investments to bring their risk infrastructure and MIS systems into compliance with the enhanced standards under the Proposed Rules, Large BHCs already have existing infrastructure and MIS systems that are generally designed around such requirements. Nonbank financial companies have developed risk infrastructure and MIS systems based on their own specific mix of financial activities (principally nondepository activities) and on applicable regulatory requirements such as state insurance law requirements. These infrastructure and MIS systems differ substantially from those applicable to a financial institution with a dominant depository institution, such as a Large BHC. As a result, a Nonbank Covered Company will either have to develop entirely new risk infrastructure and MIS systems or graft a risk and technology infrastructure designed for a large banking organization onto its existing framework. In either case, a Nonbank Covered Company will face significantly greater challenges than a Large BHC in meeting the requirements of the Proposed Rules.

In requesting an appropriate phase-in period for Nonbank Covered Companies, we also note that Nonbank Covered Companies will not have the benefit of having been subject to Board regulation and supervision for many years, unlike Large BHCs. An established supervisory relationship means that Large BHCs are more familiar with the Board’s expectations than Nonbank Covered Companies as it relates to supervision generally and as it relates to implementation of the Proposed Rules. Greater familiarity with Board supervision will translate to greater ease of compliance with the Proposed Rules. It would be inappropriate to expect a Nonbank Covered Company to exhibit the same familiarity with Board supervisory approaches and techniques as a Large BHC, and as such it would be inappropriate to expect a Nonbank Covered Company to bring itself into compliance with the Proposed Rules within the same timeframe as a Large BHC.

In light of these concerns, we request that the Proposed Rules be amended to provide for an appropriate phase-in period for Nonbank Covered Companies, one that provides Nonbank Covered Companies with sufficient time to make investments in and implement the necessary risk infrastructure and MIS systems to bring themselves into compliance with the enhanced prudential standards and early remediation requirements. In this regard we note by analogy that the Basel Committee has provided for a “lengthy transition period” for the enhanced capital standards under Basel III, including in particular for the new leverage ratio.²⁰ We also note that the Basel III framework provides for multi-year observation periods prior to full implementation of its two new liquidity ratios, the Liquidity Coverage Ratio and the Net Stable Funding Ratio. These multi-year observation periods, which the Basel Committee instituted to mitigate any potential “unintended consequences”²¹ associated with implementation of the new liquidity ratios, illustrates the importance of observation, testing and calibration when requiring financial institutions to adhere to a new or enhanced prudential regulatory regime. We submit that the Board should take an

²⁰ See, e.g., Jaime Caruna, General Manager, Bank for International Settlements, *Remarks at the 2012 ADB Financial Sector Forum on “Enhancing financial stability – issues and challenges”* (Feb. 7, 2012), available at <http://www.bis.org/speeches/sp120208.htm?q1=1>.

²¹ See *Basel III: International framework for liquidity risk measurement, standards and monitoring* (Dec. 2010), available at <http://www.bis.org/publ/bcbs188.htm>.

analogous approach as the Basel Committee when applying the enhanced standards to Nonbank Covered Companies, which are themselves a new prudential regulatory regime as applied in such a context. Such an approach should also include an observation period to assess the potential effects of any new regime.

We offer specific comments on the Proposed Rules below.

VI. Enhanced Prudential Standards

A. Capital and Leverage

The Proposed Rules would require a Nonbank Covered Company to comply with three capital standards potentially as early as 180 days after being designated by the FSOC. First, the Proposed Rules would require a Nonbank Covered Company to calculate minimum risk-based capital and leverage requirements as if it were a BHC, in accordance with any minimum capital requirements established by the Board for BHCs. Second, the Proposed Rules would require a Nonbank Covered Company to hold capital sufficient to meet: (i) a tier 1 risk-based capital ratio of 4 percent and a total risk-based capital ratio of 8 percent, as calculated according to the general risk-based capital rules; and (ii) a tier 1 leverage ratio of 4 percent as calculated under the leverage rule. Third, the Proposed Rules would require a Nonbank Covered Company to comply with, and hold capital commensurate with, the requirements of regulations adopted by the Board relating to capital plans and stress tests as if the Nonbank Covered Company were a BHC, including the Board's recently finalized rule on capital plans.²² The Board's final capital plan rule in effect imposes an additional minimum capital requirement of tier 1 common risk-based capital of 5% under expected and stressed conditions over a minimum nine-quarter planning horizon.

Requiring a Nonbank Covered Company to comply with enhanced capital standards designed for BHCs as early as 180 days after being designated would be inappropriate, both because of the uncertainty surrounding capital-related reforms and because of the conceptual and practical difficulties associated with imposing a bank-centric capital framework on a nonbank financial company in such an abbreviated timeframe. With respect to the concern about uncertainty, we note that two critically important rulemakings relating to capital have yet to be completed. The Board and the other Federal banking agencies have yet to promulgate rules implementing the Basel III capital framework, and the Board has yet to establish risk-based capital requirements for SLHCs. Grandfathered unitary SLHCs share several common elements with the potential nonbank financial companies to be designated under section 113. Among the shared elements is the prevalence of diverse business models, including models that are heavily weighted toward nondepository financial activities including insurance where the Board has had less direct supervisory experience. Another shared element is the existence of other comprehensive regulatory regimes specifically designed by regulators with longstanding responsibility and experience in financial activities such as insurance. Of particular note is the insurance risk-based capital regime implemented by the states and utilizing formulas developed and modified by the National Association of Insurance Commissioners (the "NAIC").

Because these rulemakings are of critical importance, we submit that the Proposed Rules should not apply to Nonbank Covered Companies until these two rulemakings have been promulgated and finalized. This will provide nonbank financial companies potentially subject to designation by the FSOC with much-needed certainty as to the nature of the enhanced capital standard they face, and will also reduce the potential for significant problems which could otherwise arise if the Board requires Nonbank Covered Companies to adhere to a capital frameworks designed for BHCs. It will also provide an important opportunity to develop the tailored approach to the implementation of section 165 which is required by the terms of section 165 for nonbank financial companies.

²² Capital Plans, 76 *Fed. Reg.* at 74631 (Dec. 1, 2011).

More fundamentally, we believe that any capital framework applicable to Nonbank Covered Companies must recognize the fundamental differences between life insurance companies and banking organizations to avoid the significant conceptual and practical problems that would arise from the imposition of a capital framework specifically designed for banking entities on insurance entities. As we have discussed on previous occasions, the Board's current capital rules, as well as its approach to capital regulation in general, do not account for these fundamental differences.²³ For instance, the BHC rules do not sufficiently account for insurance-related assets, nor do they sufficiently account for instances where a company engages in other nondepository activities. Nor do the BHC rules appropriately account for the unique nature of various life insurer products.²⁴ Similarly, the risk-based capital formulas provide no weightings for insurance risks, such as exposure to mortality losses or fluctuations in claims reserves. As noted in a 2002 joint report of the staff of the Board and the NAIC, the different capital approaches for insurance companies and banks reflect the "inherent differences between the insurance and banking industries."²⁵ As was further noted in that report, the "two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors." and "the effective capital charges cannot be harmonized simply by changing the nominal capital charges on an individual basis."²⁶ Rather, the different capital approaches "arise from fundamental differences between the two industries, including the types of risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."²⁷ The fundamental differences between the insurance industry and the banking industry must be taken into account by the Board as it designs risk-based capital and leverage requirements for any insurance company that might be designated by the FSOC.

Because of these differences, any attempt by the Board to apply the BHC capital framework to a Nonbank Covered Company predominantly engaged in insurance activities would give rise to myriad practical problems related to implementation, and would lead to Nonbank Covered Companies reporting capital ratios to the Board which provide inaccurate or misleading information about the Company's overall risk profile. These problems will no doubt be exacerbated if the Nonbank Covered Company has only 180 days after being designated to design and implement the necessary systems to calculate and report risk-based capital ratios on a consolidated basis. In sum, requiring a Nonbank Covered Company to adhere to the BHC capital and leverage rules would do little to achieve the underlying objectives of an enhanced prudential framework, and would run the risk of providing inaccurate or irrelevant information to the regulators and to the market about a Nonbank Covered Company.

B. Liquidity

The Proposed Rules would require a Nonbank Covered Company to implement substantial and extensive policies and procedures relating to liquidity risk management, including extensive liquidity stress testing, the creation and maintenance of cash flow projections, and the establishment and maintenance of a contingency funding plan. The Proposed Rules would also require significant involvement of a Nonbank Covered Company's board of directors in the liquidity risk management process by, for example,

²³ See, Letter from the ACLI, to the Board (May 20, 2011), *available at* http://www.federalreserve.gov/SECRS/2011/May/20110523/OP-1416/OP-1416_052011_71615_425273793596_1.pdf; Letter from the ACLI, to the Board (Feb. 25, 2011), *supra* note 2.

²⁴ One example can be seen in the treatment of variable separate accounts. That base product's inherent risks come from fluctuations in interest rates, equity markets, etc., and the resulting changes in fund performance are borne by policyholders as reflected in the account value change. In some instances policyholders can purchase guarantees that transfer a portion of the risks to the company's general account, and separate reserves are held by the insurance company in the general account for these guarantees. As a result, these separate account assets need to be treated quite differently from the general account assets of life insurance companies.

²⁵ Report of the NAIC and the Federal Reserve System Joint Subgroup on Risk-based Capital and Regulatory Arbitrage (May 24, 2002), at 1.

²⁶ *Id.*

²⁷ *Id.* at 3.

requiring a Nonbank Covered Company's board of directors to oversee the Company's liquidity risk management processes and review and approve the liquidity risk management strategies, policies and procedures established by senior management of the Company.

Because the liquidity requirements seem premised on the assumption that the Nonbank Covered Company will have the liquidity profile of a Large BHC, they suffer from the same flaw as the provisions of the Proposed Rules relating to enhanced capital and leverage requirements, in that there is no allowance for the differences between Nonbank Covered Companies and Large BHCs.

This distinction is particularly significant when comparing life insurance companies to Large BHCs. As we have discussed above, there are several fundamental characteristics of life insurers that should be taken into account when developing a liquidity risk management policy that could potentially apply to these companies. Most importantly, life insurers have a much different mix of liabilities on their balance sheets than traditional banking organizations, in that life insurer liabilities are predominantly long-dated (as in the case of a life insurance policy), rather than short-dated (as in the case of a bank deposit). It is unlikely that a life insurer will be subject to a "liquidity" problem arising from a lack of short-term funding. Indeed, the insurance industry as a whole provided significant funding stability to the financial sector during the recent financial crisis.²⁸

Liquidity risk management by life insurers is therefore appropriately informed by the fact that the risk of a short-term liquidity squeeze is low. It would thus be inappropriate to apply the provisions of the Proposed Rules relating to liquidity risk management in their current form to a life insurer, as these provisions presuppose that the Nonbank Covered Company is likely to face a shortfall in short-term funding. Provisions relating to liquidity risk management inapposite to life insurers include:

- The Proposed Rules would require a Nonbank Covered Company to evaluate the liquidity costs, benefits, and risks of each significant new product.
- The Proposed Rules would require a Nonbank Covered Company to undertake annual reviews of the liquidity risk implications of existing significant business lines and products, regardless of whether review was necessary in light of the "material" liquidity risks with respect to significant business lines and products that the Nonbank Covered Company actually faced.
- The Proposed Rules would require the Nonbank Covered Company to conduct monthly liquidity stress tests, quarterly reviews and approvals of cash flow projections, and review liquidity practices, methodologies, assumptions and liquidity stress test results, regardless of whether such analyses are relevant to the risks that are actually material to the Nonbank Covered Company's business model.
- The Proposed Rules would require a Nonbank Covered Company to project comprehensive cash flows on a daily and monthly basis, when for Nonbank Covered Companies with predominantly insurance operations, cash flow analysis focuses on ensuring that long-term cash flows arising from insurance company investment holdings (such as long-dated corporate bonds) are appropriately matched with the Company's long-term liabilities.

As a general matter, there are substantial differences between bank liabilities and life insurance liabilities. Bank account balances can be withdrawn at any time with no or only relatively minor penalty so there is little disincentive for a customer to withdraw and redeposit the account balance with another bank. By comparison, life insurance liabilities and annuities are subject to substantial disincentives for a customer to withdraw her policy account value or annuity. Here are some important examples:

²⁸ See Paul J. Davies, *Banks Eye Insurers for Funding Stability*, FIN. TIMES, Apr. 9, 2012, <http://www.ft.com/intl/cms/s/0/b08970f2-7a5a-11e1-9c77-00144feab49a.html#axzz1rdsf5as7> (noting that "banks are now looking to insurance-type businesses as a potential source of very long-term and stable funding").

- Surrender Charges. Most deferred annuity contracts include a surrender charge as a contract feature. A surrender charge is a direct deduction the insurer makes against the account balance if the policyowner makes a full or partial withdrawal of the account balance. Given the long-term nature of these contracts, this charge is specifically designed to take into account the effect of an early withdrawal on the long-term matching of assets to liabilities that occur at contract issuance.
- Insurability. Persons who have been insured under a life insurance policy for some years may have since declined in health and may either not be eligible for replacement life insurance from another insurer or would be required to pay a substantial increased cost for replacement life insurance. Thus, the insurability of the insured life acts as a disincentive to policy replacement activity. It may be more cost effective for an insured person to retain her original life insurance than seek to replace it.
- Ongoing Premium Payments. Many life insurance policies require payment of a periodic premium. Failure to pay the premium results in a lapse and termination of coverage (e.g., the life insurer is no longer obligated to pay a death claim). Coupled with changes in insurability, there is a substantial incentive for a policyowner to continue to pay periodic premiums. Causing a policy to lapse results only in a modest nonforfeiture benefit under a whole life insurance policy but complete forfeiture of previously paid premiums under a term life insurance policy.
- Tax Implications. Termination of a life insurance policy or annuity contract (particularly a variable insurance policy or contract) may result in a tax event on the withdrawal value if the assets supporting the policy have performed well. This acts as a disincentive to such a withdrawal in that the policyowner may not wish to pay taxes on the gain under the policy. Taxes on the gain are otherwise deferred so long as the policy remains in effect.

In sum, the provisions of the Proposed Rules relating to liquidity and liquidity risk management are based on the incorrect assumption that a Nonbank Covered Company faces the same set of liquidity risks as a Large BHC. In so assuming, the Proposed Rules make no explicit provision for tailoring the liquidity and liquidity risk management requirements to the scale and nature of the liquidity risks that Nonbank Covered Companies such as insurance companies actually face. We request that the final rules explicitly provide for tailoring of the liquidity and liquidity risk management requirements based on the actual risks faced by a Nonbank Covered Company and provide the appropriate flexibility for a Nonbank Covered Company to design its liquidity risk management program based on its specific business model and products.

C. Single-Counterparty Exposure Limit

As is the case with the other provisions of the Proposed Rules, it is our belief that the provisions of the Proposed Rules relating to the single-counterparty exposure limit are ill-suited to the structures and activity mixes of Nonbank Covered Companies.

Under the Proposed Rules, a Nonbank Covered Company, together with its subsidiaries, would be prohibited from having aggregate net credit exposure to any unaffiliated counterparty which exceeded 25 percent of the consolidated capital stock and surplus of the Nonbank Covered Company. The Proposed Rules define “capital stock and surplus” to include, *inter alia*, the balance of the company’s allowance for loan and lease losses not included in tier 2 capital under the capital adequacy guidelines applicable to the Nonbank Covered Company. In addition, the Proposed Rules impose a more stringent single-counterparty exposure limit on “major” covered companies, which would include Large BHCs with total assets greater than or equal to \$500 billion and all Nonbank Covered Companies.

Complying with the single-counterparty exposure limit will require a Nonbank Covered Company to engage in data aggregation efforts that far exceed any existing requirements or systems that Nonbank

Covered Companies currently have in place. The requirements of the Proposed Rules will present significant challenges for Large BHCs, but even greater challenges for Nonbank Covered Companies. These challenges will be compounded by the broad definition of “control” in the Proposed Rules. Based on the definition of “control” in the Proposed Rules, Nonbank Covered Companies may be unable to access and aggregate counterparty information required to determine which counterparties are subsidiaries of other counterparties. From the perspective of a Nonbank Covered Company itself, even if the Nonbank Covered Company would theoretically have the ability to determine which of its investments in other companies meet the proposed broad definition of “control,” the Nonbank Covered Company would in many cases (especially in the case of minority equity investments in third party investee companies) be unable to monitor and track the exposures of the investee company. As a practical matter, it will be difficult, if not impossible, for Nonbank Covered Companies to monitor and aggregate the exposures of entities in which they are passive investors. In addition, they may not have the ability to control exposures of the investee company. We submit that the definition of “control” should be amended to only include companies that are required to be consolidated for financial reporting purposes.

We also believe it is inappropriate for the Board to deem every Nonbank Covered Company, regardless of its size or interconnectedness, to be a “major” covered company, thus subjecting it to the more stringent single-counterparty exposure limit. To subject all Nonbank Covered Companies to the more stringent limit would be to ignore the significant differences in size and interconnectedness between Nonbank Covered Companies and Large BHCs and the significant variations in size and interconnectedness between and among the various Nonbank Covered Companies themselves. Given that the more stringent exposure limit for major covered companies is presumably motivated by the view that interconnectedness among large financial institutions should be reduced, the failure to draw any distinction between a “major” covered company that is a Large BHC and Nonbank Covered Companies is puzzling in light of the fact that there is major interconnectedness in the interbank market that does not exist in the insurance market.

In recognition of the distinct differences in the levels of interconnectedness between Nonbank Covered Companies as compared to banks, we submit that the Board should not require that all Nonbank Covered Companies be subject to the more stringent single-counterparty exposure limit. Instead, we request that the Board amend the final rules to explicitly provide that when contemplating imposing the more stringent limit on a Nonbank Covered Company, the Board must take into account the actual level of interconnectedness in the predominant business line of the Nonbank Covered Company.

Furthermore, as currently drafted several provisions of the Proposed Rules relating to the single-counterparty exposure limit are essentially bank-centric in focus. The inclusion of allowances for loan and lease losses in the definition of “capital stock and surplus” stands as an example of the inclusion of an essentially bank-centric provision in rules that are proposed to be applied to Nonbank Covered Companies. The Board should tailor the single-counterparty exposure limit for Nonbank Covered Companies to ensure that it does not rely on essentially bank-centric provisions. By tailoring the limit to the actual activity profile of Nonbank Covered Companies, the Board will ensure appropriate treatment for Nonbank Covered Companies.

We note that the Board has also inquired in the preamble to the Proposed Rules whether the definition of “subsidiary” should be expanded to include “any investment fund or vehicle advised or sponsored by a covered company or any other entity.”²⁹ We strongly believe that the definition of “subsidiary” should not be expanded in this manner for Nonbank Covered Companies. To expand the definition in this manner would be to disregard the legal and operational separateness of funds from their advisors and sponsors. The existing legal, regulatory and business structures of Nonbank Covered Companies would be unable to accommodate such an expansion, as the legal and operational separateness of advised and sponsored funds means that various funds advised or sponsored by the same entity do not currently

²⁹ 77 Fed. Reg. at 615.

engage in aggregate data collection with respect to counterparty exposure. In addition, funds and their advisers must adhere to strict fiduciary duties by putting the interests of the individual funds' ahead of their own interests and, with respect to each fund, ahead of the interests of other funds'. Artificial limits on counterparty exposure would not properly account for this fiduciary duty. Furthermore, expanding the definition of subsidiary to include sponsored or advised funds would produce a distorted view of counterparty exposure and likely lower inappropriately the effective limit for Nonbank Covered Companies engaged in asset management activities.

Finally, we believe the Board should exempt (i) direct exposures to the United States and its agencies, regardless of whether they are guaranteed as to principal and interest; (ii) direct exposures to U.S. States and their political subdivisions and (iii) direct exposures to foreign governments that are members of the Organization for Economic Cooperation and Development from the single-counterparty exposure limit. These exemptions are comparable to the exemptions provided for in section 252.97 of the Proposed Rules, and should be added as additional categories of exempted exposures. As is the case for the exposure categories already exempted under the Proposed Rules, there is a significant policy interest in exempting these categories of exposures from the limit.

D. Risk Management, Risk Committee and Chief Risk Officer

As is the case with the provisions of the Proposed Rule relating to liquidity risk management, the provisions of the Proposed Rules relating to risk management in general presuppose that a Nonbank Covered Company is similar in risk profile and has a similar risk management framework to a Large BHC. This assumption fails to recognize that Nonbank Covered Companies face different risks than Large BHCs and have developed risk management frameworks that are appropriately tailored to these different risks.

It is imperative to recognize that the risks facing life insurers are in many ways completely distinct from the risks facing large banking organizations. First, life insurers face risks that are almost wholly uncorrelated with the risks arising from traditional banking activities, such as lending and deposit-taking. As the IAIS notes, "The [insurance] business model exposes insurers to unique risks [] which are not typically found in banking. Unique [risks] in insurance underwriting [include] . . . mortality, morbidity, property and liability risks."³⁰ Mortality risk, for instance, is almost wholly uncorrelated with the risks arising from defaults on extensions of credit, trading book losses, or runs on deposit liabilities. Second, life insurers typically face risks which exhibit a lower level of *intra-correlation* than risks facing banking organizations, meaning that liability- and asset-specific risks facing life insurers exhibit less correlation than asset- and liability- risks facing banking organizations. Indeed, the "traditional business model of insurance builds on the underwriting of *largely diversified pools of mostly idiosyncratic and uncorrelated risks*."³¹ For example, during periods of market stress, the different types of and asset and liability-risks facing a banking organization, such as risks arising from defaults on extensions of credit, trading book losses or runs on deposit liabilities, are likely to be significantly correlated and are likely to be interconnected through positive feedback loops. Thus, increased loan or trading losses would increase the probability that the banking organization would suffer a run on its deposit or wholesale funding liabilities. By contrast, life insurer liability risks (such as increased mortality risk resulting from a natural disaster) are less likely to be correlated with risks which impact the value of the insurer's assets, such as a change in interest rates which causes issuers to default on debt obligations held by the insurer.

³⁰ *Insurance and Financial Stability*, *supra* note 3, at 3. The findings in the IAIS paper on the differences between the insurance and banking business models also parallel findings in a recent report prepared by a Working Group established by the Committee on the Global Financial System under the auspices of the Bank for International Settlements. See Committee on the Global Financial System, CGFS Paper No. 44, *Fixed income strategies of insurance companies and pension funds* 9 (July 2011), available at <http://www.bis.org/publ/cgfs44.pdf>.

³¹ *Id.* at 6 (emphasis added).

Given the significant differences in the correlation of risks facing life insurers and banking organizations, it is puzzling that the provisions of the Proposed Rules relating to risk management presuppose that a Nonbank Covered Company takes the same approach to risk management as a Large BHC. For instance, the Proposed Rules make no provision for the fact that because a Nonbank Covered Company faces risks that are less likely to be correlated, it will design its risk management framework to reflect this fact. In other words, the design of an enterprise-wide risk management framework should be a function of the probability that the enterprise itself faces correlated risks across the various activities conducted by the organization. Instead of providing that a Nonbank Covered Company's risk management framework will be tailored to its actual risk profile, the Proposed Rules simply assume that a consolidated, enterprise-wide approach to risk management is best for the Nonbank Covered Company. We submit that this assumption must itself be examined to determine whether an enterprise-wide risk management framework is in fact appropriate for a Nonbank Covered Company which faces uncorrelated risks across its various activities, activities which differ significantly from traditional banking and trading activities.

As a separate matter, it is also important to note that the provisions of the Proposed Rules relating to both liquidity risk management and risk management in general would impose responsibilities on Nonbank Covered Company boards of directors that have traditionally been within the purview of company management. This risk is especially high for life insurers, because the unique nature of insurance risk management requires that insurance company boards of directors establish foundational principles for an insurer's risk management framework, with management having responsibility for implementing these principles. There is also a concern that the Proposed Rules could be read to require that each member of a Nonbank Covered Company's risk committee have significant experience developing and applying risk management practices and procedures. This requirement is at odds with empirical realities concerning the structuring of Nonbank Covered Company risk committees and the availability of trained and experienced personnel to serve on these risk committees.

We also note that section 165(h)(1) provides that the Board must require each Nonbank Covered Company "that is a publicly traded company" to establish a risk committee. The Dodd-Frank Act thus draws an explicit distinction as to the risk committee requirement between Nonbank Covered Companies that are publicly traded and Nonbank Covered Companies that are not. The Proposed Rules, however, draw no such distinction with respect to Nonbank Covered Companies, and require any Nonbank Covered Company to establish a risk committee regardless of whether it is publicly traded or not. The Board provides no explanation for why the Proposed Rules fail to mirror this clear statutory distinction.

We thus submit that the Board should not seek to define a required risk management framework for Nonbank Covered Companies *ex ante*, and should instead assess whether the specific structure and activity mix of a Nonbank Covered Company necessitate changes to its existing risk management framework. If so, the Board should tailor the enhanced risk management requirements to the particular risks that the Nonbank Covered Company faces, including, where appropriate, allowing the Nonbank Covered Company to combine its risk and finance committees as a way to ensure strong oversight of capital, liquidity and stress testing.

E. Stress Testing

The Proposed Rules contemplate that a Nonbank Covered Company would be subject to a stress testing regime based almost entirely on the Board's experiences with stress testing of Large BHCs. Indeed, the Board prefaces its discussion of the stress testing requirements by referring to the stress testing exercises which it conducted for Large BHCs in the wake of the financial crisis, the Supervisory Capital Assessment Program and the Comprehensive Capital Analysis and Review. As is the case with the other provisions of the Proposed Rules, we believe that the Board should explicitly tailor the stress testing requirements in the Proposed Rules in recognition of the differences between Large BHCs and Nonbank

Covered Companies. In this regard, we have several concerns with the stress testing requirements as they would apply to Nonbank Covered Companies.

First, the baseline, adverse, and severely adverse economic scenarios contemplated by the stress testing regime fail to account for the different types of risks that Nonbank Covered Companies face. As discussed above, insurance companies face risks that are in many instances unique to their business model. To account for these unique risks, any stress testing regime for a Nonbank Covered Company should incorporate shocks relating to the exogenous factors that actually impact the Nonbank Covered Company, such as a shock to an insurance company's insurance policy portfolio arising from a natural disaster. Any stress testing scenarios for Nonbank Covered Companies should similarly de-emphasize shocks arising from traditional banking activities, as risks arising from traditional banking activities such as commercial and consumer lending are likely to be of comparatively less importance to these companies.

Second, the provisions of the Proposed Rules relating to required data and information for stress testing are almost entirely bank-centric in content. For instance, under the Proposed Rules a Nonbank Covered Company could potentially be required to provide information so that the Board could derive robust projections of the company's pre-provision net revenue and allowance for loan losses, a metric that, as discussed, is of great relevance to banking organizations but of little relevance to a life insurer. The requirement that the Nonbank Covered Company provide the Board with information on exposures in the Company's trading portfolio seems similarly bank-centric, as life insurers do not engage in significant trading activities as compared to a Large BHC. The specific data and information required for stress testing should be tailored to the Nonbank Covered Company which actually conducts the stress tests. For example, stress tests related to variable insurance products need to be tailored to capture long-term stress impact and the results thereof.

Third, concerns with compliance and phase-in are particularly acute in the context of the stress testing requirement, as a Nonbank Covered Company could potentially be subject to the supervisory stress testing requirement only 180 days after it is designated by the FSOC. We question the efficacy and utility of subjecting a Nonbank Covered Company to a bank-centric stress testing framework only six months after it is designated as systemically important, a framework that could be based on largely irrelevant data and yield confusing and misleading results.

Finally, we wish to raise the concern that public disclosure of a Nonbank Covered Company's stress test results could create additional problems that may not arise in the context of disclosure of a Large BHC's stress test results. The marketplace has familiarity with and thus will be better able to interpret a Large BHC's stress test results. By contrast, it is unclear whether disclosure of a Nonbank Covered Company's stress test results could provide the marketplace with useful information concerning the Company's overall risk profile. The Board should be cautious in assuming that public disclosure of a Nonbank Covered Company's stress test results will provide the same benefit as public disclosure of a Large BHC's stress test results.

F. Debt-to-Equity Limit

Section 165(j) provides that the Board shall require a covered company to maintain a debt-to-equity ratio of no more than 15-to-1 upon a determination by the FSOC that the company poses a grave threat to the financial stability of the United States and that the imposition of such a requirement is necessary to mitigate the risk that the company poses to the financial stability of the United States. Section 165(j) is intended as an extraordinary measure, which would be invoked only if the FSOC makes a finding that a particular covered company poses a grave threat to the financial stability of the United States. In making this finding, the FSOC is directed to consider the factors listed in subsections (a) and (b) of section 113.

We note that the Proposed Rules materially deviate from the language of section 165(j) by defining the word "debt" to mean "total liabilities." We submit that the substitution of the phrase "total liabilities" for

the phrase “debt” is not supported by the language of section 165(j) and fails to take account of the differences between the liability structures of Nonbank Covered Companies and Large BHCs.

In the case of a Nonbank Covered Company that is an insurer, it would be particularly inappropriate and misleading to define “debt” to mean the “total liabilities.” Insurers have different types of liabilities and account for liabilities in a significantly different manner than BHCs. Under applicable accounting principles, insurers must account for future liabilities arising from underwritten insurance policies and hold reserves in anticipation of those future liabilities. Reserves for future insurance policy liabilities understandably represent a significant part of the total liabilities of an insurer and are not comparable in kind or relative size to the reserves held by banking entities. Likewise, many life insurers maintain significant separate account balances, reflected as assets and offsetting liabilities on their balance sheets. The separate account category is unique to insurers and is not comparable to any category of asset or liability for a banking entity. Whatever conceivable arguments might be made for implementing section 165(j) by using total liabilities of a banking entity as a proxy for debt (and we note even as to banking entities that the phrase used in the statute is “debt” and not “total liabilities”), it is clear that the substitution of the phrase “total liabilities” for “debt” in the application to insurance companies is not justified and reflects a failure to take account of the fundamental differences between life insurers and banking entities. We request that the Board in a separate rulemaking tailor the proposed rules for the debt-to-equity ratio to take into account differences among nonbank financial companies and banking entities and the predominant line of business of the nonbank financial company. We specifically submit that the substitution of “total liabilities” for the statutory term “debt” is inappropriate and unauthorized as applied to any insurer.

VII. Early Remediation Requirements

The Proposed Rules contemplate an early remediation framework which expands the prompt corrective action (“PCA”) rules currently applicable to insured depository institutions under the Federal Deposit Insurance Act. Because the early remediation requirements are based on the PCA framework, the early remediation triggers are by and large bank-centric in focus and hence suffer from the same kinds of defects that affect the other proposed standards.

Most obviously, the remediation triggering events that are triggered by risk-based capital and leverage ratio tests based on the Board’s risk-based capital and leverage rules for BHCs share the same flaws as the provisions in the Proposed Rules (as discussed above) that would impose such capital and leverage requirements directly on Nonbank Covered Companies. The Proposed Rules for early remediation simply impose the same bank-centric rules on Nonbank Covered Companies indirectly. Similarly, the remediation triggering events based on the bank-centric liquidity and risk management provisions in the Proposed Rules share the similar defect of embedding these standards into the early remediation regime. Any early remediation trigger for a Nonbank Covered Company should be based on the appropriately tailored prudential standards that the Board should adopt in the separate rulemaking as suggested in section II of this letter.

For Nonbank Covered Companies that are insurers, we believe that the early remediation requirements should take into account the risk-based capital rules applicable to U.S. insurers. The U.S. insurance risk-based capital rules were developed in the early 1990s at the same time the PCA rules were developed for insured depository institutions. Each state has enacted a risk-based capital law that requires each insurer to file a uniform annual risk-based capital report, the form of which is maintained by the NAIC. The framework is similar to that of insured depository institutions – if an insurer’s total adjusted capital begins to drop below each of the four designated risk-based capital levels, various levels of increased remedial action are required, ranging from the insurer preparing a plan proposing corrective actions it intends to take to eliminate the capital deficiency (which is subject to acceptance by the insurer’s domestic state insurance regulator) to corrective actions imposed by order by the insurer’s domestic state regulator. If an insurer’s risk-based capital triggers a “mandatory control level event,” the domestic state insurance regulator must seek to place the insurer into rehabilitation or liquidation (receivership).

Most importantly, the calculation of insurer risk-based capital is specifically tailored to the business risks to which an insurer is exposed. In the case of a life insurer, these risks include asset risk (including risks associated with derivatives and reinsurance), insurance risk (the risk of underestimating liabilities from business already written or inadequately pricing business to be written), interest rate risk and market risk (risk of losses due to changes in market levels associated with life insurer variable products with guarantees). The bank-centric early remediation framework simply is not appropriate for insurers.

Although the proposed early remediation framework is clearly bank-centric in design, its major flaw would negatively impact both Nonbank Covered Companies and the larger financial system. Specifically, there is a danger that the early remediation requirements will inappropriately cabin a covered company's ability to take actions necessary to mitigate its financial distress. For example, a covered company subject to Level 2 remediation could be prohibited from acquiring assets to hedge outstanding risks or engaging in certain asset/liability management activities that could enhance its overall liquidity position. If a covered company were prevented from taking such actions, the odd result would arise that the early remediation framework would be exacerbating exactly the types of problems that it was intended to mitigate. We submit that it would be counterproductive to require the imposition of restrictions and prohibitions that the Board could impose on a covered company anyway. In the absence of early remediation requirements, the Board would retain the ability to impose restrictions on a covered company's acquisitions, asset growth or capital distributions pursuant to its supervisory authority.

Because the early remediation framework is designed for Large BHCs, we believe that imposing bank-centric early remediation triggers on Nonbank Covered Companies would not only fail to achieve the purpose of the early remediation framework, but would also give rise to false positives that would mislead the Board into believing that the financial condition of the Nonbank Covered Company had deteriorated. In order to provide for triggers which accurately capture deteriorations in the financial condition of a Nonbank Covered Company, the Board should amend the final rule to explicitly provide that the early remediation framework will be tailored to the capital structure, risk profile, complexity, activities and size of the Nonbank Covered Company. In developing an early remediation framework that is appropriately tailored to the Nonbank Covered Company, we request that the Board remain cognizant of current and ongoing international efforts to develop new frameworks for effective prudential regulation of nonbank financial companies, several of which are likely to provide the Board with helpful information in designing an appropriately tailored early remediation framework.³² The Board should seek to ensure that any early remediation requirements developed for Nonbank Covered Companies are harmonized with international regulatory standards to the greatest extent possible.

VIII. Conclusion

We thank the Board in advance for its serious consideration of our views. We are available for further discussion on this matter at your convenience.

Respectfully submitted,



Julie A. Spiezo

CC: Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave, NW, Washington, DC 20551

³² See, e.g., Press Release, IAIS, Insurance and Financial Stability –Opening Remarks of Peter Braumiller, Chairman of the IAIS Financial Stability Committee (Nov. 15, 2011), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/13350.pdf (noting that the IAIS is developing an assessment methodology for globally systemically important insurers).



Julie A. Spiezio
Senior Vice President, Insurance Regulation & Deputy General Counsel
(202) 624-2194 t (866) 953-4083 f
juliespiezio@acli.com

January 24, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551

The Honorable John G. Walsh
Acting Comptroller of the currency
Department of the Treasury
250 E St, SW
Mail Stop 2-3
Washington, DC 20219

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th St., NW
Washington, DC 20429

The Honorable Mary L. Schapiro
Chairman
Securities & Exchange Commission
100 F St., NE
Washington, DC 20549-1090

Re: Notice of Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (FRS Docket No. R-1432 & RIN 7100 AD 82; OCC Docket ID OCC-2011-14; FDIC RIN 3064-AD 85; SEC File Number S7-41-11).

Dear Sirs and Madam:

These comments are submitted on behalf of the American Council of Life Insurers (ACLI). The ACLI is a national trade association with over 300 member companies representing more than 90 percent of the assets and premiums of the life insurance and annuity industry in the U.S. We appreciate the opportunity to submit comments on the agencies' joint proposed rulemaking on prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds. For purposes of this letter, we refer to the Section 619 of the Dodd-Frank Act (adding Bank Holding Company ("BHC") Act § 13) as the "Volcker Rule," the federal regulatory agencies that proposed the rulemaking as the "Agencies" and the proposed rules attached to the proposed rulemaking as the "Proposed Regulations."

I. Introduction

The Volcker Rule is one of the most important and complex provisions in the Dodd-Frank Act. As the Agencies have recognized in the preamble to the Proposed Regulations, implementation of the Volcker Rule through the mandated rulemaking process involves an intricate analysis of the statutory provisions, including subtle but important distinctions among activities. Recognition of these subtle distinctions is necessary, for example, to permit banking entities “to continue to provide client-oriented financial services.”¹ As the Agencies have further recognized in the preamble, the Proposed Regulations must also take appropriate recognition of the interests of a banking entity in preserving its ability “to continue to structure its businesses and manage its risks in a safe and sound manner.”

We also appreciate the efforts of the Agencies reflected in the Proposed Regulations to identify areas that require greater clarity as well as their efforts to provide appropriate latitude to banking entities to continue to provide client-oriented services. Recognition of the need and desirability of providing client-oriented services is crucial not only to the banking entities, but even more importantly to their clients and the overall markets themselves. The efficient functioning of the markets, including for the institutional investor community, requires that banking entities be permitted to provide market making and other client-driven services. One area of significant concern which has been identified by the larger financial community is the impact the Volcker Rule will have on overall liquidity in the marketplace, particularly in the secondary markets. While our commentary in this letter does not focus on that issue, the ACLI will be filing a separate letter on that specific subject since, as important long-term investors in the financial markets, we share that concern. We urge you to give serious consideration to that commentary, as well as the comments you receive on the issue from other institutional investor groups.

Our comments in this letter are more narrowly focused and relate specifically to the provisions of the Proposed Regulations as they affect insurance companies that are affiliated with insured depository institutions. As a threshold matter, it is important to observe that in enacting the Volcker Rule, Congress expressly recognized the need to “appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws.”² The specific reference to insurance company *investment* laws makes it clear that the accommodation required under the Volcker Rule relates both to the proprietary trading restrictions and the private equity and hedge fund investment restrictions.

The basis for this accommodation flows from the fact that insurance companies are subject to comprehensive state investment laws that are specifically designed to promote the safety and soundness of the regulated insurance company through such measures as investment limits and diversification requirements. The basis for this accommodation also flows from the fact that the insurance company model is different from virtually all other financial institution models in its predominant focus on long-term liabilities and on the supporting these long-term liabilities with long-term assets and investments. Because of the unique nature of insurance company operations, recognition and preservation of state investment law authority is essential to the safe and sound conduct of the insurance business. This applies as much to state investment law authority to invest in private equity or hedge funds as it does to the state investment law authority to engage in putative proprietary trading. Furthermore, an essential part of the business of insurance is that both the insurer general account and separate accounts invest in a broad range of investments, including private equity and hedge funds, as permitted under applicable insurance law.

Recognition of these fundamental points is essential to any exercise in accommodating the business of insurance in the context of the Volcker Rule. We believe that several changes and clarifications to the Proposed Regulations are necessary both to conform the Proposed Regulations to the statutory intent of the Volcker Rule and to appropriately accommodate the business of insurance.

¹ Proposed Regulations, Supplementary Information, pt. II.A.

² 12 U.S.C. § 1851(b)(1)(F).

II. Executive Summary

We believe that the Volcker Rule provisions were not intended to prohibit insurance company general account or separate account investment activity or any combination of general account and separate account investment activity, including as to guaranteed separate accounts and other hybrid accounts,³ conducted in compliance with applicable insurance law with respect to either proprietary trading activities or private equity or hedge fund investment activities. The Proposed Regulations, however, create two gaps, which appear to have the effect of subjecting permitted insurance company investment activities to the prohibitions contained in the Proposed Regulations.

First, the Proposed Regulations exclude insurance company general account and separate account activity from the proprietary trading restrictions in Subpart B. However, the Proposed Regulations do not expressly refer to general account or separate account activity in Subpart C, thereby creating the implication that general account and separate account activities conducted in accordance with state insurance investment law are subject to the investment restrictions contained in Subpart C. Such a result would be inconsistent with the Volcker Rule statute itself. To conform the Proposed Regulation to the language and intent of the statute, we request that the following insurance company investment activities be specifically recognized as “permitted activities” in the Proposed Regulations:

1. General account and separate account investing in any investment allowed under applicable insurance law, including a covered fund.
2. An insurance company establishing any separate account in compliance with applicable insurance law.
3. An insurance company establishing a subsidiary under applicable insurance law that makes investments.

Second, the drafting of the definitions of “general account” and “separate account” would create a gap with the result that certain insurance company investment activity is captured by neither the “general account” exemption nor the “separate account” exemption. In order to eliminate this possible gap, we request that the definition of “separate account” be aligned with the separate account exemption conditions by adding the § __.6(b)(2)(iii)(C) condition to the “separate account” definition in § __2(z).

Lastly, we believe that the reporting and recordkeeping requirements and compliance monitoring included in the set forth in §§ __.7, __.15 and __.20 and Subpart D should not apply to insurance company investment activities that are permitted activities under BHC Act § 13 and the Proposed Regulations. A detailed discussion of each of these comments is set forth in Parts IV through VIII below.

III. Insurance Regulation and Accommodating the Business of Insurance

A. Insurance Regulation

³ The instructions to Federal Reserve Board Form FR Y-9C, Schedule HC-F (June 2011), Line Item 5c), refer to “hybrid account life insurer assets” and describes a “hybrid account insurance policy” as follows: “A hybrid account insurance policy combines features of both general and separate account insurance products. Similar to a general account life insurance policy, a hybrid policy offers a guaranteed minimum crediting rate, does not carry market value risk, and does not require stable value protection. However, like a separate account life insurance policy, a hybrid policy’s cash surrender value is supported by assets segregated from the general assets of the insurance carrier.” See www.federalreserve.gov/reportforms/forms/FR_Y-9C20111231_i.pdf, at p. HC-F-3.

The Financial Stability Oversight Council, in its study on the Volcker Rule,⁴ recognized the unique nature of insurance company investment activity and its regulation in such observations as the following:

- “Insurance companies assume risk and collect premiums and, in turn, invest those premiums. Investment returns contribute to the company’s net worth (i.e., policyholder surplus), which in turn supports underwriting and the payment of future claims to policyholders and claimants.”
- “The investment activity of [insurance] companies is central to the overall insurance business model and could be unduly disrupted if certain provisions of the Volcker Rule applied.”
- “Insurance company investment is subject to relevant state investment laws which, while not uniform, are substantially similar and generally conform to standards set out in model laws and regulations developed by the National Association of Insurance Commissioners (“NAIC”). State investment laws aim at limiting the amount and type of investments insurers can make in order to limit their investment and counterparty risk exposure. For example, among other limitations, investment laws limit the amount of investment an insurer can make in equities, low-grade securities, or in the securities of any one issuer.”
- “State insurance company investment laws and regulations govern the type of investment, and extent of such investments, an insurance company can include as “admitted” assets on their balance sheet for the purpose of determining whether the insurance company has the ability to discharge its obligations and meet capital and surplus requirements. Insurance companies can make otherwise prohibited investments, but such investments are not considered admitted assets and still have to be reported to state insurance regulators.”
- “State agencies monitor insurer investments, through reporting, valuation, and examination, to ensure that such investments are in compliance with state insurance investment laws, regulations, and guidance, and, even when insurers are otherwise in compliance to ensure that such investments do not threaten the solvency of the insurer.”

As recognized in the Financial Stability Oversight Council study on the Volcker Rule, state insurance investment laws are designed to promote safety and soundness of the insurance company – they directly impact prudent product design and help reduce the risk presented by the unique nature of insurance operations, such as the long-term maturity profile of insurance liabilities.

In addition, State insurance laws and regulations address many other aspects of the business of insurance, including, importantly, financial matters such as standards of solvency, statutory reserves, reinsurance and capital adequacy. Each insurance company is required to file reports, generally including detailed annual financial statements, with State insurance regulators in each of the jurisdictions in which it does business, and its operations and accounts are subject to periodic examination by such authorities. Each insurance company is subject to risk-based capital requirements, and reports its risk-based capital based on a formula calculated by applying factors to various asset, premium and statutory reserve items, as well as taking into account the risk characteristics of the insurance company. The formula is used as an early warning regulatory tool to identify possible inadequately capitalized insurance companies for purposes of initiating regulatory action. Insurance laws provide State insurance regulators the authority to require various actions by, or take various actions against, insurance companies whose risk-based capital ratio does not meet or exceed certain levels.

⁴ Financial Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, p. 71-73 (Jan. 2011).

B. Accommodating the Business of Insurance

The fact that insurance regulation generally, and insurance investment regulation specifically, is so comprehensive is the basis for the principle that the Volcker Rule must “appropriately accommodate the business of insurance within an insurance company.” That principle extends to all insurance company investment activity and is applicable both to the proprietary trading restriction and to the covered fund restriction. Prohibiting an insurance company from engaging in any investment activity that is allowed under applicable insurance law would be inconsistent with the principle of accommodating the business of insurance. Therefore, the Proposed Regulations should be revised and clarified to accommodate the three insurance investment activities described in Part II above.

IV. Subpart C – Insurance Company Investing in Covered Funds

A. Requested Change

We appreciate that, in connection with the proprietary trading prohibition, the Proposed Regulations (a) incorporate the “regulated insurance company” permitted activity in § __.6(c) and (b) confirm that the “on behalf of customers” permitted activity includes the purchase or sale of a covered financial position for an insurance company separate account in § __.6(b)(2)(iii). These provisions address an insurance company’s investment activity that supports fixed contracts that are backed solely by general account investments, variable contracts that are backed solely by separate account assets and guaranteed separate account contracts and other hybrid accounts that are backed by both general and separate account assets. In addition, we appreciate the clarification in the Proposed Regulations that these two insurance company permitted activities extend to the investment activity of all insurers, both U.S. and foreign, affiliated with a banking entity. However, the Volcker Rule itself extends the “regulated insurance company” and separate account “on behalf of customers” permitted activities to the prohibition against investing in private equity or hedge funds and accordingly we request that Subpart C be amended to expressly include these two exemptions.

B. Analysis and Discussion

The statutory directive of BHC Act § 13 is to have the Volcker Rule “appropriately accommodate the business of insurance within an insurance company” by allowing insurance companies to continue to engage in general and separate account investing subject to regulation in accordance with relevant insurance company investment laws. Furthermore, the language of BHC Act § 13 itself exempts insurance company general account and separate account investments from the restriction on investing in private equity or hedge funds. Lastly, imposing the covered fund prohibition on insurance company investment activity would conflict with the specific provisions of state insurance investment laws that are designed to promote both appropriate diversification of investments and the appropriate use of long-term assets to fund long-term liabilities of insurance companies. State investment laws are at bottom designed to promote the safety and soundness of insurance operations. Pre-empting the operation of these state investment laws would not promote the goal of safety and soundness but would actually undermine it.

Accommodating the Business of Insurance. As stated above, the principle that the Volcker Rule must “appropriately accommodate the business of insurance within an insurance company” is as applicable to the covered fund restriction as it is to the proprietary trading restriction. BHC Act § 13(d)(1)(D) and (F) permit an insurance company to invest in covered funds to the extent allowed by applicable insurance investment law. Prohibiting an insurance company from investing in a covered fund (under the covered fund prohibition) to the extent allowed under applicable insurance law would be inconsistent with the principle of accommodating the business of insurance – what the proprietary trading exemption would allow within the constraints of applicable insurance law, the covered fund prohibition would take away. Recognizing the state investment law authority to invest in private equity or hedge funds is as necessary

to accommodate the business of insurance as recognizing the investment law authority to permit proprietary trading.

Volcker Rule Statutory Language. The covered fund prohibition as set forth in BHC Act § 13(a) provides as follows:

(a) IN GENERAL.— (1) PROHIBITION.—Unless otherwise provided in this section, a banking entity shall not . . . (B) *acquire* or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund. (*emphasis added*)

The list of permitted activities in BHC Act § 13(d)(1) begins with the following wording:

Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as ‘permitted activities’) are permitted: (emphasis added)

The “on behalf of customers” and “regulated insurance company” permitted activities in BHC Act § 13(d)(1)(D) and (F) each read, in relevant part, as follows:

(D) The purchase, sale, *acquisition*, or disposition of securities and other instruments described in subsection (h)(4) on behalf of customers.

* * * * *

(F) The purchase, sale, *acquisition*, or disposition of securities and other instruments described in subsection (h)(4) by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate of such regulated insurance company, provided that such activities by any affiliate are solely for the general account of the regulated insurance company, if . . . (*emphasis added*)

On the face of the language of BHC Act § 13(a), the permitted activities in subparagraphs (D) and (F) are exemptions both to the proprietary trading prohibition and the covered fund prohibition. BHC Act § 13(a)(1)(B) provides that a banking entity may not “acquire” any equity, partnership or other ownership interest in a hedge fund or private equity fund. The Proposed Regulations also uses the same activity word, “acquire,” in its statement of the covered fund prohibition in § __.10(a). Subparagraphs (D) and (F) of BHC Act § 13(d)(1), the “on behalf of customers” and “regulated insurance company” permitted activities, also use the same activity wording – they permit the “acquisition” of “securities and other instruments” notwithstanding proprietary trading prohibition and the covered fund prohibition. Since the permitted activity (“acquisition”) matches the prohibited activity (“acquire”), the plain meaning of the statute is that these permitted activities provide an exemption from the covered fund prohibited activity as well as the proprietary trading prohibition.

There is also a clear alignment between the instruments in BHC Act § 13(a)(1)(B) that may not be acquired by a banking entity under the covered fund prohibition (“any equity, partnership or other ownership interest in . . . a hedge fund or a private equity fund”) and the kinds of instruments that may be acquired under the subparagraph (D) and (F) permitted activities (“securities and other instruments described in subsection (h)(4)”). The securities and other instruments described in subsection (h)(4)

are “any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may . . . determine.” Since the securities and other instruments described in subsection (h)(4) include *any* security, a security representing an investment or ownership interest in a private equity and hedge fund is clearly among the securities and other instruments that may be acquired under the subparagraph (D) and (F) permitted activities.⁵

We request that the permitted covered fund activities and investments under Subpart C of the Proposed Regulations be expanded to include explicitly an insurance company separate account “on behalf of customer” exemption and a “regulated insurance company” exemption subject to the same conditions as the comparable exemptions in Subpart B of the Proposed Regulations, §§ __.6(b)(2)(iii) (insurance company separate accounts) and 6(c) (regulated insurance company). In each case, the permitted covered fund activity will be limited to compliance with applicable insurance company investment laws. We propose the amending wording attached as Appendix A be added as a new § __.13(e) to the Proposed Regulations. Furthermore, as a technical amendment, the definitions of “foreign insurance regulator,” “general account” and “State insurance regulator” should be moved from Proposed Regulations § __.3(c) (Subpart B, proprietary trading definitions) to Proposed Regulations __.2 (general definitions) so that they will apply equally to Subpart B and Subpart C (where the new insurance company permitted covered fund activities will be added).

Conflict with State Investment Law Regime and the Goal of Safety and Soundness. State insurance laws establish a detailed and comprehensive investment regime for insurance companies. These laws are specifically designed to promote the safe and sound operation of insurance companies *inter alia* by establishing limits and diversification requirements and by fostering investments in longer-term instruments that more appropriately correspond to the long-term liability structure of insurance companies. Covered funds and other alternative investments provide insurance companies access to companies, markets and investment strategies to create diversification benefits which otherwise would be inefficient or more difficult for insurance companies to try to recreate on their own. In addition, alternative investments have low historical correlation to other insurance company investments and afford a key portfolio construction tool to fund long-dated liability products and insurance company surplus accounts. Alternative investments also provide insurance companies with access to other world-class asset managers with strong governance protections and alignment of interests. Lastly, alternative investments have generated historically high rates of return and have outperformed public equity indices over a 10+ year period with lower volatility.

Denying insurance companies access to alternative investments would not further the underlying purpose of the Volcker Rule. Rather it would have harmful effects both on the insurance company and its customers. Insurance companies have existing long-term insurance liabilities and must appropriately plan to meet those liabilities using an investment strategy that includes permitted investments. Insurance companies widely use investment strategies that include reliance on a wide variety of asset classes that include alternative investments that are available in the form of covered funds. If the

⁵ We recognize that subsection (d)(1)(F) refers to the purchase or sale of “securities and other instruments described in subsection (h)(4),” and that subsection (h)(4) defines proprietary trading. However, this does not indicate that the subsection (d)(1)(F) exemption is limited to proprietary trading. Subsection (d)(1)(F) refers to “securities and other instruments” *described* in subsection (h)(4); subsection (d)(1)(F) does not refer to “proprietary trading” described in subsection (h)(4). The instruments *described* in subsection (h)(4) include “any security.” Because the plain language of subsection (d)(1)(F) clearly provides that the purchase or sale of any security or instrument *described* in subsection (h)(4) is permitted, there is no basis for creating an implication that the exemption in subsection (d)(1)(F) is intended to apply only to proprietary trading activities. To conclude otherwise would conflict with established canons of statutory construction, which provide that, if the meaning of a particular phrase is clear, no other section or part of a statute should be applied to create a doubt as to its meaning. See 2A Norman J. Singer and J.D. Shambie Singer, SUTHERLAND ON STATUTORY CONSTRUCTION, § 47.2, at 279 (7th ed. 2007).

Volcker Rule as applied to insurance companies bars covered fund investments, these investments will have to be eliminated resulting in a weakened ability to manage assets and liabilities due to the lack of appropriate substitutes for federally prohibited covered funds.

In addition to their importance to insurance company claims paying ability, alternative investments through covered funds are also vital to insurance company profitability and ability to pay dividends and offer crediting rates on insurance products such as whole life insurance sold to individuals and stable value investment options offered to participants in defined contribution retirement plans. A covered fund prohibition will likely reduce credited interest rates on both existing and future insurance products with adjustable crediting rates and dividend rates on participating policies as each are tied to earnings on insurance company assets.

Finally, we note that there is no evidence to suggest that Congress had any concerns about insurance company general account or separate account investments in hedge funds or private equity funds (much less the much broader universe of “covered funds” as defined in the Proposed Rules), or sought to create new federal insurance company investment laws through the Volcker Rule.

V. Subpart C – Insurance Company Sponsoring Unregistered Separate Accounts

A. Requested Confirmation

We note that the Proposed Regulations provide an exemption to permit a banking entity to acquire an ownership interest in or sponsor a separate account used solely to purchase a bank owned life insurance policy. We support this provision. We request that the Agencies also confirm that an insurance company (that is a banking entity for purposes of the Volcker Rule) may continue to provide the traditional range of insurance products supported by unregistered separate accounts to its clients as part of its ordinary insurance business.

B. Analysis and Discussion

The SEC and the courts take the view that, in order to effect the disclosure and other investor protection purposes of the Investment Company Act of 1940 (the “Investment Company Act”) with respect to variable insurance and annuity products offered to the retail public, an insurance company separate account is itself an “investment company” within the meaning of the Investment Company Act. Such separate accounts are not required to be registered and regulated under the Investment Company Act if the relevant insurance contracts are issued in a private placement and either (i) contract owners are limited to “qualified purchasers” (in which case the separate account may rely on section 3(c)(7)), or (ii) there are no more than 100 contract owners (in which case the separate account may rely on section 3(c)(1)).⁶ In these circumstances, an unregistered separate account might itself be deemed to be a “hedge fund” or “private equity fund” within the meaning of BHC Act § 13(h)(2) (and a “covered fund” as defined in Proposed Regulations § __.10(b)(1)). If so, the question then arises whether the insurance company could be deemed to be “sponsoring” the separate account within the meaning of BHC Act § 13(h)(5).

An insurance company should not be deemed to be “sponsoring” a separate account within the special meaning of that term as defined in BHC Act § 13(h)(5). The definition of the term “sponsor” contained in BHC Act § 13(h)(5) presupposes that the fund is separate legal entity from the sponsor, but as a separate legal entity it is nonetheless managed or controlled by the sponsor or associated with the sponsor by sharing the name of the sponsor. But a separate account is merely a designated pool of assets on the insurance companies’ own balance sheet and is not a separate legal entity so an insurance company cannot serve as a general partner, managing member, or trustee of a separate

⁶ Where the only insurance contract holders are qualified pension plans, the separate accounts, like similar bank collective investment funds, are exempt under section 3(c)(11) of the Investment Company Act.

account. Similarly, since the separate account is not a separate legal entity, the insurance company cannot select or control a majority of the directors, trustees, or management of a separate account. Likewise, it is unclear how an insurance company can be said to “share” a name with itself.

Since the separate account represents a specified pool of assets of the insurance company that support a policy claim on the insurance company, and is not a separate legal entity or fund within the intended meaning of BHC Act § 13(h)(2), the insurance company cannot be a “sponsor” of its separate accounts within the special meaning of BHC Act § 13(h)(5). Any other reading of the definition would cause the result, clearly not intended by Congress, that significant parts of the ordinary business of insurance companies would be prohibited.

Accordingly, we request that the Agencies confirm that separate accounts maintained in accordance with applicable insurance laws are not subject to the covered fund prohibitions in the Proposed Regulations. To do otherwise would bar insurance companies from establishing unregistered separate accounts which are currently used, for example, to allow a corporation to purchase corporate owned life insurance on the lives of its employees, an individual to purchase private placement variable life insurance on his or her life, and a corporation to purchase a group variable annuity contract that supports its pension and retirement plan obligations.⁷

VI. Subpart C – Insurance Company Establishing a Permitted Subsidiary

A. Requested Change

Many state insurance laws authorize an insurance company to invest in or organize subsidiaries for the purpose of making investments under applicable insurance law. Such a subsidiary may technically fall within the definition of “covered fund” if it would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act. If so, an insurance company that is a banking entity would be prohibited from investing in or organizing the subsidiary as a “covered fund.” We request that an exemption to the covered fund prohibition be added to the Proposed Regulations to allow an insurance company to invest in or organize a subsidiary for the purpose of making investments under applicable insurance law.

B. Analysis and Discussion

Accommodating the business of insurance must include accommodating the authority in applicable insurance law to invest in or organize subsidiaries for the purpose of making investments.

Subpart C, § __.14(a)(2), provides that the covered fund prohibition does not apply to owning an interest in or sponsoring certain entities that would otherwise qualify as a covered fund. We request that an insurance company permitted subsidiary be added to this list to allow an insurance company to invest in or organize a subsidiary as permitted under applicable insurance law. While insurance company subsidiaries are not required as a matter of applicable insurance law to be wholly-owned, we are sensitive to any concern that might be raised by the possibility of interests being owned in such a subsidiary by unaffiliated third parties. Therefore, we propose that the exemption be available only for a subsidiary that is wholly-owned by the insurance company itself or by the insurance company and entities that are affiliated with the insurance company. We propose that the following be added as a new Proposed Regulations § __.14(a)(2)(vi):

⁷ In the Proposed Rules, the Agencies appropriately exempted bank-owned life insurance from the covered fund prohibitions, with respect to both purchase by insured depository institutions and their affiliates and issuance by insurance companies that are banking entities. We believe that there is an equally valid basis to exempt generally insurance company products supported by unregistered insurance company separate accounts, and we would be glad to provide further comments if the Agencies desire. However, in light of the clear language in BHC Act § 13(h)(5), under which it is not reasonable to consider that insurance companies “sponsor” their separate accounts, we believe the Agencies do not need to reach the question of exemption.

(vi) A wholly-owned subsidiary of a covered banking entity in which one or more affiliated insurance companies invests in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which each such insurance company is domiciled.

VII. Bridging Any Potential Gap Between the “General Account” and “Separate Account” Exemptions

A. Requested Change

As stated above, in order to effectively accommodate the business insurance, insurance company investment activity permitted under applicable insurance law should be exempted from both the proprietary trading prohibition and the covered fund prohibition of the Volcker Rule. As a consequence, all permitted insurance company investment activity should be subject to either the “general account” exemption under § __6(c) or the “separate account” exemption under § __6(b)(2)(iii). While that is the apparent intent of the Proposed Regulations, some insurance company separate account investment activity might inadvertently fail to satisfy either exemption since the investment may at the same time be allocated to a separate account as defined in § __.2(z) (and thus not be an investment for the “general account” as defined in § __3(c)(6)), but also some of the profits and losses arising from the investment may inure to the benefit or detriment of the insurance company (and thus fail condition § __.6(b)(2)(iii)(C) to the separate account exemption).

This inadvertent problem can be remedied by adding the § __.6(b)(2)(iii)(C) condition to the § __.2(z) definition of “separate account.” This change will eliminate any potential gap created by the lack of symmetry between the separate account exemption conditions (especially condition § __.6(b)(2)(iii)(C)) and the definition of “separate account” which is not subject to the § __.6(b)(2)(iii)(C) condition. The change will assure that all insurance company investment activity permitted under applicable insurance law qualifies for the appropriate exemption – either the general account exemption under § __6(c) or the separate account exemption under § __6(b)(2)(iii) (together with the comparable exemptions requested in Part IV above in respect of covered funds).⁸

B. Analysis and Discussion

Subpart B, § __.6(b)(2)(iii), of the Proposed Regulations provides four conditions that must be met for a covered banking entity that is an insurance company to purchase or sell a covered financial position for a separate account and that purchase and sale to be considered on behalf of customers and exempted from the prohibition on proprietary trading contained in § __.3(a). The third condition requires that:

(C) All profits and losses arising from the purchase or sale of a covered financial position are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, *and not the insurance company; (emphasis added)*

While this condition is true for insurance company variable separate accounts, applicable insurance law also allows an insurance company to allocate or transfer its own funds to a separate account with the profits or losses on those funds inuring to the benefit or detriment of the insurance company. Two examples of this permitted separate investment activity are “seed money” and separate accounts that are used to support certain non-variable separate account contracts.

⁸ In the alternative, the potential gap could also be eliminated by conforming the separate account definition and separate account exemption through deleting condition § __.6(b)(2)(iii)(C) to the separate account exemption. This alternative approach would better align the kinds of separate accounts eligible for the separate account exemption with the kinds of separate accounts that are authorized and recognized under applicable insurance law.

Seed Money. New York Insurance Law Section 4240(a)(3) permits a life insurance company to “allocate amounts to a separate account to facilitate its initial operations” – so-called “seed money.”⁹ Seed money is typically reimbursed to the insurance company within a reasonable period of time after it is allocated to the separate account.¹⁰ New York Insurance Law Section 4240(a)(3) also requires that such seed money be subject to certain general account qualitative standards and quantitative limitations.

Certain Non-Variable Separate Account Contracts. Separate account assets may support modified guaranteed contracts,¹¹ market value adjusted contracts and contracts with book value guarantees similar to contracts generally in the general account.¹² Because the insurance company is responsible for credit related asset loss or fair value loss in connection with these kinds of contracts, statutory accounting practices require that the insurance company establish an asset valuation reserve for the separate account assets supporting these contracts.¹³ Because of the risk assumed by the insurance company, the model regulation of the National Association of Insurance Commissioners governing modified guaranteed annuities requires that the separate accounts relating to modified guaranteed annuities be subject to the insurance company’s general account investment laws (unless otherwise approved by the state insurance regulator).¹⁴

Insurance company investment activity in respect of separate account “seed money” and separate accounts that are used to support these kinds of non-variable separate account contracts may inadvertently fail to satisfy either the general account exemption under § __6(c) as currently drafted or the separate account exemption under § __6(b)(2)(iii) as currently drafted since the investment may be allocated to a separate account as defined in § __.2(z) (and thus not an investment for the “general account” as defined in § __3(c)(6)) and some of the profits and losses arising from such investment may inure to the benefit or detriment of the insurance company (and thus fail condition § __.6(b)(2)(iii)(C) to the separate account exemption). In order to eliminate this potential gap between these two exemptions, we request that the definition of “separate account” be aligned with the separate account exemption conditions by adding the § __.6(b)(2)(iii)(C) condition to the “separate account” definition. We

⁹ See also Connecticut Insurance Code Section 38-433(a)(6); New Jersey Insurance Code Section 17B:28-9(c).

¹⁰ The New York Department of Financial Services generally requires that seed money be repaid within two years. See “Separate Account Agreements” Product Outline, pt. II.E(3)(a)(iii), available at www.dfs.ny.gov/insurance/acrobat/saaout.pdf. In New York, the seed money duration is set out in the insurance company’s separate account plan of operation which, in New York, is approved by the New York Superintendent of Financial Services. See New York Insurance Law Section 4240(e).

¹¹ A “modified guaranteed annuity” is defined to mean “a deferred annuity contract, the underlying assets of which are held in a separate account, and the values of which are guaranteed if held for specified periods. The contract contains nonforfeiture values that are based upon a market-value adjustment formula if held for shorter periods. This formula may or may not reflect the value of assets held in the separate account. The assets underlying the contract shall be in a separate account during the period or periods when the contract holder can surrender the contract.” National Association of Insurance Commissioners, Modified Guaranteed Annuity Model Regulation, Model 255, § 4.A.

¹² In connection with group life and group annuity contracts and funding agreements, a “book value contract” is defined to mean “a fixed accumulation contract (GIC), purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, that does not participate in the investment experience of a separate account, with a fixed interest rate guarantee, including a guarantee based on an external index, and that is supported by a separate account, the plan of operations of which provides that the separate account’s assets are valued as if the assets were held in the insurance company’s general account.” National Association of Insurance Commissioners, Separate Accounts Funding Guaranteed Minimum Benefits Under Group Contracts Model Regulation, Model 200, § 4.H.

¹³ National Association of Insurance Commissioners, Accounting Practices & Procedures Manual as of March 2011, Statement of Statutory Accounting Principles No. 56, ¶ 20.

¹⁴ National Association of Insurance Commissioners, Modified Guaranteed Annuity Model Regulation, Model 255, § 9.D.

propose the following amending wording to the § __2.(z) definition of “separate account” (underlined text is added):

(z) Separate account means an account established and maintained by an insurance company subject to regulation by a State insurance regulator or a foreign insurance regulator under which:

(1) income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company; and

(2) all profits and losses arising from the purchase or sale of a covered financial position or the acquisition or retention of any ownership interest in a covered fund are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company.

By making this change, the intent of the Proposed Regulations in respect of the separate account exemption will be preserved in that variable separate accounts with “legally segregated” assets (for which there is no insurance company “seed money”) will remain eligible for the separate account “on behalf of customers” exemption. However, the following kinds of separate accounts would qualify for and be subject to the general account exemption:

- Variable separate accounts with “seed money,” whether or not the assets in the account are “legally segregated” (these would not be a separate account under the revised definition since profits and losses may inure to the benefit of the insurance company; therefore, the assets in these accounts will be “general account” assets and would qualify for the general account exemption)
- Non-variable separate accounts, whether or not the assets in the account are “legally segregated” (these would also not be a separate account under the revised definition since profits and losses may inure to the benefit of the insurance company; therefore, the assets in these accounts will be “general account” assets and would qualify for the general account exemption)
- Separate accounts the assets of which are not “legally segregated” (by not being “legally segregated,” these assets satisfy the definition of “general account” and would qualify for the general account exemption)

This allocation of separate account investments to the general account and separate account exemptions is especially appropriate since, as stated above, separate account “seed money” and investments for separate accounts relating to modified guaranteed annuities are typically subject to the insurance company’s general account investment laws.¹⁵

VIII. Reporting and Recordkeeping Requirements and Compliance Monitoring

A. Requested Change

¹⁵ Furthermore, as a technical amendment, the definitions of “covered financial position” and “covered fund” may need to be moved to Proposed Regulations § __.2 (general definitions) so that they will apply to this revised general definition of “separate account.”

We believe that the reporting and recordkeeping requirements and compliance monitoring included in the set forth in §§ __.7, __.15 and __.20 and Subpart D should not apply to insurance company investment activities that are permitted activities under BHC Act § 13 and the Proposed Regulations since insurance companies already have, and have long had, comprehensive and effective oversight of their permitted investment activities under applicable insurance law.

B. Analysis and Discussion

As stated above, insurance companies are subject to comprehensive regulation of the kinds and amounts of investments they can make under the insurance laws and regulations of their domestic jurisdictions. These laws and regulations typically impose qualitative and quantitative limitations on general account investments by insurance companies. Separate account investments may also be subject to investment standards – certain prohibited investments or investment diversification requirements.

A typical insurance investment law requires that the insurance company's board of directors (or an investment committee of the board) adopt a written plan for acquiring and holding investments. The plan would include investment quality, maturity and diversification standards designed to assure that the investments are appropriate for the insurance company's business and its liquidity needs. The board of directors or investment committee typically has an oversight duty – it must receive and review a summary report on the insurer's investment portfolio and investment activities at least quarterly in order to determine whether the portfolio and activity is consistent with its written plan.

In addition, a domestic insurance regulator has the authority to and must, on a periodic basis, conduct an examination of the insurance company, including the authority to determine whether the investments made by the insurance company are in compliance with applicable insurance law and the written plan of the board or investment committee.

BHC Act § 13(d)(1)(F) expressly recognizes this comprehensive insurance investment regulatory scheme and gives appropriate deference to it, subject to the ability of Federal banking agencies, after consultation with the Financial Services Oversight Council and relevant State insurance regulators, to determine that a particular law, regulation or written guidance is insufficient to protect the safety and soundness of the insurance company, or the financial stability of the U.S.

The Proposed Regulations introduce reporting and recordkeeping requirements for both trading activities and (§ __.7) and covered fund activities and investments (§ __.15) together with a compliance monitoring requirement for both activities (§ __.20). While these requirements may be relevant to activities and investments of banking entities other than insurance companies because the Proposed Regulations may be the only substantive law or rule relating to these activities, we believe that that these are not relevant to and should not apply to insurance companies since insurance companies already have, and have long had, comprehensive and effective oversight of their permitted investment activity under applicable insurance law.

We request that the reporting and recordkeeping requirements and compliance monitoring set forth in §§ __.7, __.15 and __.20 and Subpart D should not apply to insurance company investment activity that are permitted activities under BHC Act § 13 and the Proposed Regulations. These would include (i) the permitted proprietary trading activities in §§ __.6(b)(2)(iii) (separate account) and 6(c) (regulated insurance company); and (ii) permitted covered fund activities and investments described in Part IV of this letter (insurance company investing in covered funds). Among the rules that should have such an insurance company exception are the following:

1. The general requirements in §§ __.7 (including the \$1 billion threshold in § __.7(a)) and __.15 (including compliance with the reporting and recordkeeping requirements in Appendix A and its quantitative thresholds).

2. The program for monitoring compliance in § __.20 (including the recordkeeping requirements in Appendix C) and the additional standards thresholds (\$1 billion and 10% of total assets).

Thank you in advance for your serious consideration of our views. We are available for further discussion on this matter at your convenience.

Respectfully submitted,



Julie A. Spiezio

CC:

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th St. & Constitution Ave., NW
Washington, DC 20551

Robert E. Feldman
Executive Secretary
ATTN: Comments, Federal Deposit Insurance Corporation
550 17th St., NW
Washington, DC 20429

Elizabeth M. Murphy
Secretary
Securities & Exchange Commission
100 F St., NE
Washington, DC 20549

Appendix A
New § __.13(e)

(e) Permitted covered fund investments by a regulated insurance company.

(1) The prohibition contained in § __.10(a) does not apply to the acquisition or retention of any ownership interest in a covered fund by a covered banking entity that is an insurance company for a separate account if:

(i) The insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;

(ii) The insurance company acquires or retains any ownership interest in a covered fund solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;

(iii) All profits and losses arising from the acquisition or retention of any ownership interest in a covered fund are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company; and

(iv) The acquisition or retention is conducted in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.

(2) The prohibition contained in § __.10(a) does not apply to the acquisition or retention of any ownership interest in a covered fund by a covered banking entity that is an insurance company or any affiliate of an insurance company if:

(i) The insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;

(ii) The insurance company or its affiliate acquires or retains any ownership interest in a covered fund solely for the general account of the insurance company;

(iii) The acquisition or retention is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(iv) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (e)(2)(iii) of this section is insufficient to protect the safety and soundness of the covered banking entity, or of the financial stability of the United States.