

**Meeting Between Federal Reserve Board Staff and
Various Industry Representatives
August 22, 2012**

Participants: Michael Gibson, Maryann Hunter, Jack Jennings, Art Lindo, Mark Van Der Weide, Kevin Bertsch, Tom Boemio, Felton Booker, Karen Caplan, Linda Duzick, and Constance Horsley (Federal Reserve Board)

Wayne Cimon (State Farm), Marlene Debel (MetLife), James Donnellan (MetLife), Langston Emerson (TIAA-CREF), Sheila Greenwood (Prudential Financial), Mark Grier (Prudential Financial), Bridget Hagan (Nationwide), Michael Mahaffrey (Nationwide), Christopher Payne (Principal Financial), Mark Schwamberger (State Farm), Michael Streck (Principal Financial), Mark Thresher (Nationwide), and Virginia Wilson (TIAA-CREF)

Summary: Federal Reserve Board staff met with insurance industry representatives who shared their views on the Federal Reserve Board's proposed approach to the regulation and supervision of insurance holding companies, including insurance company accounting and regulatory capital issues. The written materials provided by the industry representatives at the meeting are attached below.

Meeting with the Federal Reserve Board and Insurance Company Executives

August 22, 2012, 11:30 AM

1850 K Street NW, Washington, DC

- I. General Introduction

- II. Approach to Insurance Regulation
 - Description of our Group
 - General Reaction to Proposed Capital Rules
 - Insurance Model (e.g., importance of reserving)

- III. Transition Period/Effective Date

- IV. Insurance Company Accounting

- V. Treatment of Insurance Sub Regulatory Capital

- VI. Treatment of Separate Accounts

- VII. Treatment of Unrealized Gains and Losses

- VIII. Potential Economic Impacts

Insurance Companies and the Basel III Capital Standards Proposed Rulemaking

The banking and insurance industries operate under vastly different capital structures given the very different natures of the two business sectors. Thus, it is not appropriate and actually harmful to apply a bank-centric capital framework to financial institutions that are predominantly engaged in the business of insurance.

- The Federal Reserve Board's (FRB) notice of proposed rulemaking (NPR) on capital standards released on June 7, 2012, fails to recognize the distinct differences between the business of banking and insurance. While we support strong capital standards, the NPR adopts a consolidated "one-size-fits-all" bank-centric approach and fails to adequately address the unique characteristics of insurance companies that are or could be subject to the rulemaking.
- Bank capital requirements presume customer obligations are bank deposits and therefore, do not consider the principles of long term maturity/duration matching within the framework. Furthermore, the NPR's approach to capital treatment promotes a bank lending paradigm over an insurance company investing paradigm, and thus disfavors a core element of the business of insurance.
- The Basel III capital framework was designed specifically for banks and is based on consideration of a bank's balance sheet, risk profile, and capital needs. Likewise, state insurance risk-based capital (RBC) rules were designed specifically for insurance companies' balance sheet, risk profile and capital needs.
- The state-based regulatory RBC regime captures a number of risk exposures tailored to insurance companies, including asset risk, insurance/underwriting risk, interest rate risk, and business risk. By contrast, the Basel capital framework essentially measures asset risk and was developed specifically for the asset profile of banks. Moreover, the insurance RBC framework is tailored to different types of insurance such as life, health, and property casualty. The bank capital rules fail to make a similar distinction.
- The risk-weightings for bank assets are often inappropriate for insurance company assets due to the long-term nature of insurance company liabilities, and the fact that insurance companies are significantly less reliant on borrowed debt, especially short-term debt, and therefore do not require the same level of liquidity as banks.
- The FRB itself has recognized that making nominal adjustments to the its bank-centric capital framework does not appropriately account for the differences in the capital structure and risk profile of insurance companies. The FRB made this observation in a 2002 joint report with the NAIC in which it concluded that "the effective regulatory capital requirements for assets, liabilities, and various business risks for insurers are not the same as those for banks ... [and] the effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets."¹
- Imposition of a bank-centric capital framework on insurance companies would be duplicative, unduly burdensome and costly, and may drive insurers to make business decisions based on a capital framework that does not adequately assess their risks. This could cause negative distortions in the marketplace, introduce more risk into the financial system, and increase costs for customers/policyholders.

Specific Issues for Insurance Companies

¹ 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.

GAAP/SAP: The imposition of GAAP accounting on insurance companies is inappropriate and excessively costly.

All U.S. insurance companies currently prepare statutory accounting statements, as required by state insurance regulation. Only certain insurance companies (e.g., insurers whose stock is publicly traded) are currently required to prepare GAAP-based financial statements. Under the NPR, *all* insurance companies subject to the rule would be required to prepare GAAP-based financial statements to support the underlying calculation of a bank-focused capital adequacy regime. By contrast, the SAP accounting model supports the well established state RBC capital regime, and SAP accounting appropriately reflects core insurance activities, related longer term investments, and insurer solvency considerations. Imposing GAAP accounting on insurance companies that are not required to do so today would inflict considerable expense and burden on those companies without yielding additional information that is not already made available through SAP accounting statements.

Timing: The NPR fails to provide for a meaningful transition period for insurers.

The NPR provides a proposed effective date of January 1, 2013 for insurance company savings and loan holding companies (SLHCs). Such companies have never before been subject to Basel requirements or consolidated capital requirements, and this extremely short transition time is unduly burdensome and contrary to the express intent of Congress in the Collins Amendment. In addition, the proposed rule would require the implementation of GAAP accounting beginning in January 2013. This is simply not enough time for insurers to institute the systems and processes necessary to provide the data required by the NPR.

Double Counting of Assets: Deducting an insurance subsidiary's regulatory capital from total capital results in a double-counting of asset-risks, and will unfairly result in insurers having to hold additional capital.

The NPR would require an SLHC to deduct from its consolidated capital ratios an amount equal to the minimum regulatory capital requirement established by the regulator of any insurance underwriting subsidiary of the SLHC. This amount generally would be 200% of the subsidiary's authorized control level Risk Based Capital ("RBC" as defined by an insurance company's regulatory capital requirements). As a result of this requirement, assets owned by an insurance underwriting subsidiary would be considered within the context of the capital requirements of both the insurance company RBC requirements and the SLHC capital requirements. Therefore, the SLHC would risk weight assets in its capital requirements which have already been considered for purposes of establishing the SLHC's insurance underwriting deduction. While the capital standards are designed to reduce regulatory arbitrage opportunities available to financial institutions with multiple legal entity structures, the SLHC deduction of an insurance subsidiary's capital requirement would result in the same asset being risk weighted twice in the SLHC capital calculation: once as a holding of the insurance subsidiary and a second time as a consolidated holding of the SLHC (as owner of the insurance subsidiary).

Separate Accounts: The definition of "non-guaranteed" separate accounts is overly restrictive and will potentially exclude all separate accounts from being deemed "non-guaranteed."

The Proposed Rules would provide for a 0% risk-weighting of "non-guaranteed" separate accounts. To qualify as "non-guaranteed" (i) the insurance company could not guarantee a minimum return or account value to the contract holder, and (ii) the insurance company would not be required to hold reserves for these separate account assets pursuant to its contractual obligations on an associated policy. In the event that a separate account is not considered "non-guaranteed," then banking organizations must apply the risk-weighting calculations to the underlying assets.

While we support a 0% risk-weighting for non-guaranteed separate accounts, the definition of non-guaranteed is overly restrictive. For example, certain variable life insurance policies and variable annuities may provide minimum guarantees such as death benefits, guarantees which are not related to minimum returns or account values. However, these death benefits require some reserving in the general account. Such products should fit within the definition of non-guaranteed separate accounts.

Non-guaranteed separate account assets should also be excluded from the Tier 1 Leverage Ratio since in such products the insurance company does not guarantee a minimum return or account value for the separate account assets. In addition, any liquidation of separate account assets would be met by selling those assets in the open market and the insurer has no debt or leverage associated with those assets and cannot be forced to liquidate the assets by debtholders or an inability to roll over any debt.