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FINDING THE RIGHT CAPITAL REGULATIONS FOR INSURERS

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BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

FINDING THE RIGHT CAPITAL REGULATIONS FOR INSURANCE COMPANIES UNDER THE DODD-FRANK ACT

MARCH 11, 2014

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C O N T E N T S

TUESDAY, MARCH 11, 2014

WITNESSES

Additional Material Supplied for the Record

FINDING THE RIGHT CAPITAL REGULATIONS FOR INSURERS

TUESDAY, MARCH 11, 2014

U.S. SENATE, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:07 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. The Committee will come to order. Thank you for joining us, especially Senator Collins, thank you for your leadership on this issue and sharing your ideas for legislation and advice for the Fed with the Subcommittee. Thank you for that.

I want to first thank Chairman Johnson for permitting Senator Toomey and me to address this important issue on our Subcommittee and a number of others over the past 3 years. Chairman Johnson has allowed us to examine a number of important issues and take a more active role than Subcommittees—at least in my understanding Subcommittees over the years in Banking have traditionally assumed. And I appreciate very much Tim's generosity and certainly his staff's work with us.

I thank Senator Toomey for working with us on this hearing. There is across the political spectrum and across party lines broad agreement that providing traditional life and property and casualty insurance is different from banking. I appreciate particularly Senator Johanns' efforts on this Committee with Senator Collins and others in fixing what we think is a very fixable issue.

Funding sources are different for insurance and banking. Insurers rely on customer premiums and investment proceeds. The nature of their investments is different. Insurers must match long-term investments with long-term policies, and the risks are different. Insurers are concerned with natural disasters and life events.

While I believe that traditional insurance is distinct business from banking, institutions often combine regulated banking and so-called shadow banking activities. Similarly named institutions can engage in a wide range of activities from derivatives to repo to securities lending under a range of corporate structures. Dodd-Frank Act tried to remedy this problem by creating the FSOC, the Financial Stability Oversight Council, to identify systemic financial firms and encourage regulation of risky activities. If any institution engages in activities like securities financing transactions, those activities should absolutely—absolutely—be subject to the same capital rules as banks.

But I agree with New York's Banking Commissioner Ben Lawsky, who regulates some of the Nation's largest insurers, that applying bank capital standards to insurance is like trying to, as he said, "fit a square peg in a round hole." For that reason, it is important that the Federal Reserve delayed applying Basel III and Section 165 prudential standards to insurers. The Fed must determine that insurance capital rules are appropriate under the Collins amendment. Chairman Dodd and Senator Collins anticipated this issue. There is nearly universal agreement that this should not require legislation.

In 2011, Senator Johanns and I sent a letter with a group of 20 of our colleagues representing large numbers of colleagues in both parties agreeing that Dodd-Frank gives regulators the flexibility to treat insurance differently. If the Fed continues to disagree, I am committed to working with both of my colleagues, Senator Collins and Johanns, to find a legislative solution.

We are all concerned about creating another AIG, which realized 45 percent of the losses of all insurers in 2008 and received 55 percent of the Government's support provided to insurers. Dodd-Frank contains a number of provisions to prevent that from happening again: one, regulating derivatives to address their credit default swap business; second, eliminating the Office of Thrift Supervision and moving thrift regulation to the Fed; three, creating nonbank systemically important financial institution designations, SIFI designations; and, last, requiring enhanced capital and leverage rules for nonbank SIFIs.

Legislation would not alter these provisions. It would address a narrow, specific element of the Collins amendment, allowing the Fed to tailor capital rules to the insurance business model. This issue is not whether applying bank standards to insurers would require too much capital or too little capital. There is general agreement that institutions must have enough capital to pay for the cost of their failures. Capital rules should, must accurately measure and address the risks of the businesses to which they are being applied.

I look forward to Senator Collins' testimony and to our panel. And, Senator Toomey, thank you.

STATEMENT OF SENATOR PATRICK J. TOOMEY

Senator TOOMEY. Thanks very much, Mr. Chairman, and thanks for having this hearing. I think it is a very important topic. I want to thank you and Senator Johanns for the legislation you have introduced which addresses this and which I am a cosponsor of.

I want to thank Senator Collins for joining us today and for testifying before the Committee.

I just want to underscore a couple of points. I agree completely that the insurance business model is completely different in so many ways from a banking model that it would be completely inappropriate to impose a bank-centric, a bank-designed capital regime on insurance companies.

I would argue that the same principle applies with asset management. That, too, is completely different and very dissimilar from the banking business, and, therefore, a banking capital regime does not make sense for asset managers either.

And I would also point out that, in addition to some danger that the Fed may be inclined to go down this road of requiring a banking type capital on insurance companies, I am concerned that there is a danger that the Financial Stability Board might also move in the direction of imposing European-style insurance capital on an American industry that has evolved in a way that is very different from the European model and for which that model, I think—that capital model is not appropriate.

So I think this is extremely timely. You pointed out the problems with AIG, and I know you know very well it was not their insurance business that caused the problems at AIG. It was activities that had nothing to do with insurance. And, in fact, for many, many decades, the insurance industry has weathered all kinds of storms and volatility and different kinds of markets and circumstances and weathered it quite well, which I think further suggests that this is an industry that has an appropriate set of capital requirements.

So thanks for having the hearing. I look forward to the testimony of our colleague.

Senator BROWN. Thank you, Senator Toomey.

Senator Johanns.

STATEMENT OF SENATOR MIKE JOHANNS

Senator JOHANNS. What I was going to say has basically been said, so I am not going to repeat that. We do know the difference between the two industries, the banking and the insurance. But I do want to make a very important point today.

First of all, I want to say thank you to the Chairman for his efforts. My point there is that without your engagement, I do not think we would be this far along.

The second point is to Senator Collins. Senator, without you grabbing hold of this and trying to wrestle your way through these technical, difficulty issues, I think we would be stalled, to be very honest with you. I know you feel very passionately about getting this right. That is what we want to do. We want to make sure that whatever we end up doing with capital standards we have got it right—we have got it right for the banking industry, we have got it right for the insurance industry.

And I think this is an opportunity with Dodd-Frank to reflect upon what was there, is it working, what can we do to improve it. And your engagement I think is critical to get us to the finish line.

If we can have a breakthrough on this, then I think this is literally a bill we can get passed, we can get done, get to the President for his signature. So I just wanted to devote my time, Senator, to just say thank you for being here today and thank you for engaging on this very, very challenging, difficult issue. But I think I see a light at the end of the tunnel.

Thank you.

Senator BROWN. Thank you, Senator Johanns.

Senator Tester.

Senator TESTER. I am going to break Senate protocol here because everything has been said, I just have not said it, and I am not going to say it. So I look forward to Senator Collins' testimony.

Senator BROWN. Thank you, Jon.

Senator Collins, the senior Senator from Maine, welcome.

STATEMENT OF SUSAN M. COLLINS, A UNITED STATES SENATOR FROM THE STATE OF MAINE

Senator COLLINS. Thank you very much, Mr. Chairman, Ranking Member Toomey, Senator Johanns, Senator Tester. It is a great pleasure to join you this morning. I wager that this hearing is the most technical hearing that is being held on Capitol Hill today, perhaps this week, perhaps this year.

I do thank you for convening this hearing on insurance capital standards and for inviting me to come before you today to share my views on this important topic. As a former financial regulator myself, I appreciate how complex it is to develop proper capital standards. For 5 years I headed Maine's Department of Professional and Financial Regulation and oversaw the Bureau of Banking, the Bureau of Insurance, the Bureau of Consumer Credit Protection, and the Securities Division.

There are three issues that I would like to touch upon this morning.

First, I would like to describe why I authored what has become to be called "the Collins capital standards amendment," Section 171 of Dodd-Frank, and why I feel strongly that it is so important that nothing be done to diminish or weaken it.

Second, I want to emphasize my belief that the Federal Reserve is able to take into account and should take into account the differences between insurance and other financial activities when consolidating holding company capital under Section 171.

And, third, I will comment on how the Federal Reserve's authority on this point can be clarified, if necessary, through legislation that I have recently introduced, Senate bill 2102. I am also very aware of the legislation that the Chairman, the Ranking Member, and Senator Johanns—Senator Tester may be on it also—have introduced, and I think we are not that far apart. And I hope that we can continue to work to reach consensus.

With regard to my first point, we all recall the circumstances we faced 4 years ago as our Nation was emerging from the most serious financial crisis since the Great Depression. That crisis had many causes, but among the most important was the fact that some of our Nation's largest financial institutions were dangerously undercapitalized while at the same time they held interconnected assets and liabilities that could not be disentangled in the midst of a crisis.

I remember the big debate during Dodd-Frank about what financial institutions should be allowed to do. Should they be involved in the derivative business? Should they be able to issue credit default swaps? And I kept thinking, from the perspective of the former regulator that I once was, that what really was important was how much capital they had if they were going to engage in riskier transactions. And when I looked at the leverage ratios of, for example, Bear Stearns and found that it was 30:1, I once again came to the conclusion that what was important was having adequate capital standards.

The failure of these overleveraged financial institutions threatened to bring the American economy to its knees. As a consequence, the Federal Government was forced to step in to prop up financial institutions that were considered too big to fail. Little has angered the American public more than these taxpayer-funded bailouts. That is the context in which I offered my capital standards proposal as an amendment to the Dodd-Frank bill.

Section 171 is aimed at addressing the too-big-to-fail problem at the root of the 2008–09 crisis by requiring large financial holding companies to maintain a level of capital at least as high as that required for our Nation's community banks, equalizing their minimum capital requirements, and eliminating the incentives for banks to become too big to fail.

Incredibly, prior to the passage of the Collins amendment, the capital and risk standards for our Nation's largest financial institutions were more lax than those that applied to smaller depository banks, even though the failure of larger institutions was much more likely to trigger the kind of cascade of economic harm that we experienced during the financial meltdown. Section 171 gave the regulators the tools and the direction to fix this problem.

Let me now turn to my second point, that Section 171 allows Federal regulators to take into account the distinctions that you have all discussed between banking and insurance and the implications of these distinctions for capital adequacy. While it is essential that insurers subject to the Federal Reserve Board oversight be adequately capitalized on a consolidated basis, it would be improper and not in keeping with Congress' intent for Federal regulators to supplant the prudential State-based insurance regulation with a bank-centric capital regime for insurance activities.

Indeed, nothing in Section 171 alters State capital requirements for insurance companies under State regulation nor the State guarantee funds. Section 171 directs the Federal Reserve to establish minimum consolidated capital standards with reference to the FDIC's Prompt Corrective Action regulations. But as I have publicly and repeatedly stressed, Section 171 does not direct the regulators to apply bank-centric capital standards to insurance entities which are already regulated by the States. And having been in that role of overseeing insurance regulation plus State banking regulation, I am keenly aware of the difference and of the regulation at the State level with the requirement for adequate reserves and with the guarantee fund.

I have written to the financial regulators on more than one occasion to make this point. For example, in a November 26, 2012, letter, which I would respectfully request be inserted in the record, I stressed to financial regulators that while it is essential that insurers subject to the Federal Reserve Board oversight be adequately capitalized on a consolidated basis, it was not Congress' intent to replace State-based insurance regulation with a bank-centric capital regime. For that reason, I called upon the Federal regulators to acknowledge the distinctions between banking and insurance and to take these distinctions into account in the final rules implementing Section 171.

While the Federal Reserve has acknowledged the important distinctions between insurance and banking, it has repeatedly suggested that it lacks authority to take those distinctions into account when implementing the consolidated capital standards required by Section 171. As I have already said, as the author of Section 171, I do not agree that the Fed lacks this authority and find its disregard of my clear intent, as the author of Section 171, to be frustrating, to say the least.

Since I am the author of the Collins amendment, since I am Senator Collins, I think I know what I meant.

[Laughter.]

Senator COLLINS. Which brings me to my final point: how the Federal Reserve's authority to recognize the distinctions between insurance and banking may be clarified through legislation that I have recently introduced, Senate bill 2102.

My legislation would add language to Section 171 to clarify that in establishing minimum capital requirements for holding companies on a consolidated basis, the Federal Reserve is not required to include insurers so long as the insurers are engaged in activities regulated as insurance at the State level. My legislation also provides a mechanism for the Federal Reserve, acting in consultation with the appropriate State insurance authority, to provide similar treatment for foreign insurance entities within a U.S. holding company where that entity does not itself do business in the United States. That was a very difficult issue to try to come up with a solution to. I would encourage you to take a look at that section of the bill that I have introduced. We have tried very hard to deal with the situation where there is a foreign insurance entity within a U.S. holding company when the entity does not do business in the United States. I think we have come up with a reasonable approach.

I should point out that my legislation does not in any way modify or supersede any other provision of law upon which the Federal Reserve may rely to set appropriate holding company capital requirements.

In closing, I want to thank the Committee for holding this hearing. This has been an enormously complex issue to resolve in a way that does not undermine the intent of Section 171. I want to especially thank you, Chairman Brown and Senator Johanns, for your hard work. Your staff has worked night and day with my staff over many months to try to craft language that clarified the Fed's authority to provide the appropriate treatment for insurer capital. I believe that the language that I have introduced should give the Fed the clarity it needs to address the legitimate concerns raised by insurers that they not have a bank-centric capital regime for their insurance activities imposed upon them.

This is an exceptionally complex area of the law, and I recognize that some, including Members of this Committee, may prefer a different approach than the one that I have taken. I am also aware that there is an unusual accounting issue here that involves some insurers, not all of them, not those that are publicly traded, for example, but on whether there should be generally accepted accounting principles or the SAP approach that is used by insurers.

I am, of course, more than willing to continue to work with you on a carefully tailored response to address those legitimate concerns, but I would ask that we all be mindful of the fact that we must not take action that would diminish the taxpayer protections that provided the motivation for my writing the Collins amendment and that are provided by the critical reforms in Section 171.

Thank you very much for allowing me to testify. I realize I went over my 5 minutes, but this is a very complex issue, and I appreciate your indulgence.

Senator BROWN. Thank you, Senator Collins, for your explanation and your leadership and your hard work on this and so much else in the Senate. Your letter, without objection, the Collins letter, will be inserted in the record.

Senator BROWN. Thanks for joining us.

Senator COLLINS. Thank you very much.

Senator BROWN. We appreciate it.

Senator Collins said this is the most technical, maybe the most technical hearing in the Senate, at least today if not for the last few months, and that is why we have five really smart people testifying—including Senator Collins, six really smart people.

Senator COLLINS. I was just going to take a great exception to that.

[Laughter.]

Senator COLLINS. Thank you, Mr. Chairman. And good save there.

Senator BROWN. If the witnesses would come forward, I will begin the introductions.

[Pause.]

Senator BROWN. Thank you to the five of you for joining us, a couple of you on pretty short notice, so thank you for that.

Gina Wilson is Executive Vice President and Chief Financial Officer of TIAA–CREF. Welcome, Ms. Wilson. Thank you for joining us.

Daniel Schwarcz is Associate Professor of Law and Solly Robins Distinguished Research Fellow at the University of Minnesota Law School. His research primarily focuses on consumer protection and regulation and property and casualty and health insurance markets. Thank you for joining us.

Rodgin Cohen is Senior Chairman of the law firm Sullivan & Cromwell. The New York Times described him as the "Dean of Wall Street Lawyers." Welcome, Mr. Cohen.

Aaron Klein is no stranger to this Committee room, having served on the Banking Committee staff for some 8 years. He is now Director of the Bipartisan Policy Center's Financial Regulatory Reform Initiative. Welcome back, Mr. Klein.

And Michael Mahaffey is the Senior Vice President and Chief Risk Officer for Nationwide Insurance in Columbus, Ohio.

Welcome to all of you. Ms. Wilson, would you like to start?

STATEMENT OF GINA WILSON, EXECUTIVE VICE PRESIDENT & CHIEF FINANCIAL OFFICER, TIAA–CREF

Ms. WILSON. Thank you very much, Chairman Brown, Ranking Member Toomey, Members of the Subcommittee. Thank you for providing TIAA–CREF with the opportunity——

Senator BROWN. Microphone? Either you are not speaking into it or it is not on.

Ms. WILSON. Chairman Brown, thank you, also to Ranking Member Toomey, Members of the Subcommittee, thank you for providing TIAA–CREF the opportunity to testify on an important issue to us and to the clients we serve.

My testimony today focuses on the final rules governing capital standards and the Basel III accords issued by the Federal Reserve Board in conjunction with the Office of the Comptroller of Currency and the Federal Deposit Insurance Corporation, which I will collectively refer to as the "agencies."

The final rules issued in July contain several changes from the proposed rulemaking. Most notably for TIAA–CREF, it temporarily exempted savings and loan holding companies, or SLHCs, substantially engaged in insurance underwriting or commercial activities.

We are a leading provider of retirement services in the academic, research, medical, and cultural fields managing retirement assets on behalf of 3.9 million clients with more than 15,000 institutions nationwide.

While we are primarily engaged in the business of insurance, we hold a small thrift institution within our structure and as a result are registered as an SLHC. This thrift provides us the opportunity to offer our clients deposit and lending products integrated with our retirement, investment management, and life insurance products and enhances our ability to offer them the chance to attain lifelong financial security.

Our status as an SLHC places us under the purview of the Federal Reserve and consequently subjects us to the proposed capital regime the agencies have set forth. TIAA–CREF supports strong and appropriate capital standards that consistent with SLHCs' operating models and the risks inherent in our businesses. To be clear, this includes our support for appropriate capital standards for banking organizations, and we are not seeking to exempt insurers from the tenets of the Dodd-Frank Act. We do not object to the Federal Reserve oversight to enterprise capital standards. We are very concerned, however, about how the final standards will be fully accounting for the diverse business models under which different financial service organizations operate. In short, we want to make sure that the metrics we are measured on appropriately reflect the nature of our business. Applying metrics designed for banks to an insurer would be inappropriate and could have negative effects for the economy, our customers, and insurers.

Bank-centric standards do not effectively recognize the long dated nature of both sides of an insurer's balance sheet and would likely encourage insurers to modify certain investment practices and strategies that would be detrimental to our core activities. A bank's core business is lending and maturity transformation while insurers practice risk pooling and management. As a result, insurers' investment portfolios involve duration matching of assorted longer-term liabilities. That is, we match our long-term liabilities with longer-term investments. Imposing a capital framework designed to address maturity mismatch inherent in banking on an insurer would create a challenging insurer investment portfolio consideration where none previously existed.

Under the rules, certain long dated investments, which are typically less liquid than shorter-term investments, are discouraged. Applying these bank capital standards on insurers would also create a disincentive to invest in the very assets that promote stability and solvency best.

The rules set forth by the agencies, if applied to insurers, would have a detrimental effect on the ability to offer affordable financial products, which in turn could trickle down to individuals who utilize insurance products to help them build a more secure financial future.

The rules also could have macroeconomic impact, for example, creating disincentives for insurers to invest in asset classes that promote the long-term economic growth such as long-term corporate bonds, project finance, and infrastructure investments, commercial real estate assets, private equity, and other alternative asset classes.

In our comment letter to the Federal Reserve Board and in our subsequent conversations with them, we have proposed alternative methodologies for measuring an insurer's capital that support both the policy concerns of the Federal Reserve and ensure a strong capital regime, while also accounting for the business of insurance. We hope that they continue to study the issue and that they will find a sensible way to integrate a capital standard that is appropriately designed for insurers. In the meantime, we ask Congress to explicitly give the agencies the ability to ensure that capital standards are appropriately tailored for our business.

Thank you again for the opportunity to testify. We appreciate the Subcommittee's interest in this issue and affording us another venue in which to express our concerns.

I look forward to answering any questions you may have.

Senator BROWN. Thank you, Ms. Wilson.

Professor Schwarcz, welcome.

STATEMENT OF DANIEL SCHWARCZ, ASSOCIATE PROFESSOR AND SOLLY ROBINS DISTINGUISHED RESEARCH FELLOW, UNIVERSITY OF MINNESOTA LAW SCHOOL

Mr. SCHWARCZ. Thank you very much, Chairman Brown, Ranking Member Toomey, Members of the Subcommittee. My comments today are going to be focused on what I am going to call "insurance SIFIs." These are nonbank financial holding companies that FSOC designates as "systemically significant" and that are predominantly engaged in insurance activities. Also, savings and loan holding companies that have predominant insurance businesses are covered by the Collins amendment. I deal with that in my testimony, but I am not going to be talking about that today.

In starting off talking about insurance SIFIs, I want to note where I agree with members of this panel and with many of you. I agree that bank-centric capital requirements should not be applied to insurers. I agree that insurance and banking are different and that, as a result of that difference, there must be appropriately tailored capital requirements. I agree that the Collins amendment gives the Fed the authority, very clearly I think—I find the legal analysis of my fellow witness Mr. Cohen to be very persuasive that the Fed has the authority to implement that.

Here is where I disagree. There is a tendency in much of the writing and much of the rhetoric to say the fact that we should not apply bank-centric capital rules to insurers means that we should completely defer to the State-based risk-based capital requirements. That I do not believe is true.

I believe that Dodd-Frank requires the Fed to craft appropriate capital requirements to apply to insurance SIFIs and that those rules should differ from the State risk-based capital rules.

Why is that? What we learned during the crisis is that insurance can pose a real systemic risk. I deal with this in my written testimony and much more thoroughly in an article that is referenced in the written testimony.

People like to say, "Oh, well, AIG, the portion of AIG that got AIG into trouble was not about insurance." Well, that is true with respect to its credit default swaps. But a major problem at AIG was its securities lending business. Its securities lending business involved the lending of insurers' assets. So insurers' at AIG were intimately involved in the problem.

Moreover, if you look at FSOC's report designating Prudential as a SIFI, you will see that FSOC, after looking at the portfolio of Prudential quite carefully, says that they are, in fact, potentially susceptible to a run.

Now, I admit and I want to emphasize this risk is different and less substantial than the risk of a run in banking. But at the same time, it is real. There, in fact, have been runs on insurance companies. Executive Life in 1991 was subject to a run wherein policy holders removed from the company $3 billion within the course of a single year.

Why is this significant? It can result in systemic risk not because the insurer fails necessarily, but because an insurer facing massive liquidity problems can immediately try to dump its portfolio, thereby interfering with broader capital markets. There is emerging research showing that insurers were a big part of the problem in their purchase of mortgage-backed securities leading up to the crisis and in triggering a fire sale of mortgage-backed securities when they offloaded those assets.

So the point I want to make is this: Insurance is less systemically risky than banking, but it can be systemically risky. Why then does that lead to the conclusion that we need to have distinct capital requirements at the Federal level?

State risk-based capital requirements are not meant to deal with systemic risk. They are meant to deal with consumer protection. There is no, absolutely no consolidated capital requirement of State-based regulation. Therefore, you do not have any sense of whether the aggregated insurance business of a company presents capital risk. You are not dealing with the possibility of multiple gearing.

State risk-based capital requirements directly and uncritically incorporate rating agencies in terms of assessing capital penalties. A core provision of Dodd-Frank says that is a mistake, that can cause systemic risk. And yet that is what State regulation does, because it is not concerned about systemic risk, it is concerned about consumer protection.

State risk-based capital requirements, remarkably, are moving toward a system for reserving where life insurers' reserves are going to be determined almost exclusively based on insurers' private models—the very private internal risk models that got companies in trouble in the years preceding the crisis.

Here then is the point. I am not saying that State risk-based capital requirements do not work. What I am saying is that they are geared toward consumer protection concerns. Yet we know that insurers, at least some insurers, raise systemic risks. And as such, we need an appropriate risk-based capital requirement at the Federal level for those conglomerates to protect against that systemic risk.

Thank you very much.

Senator BROWN. Thank you, Professor Schwarcz.

Mr. Cohen.

STATEMENT OF H. RODGIN COHEN, SENIOR CHAIRMAN, SULLIVAN & CROMWELL LLP

Mr. COHEN. Chairman Brown, Ranking Member Toomey, and distinguished Members of the Subcommittee, I am honored to appear before you today to discuss the application of the capital standards in Section 171 of the Dodd-Frank Act—the Collins Amendment—to insurance companies that are savings and loan holding companies or have been designated as "systemically important" by the FSOC. Let me begin by commending your leadership on this important issue.

As far as I know, not a single legislator or regulator has expressed the belief that, as a matter of policy, the same capital framework should be automatically imposed on two very different businesses—banks and insurers. Nor do I know of a single Member of Congress who believes that Congress intended such a result. This overwhelming agreement on what the right answer is, both in terms of sound policy and effecting congressional intent, led to Chairman Brown's suggestion that I focus my remarks this morning on the legal analysis of whether the Fed has the authority under Section 171 to reach this answer.

In my view, the Federal Reserve does have the interpretive authority to differentiate between banking organizations and insurance companies solely on the basis of the language of Section 171. This conclusion becomes compelling when one takes into account the statutory framework of which Section 171 is a part.

Section 171 does not require that designated insurers be subject to the Bank Capital Framework, but only that the capital standards for these entities not be less than bank standards. Because Section 171 is not prescriptive as to how this compatibility analysis should be conducted, Supreme Court precedent makes clear that the Federal Reserve has the authority to adopt an interpretation that implements Congress' policy objectives.

Accordingly, even reading Section 171 in isolation, the Federal Reserve has the necessary flexibility to apply capital requirements to insurance companies that are appropriately tailored for business, liability mix, and risk profile. But it is also a fundamental canon of statutory interpretation and construction that Section 171 must be read in its context. This requires us to consider the other provisions of Title I of Dodd-Frank, which collectively established the enhanced prudential framework for the Federal regulation of both systemically important banks and nonbank SIFIs.

Under the enhanced prudential standards of Section 165, Congress required that there be both robust regulation and differentiated regulation. These two objectives are not inconsistent but mutually reinforcing, because regulation is more effective when directed to the actual risk involved.

Section 165 is replete with congressional instructions that the Federal Reserve apply enhanced prudential standards through a differentiated approach. This includes a provision in Section 165 titled "Tailored Application" that expressly authorizes the Federal Reserve differentiate among companies by category.

Another provision requires the Federal Reserve to take into account differences between bank and nonbank SIFIs, including the nature of a company's liability, in particular the reliance on short-term funding.

In addition, in Section 169, Congress directed the Federal Reserve to avoid duplicative requirements. Given that insurance companies are already subject to a comprehensive risk-based capital framework under State law, superimposing the Bank Capital Framework would fail to fulfill that mandate.

Let me close with two points.

First, as I detail in my written testimony, there is an interpretive solution that the Federal Reserve could apply without legislation that conforms to the literal language of the statute, the intent of Congress, and sound public policy. Key to this solution would be the application of the risk-based capital framework, as it may be modified, if necessary, to an organization's insurance operations while applying bank capital standards to the remainder.

Second, if the Federal Reserve is not prepared to act, I would urge that Congress do so to prevent a result that is so clearly unwarranted. I recognize the concern that some have about opening up Dodd-Frank. But if there were ever to be a revision, this is the time and place. An amendment to clarify Section 171 could be both surgical and bipartisan; of most importance, it is the right result.

I would be pleased to answer any questions you may have. Thank you.

Senator BROWN. Thank you, Mr. Cohen. I have never heard "surgical" and "bipartisan" in the same sentence.

[Laughter.]

Senator BROWN. Mr. Klein, thank you.

STATEMENT OF AARON KLEIN, DIRECTOR, FINANCIAL REGULATORY REFORM INITIATIVE, BIPARTISAN POLICY CENTER

Mr. KLEIN. Thank you very much, Chairman Brown, thank you, Ranking Member Toomey, Members of the Subcommittees, and as you mentioned, Chairman Brown, due to my service on the Committee staff, allow me to extend a special warm thank you to the staff of the Subcommittee and full Committee for all of their excellent work.

Today I serve as the director of the Bipartisan Policy Center's Financial Regulatory Reform Initiative, and I would like to make four key points in my testimony this morning.

First, the business of insurance is fundamentally different from that of banking and, hence, must be subject to appropriate yet different capital standards.

Second, the Dodd-Frank Act envisions regulators overcoming bank centricity and empowers them to do so.

Third, insurance company regulation is a real test case in whether regulators can overcome their bank-centric approach.

And, finally, fourth, going forward, a better regulatory structure would include a Federal insurance regulator and an optional Federal charter.

To understand why it is so important that banks and insurance companies be subject to different capital regimes, one must first appreciate the differences in their business models.

At its core the business of insurance is about aggregating risks, matching a company's liabilities to its assets. Aggregating risk, paradoxically, makes insurers less risky by avoid adverse selection and protecting themselves against statistically unlikely outcomes.

By contrast, banks are in the business of mitigating risk. For example, banks transfer timing risk by allowing depositors to instantly access their money while making longer-term loans to consumers and businesses. In contrast to insurance companies, banks avoid overconcentration of a specific risk. In fact, overconcentration is a classic red flag for safety and soundness concerns for bank regulators.

Mixing insurance and banking has generally not worked for financial services firms. It remains to be seen whether a regulator can effectively regulate both businesses.

Under Dodd-Frank the Federal Reserve is now the regulator for a diverse set of insurance companies. It is unclear how broadly appreciated that fact was during consideration of Dodd-Frank. What is clear is that Dodd-Frank's decision to move thrift holding companies along with regulatory responsibility for nonbank SIFIs to the Federal Reserve was given along with the ability and responsibility for the Fed to develop appropriate capital standards, tailored to each entity or separate class of institutions it regulates. This requirement to tailor capital standards is a key theme throughout Dodd-Frank.

Even if the Federal Reserve is unwilling or unable to use a tailored approach, the FSOC could solve this problem. Among the responsibilities granted to FSOC are to make recommendations to the Federal Reserve concerning the establishment of heightened prudential standards, including capital standards, for nonbank companies supervised by the Board.

My first preference would be for regulators to follow the intent of Congress and tailor capital standards for insurance companies. My second preference would be for FSOC to use this authority, make recommendations which the Board could then adopt. If neither approach is implemented, I would then support a legislative solution such as the bipartisan one proposed by Chairman Brown and Senator Johanns or possibly the one described this morning by Senator Collins.

This hearing raises the fundamental question of who is best positioned to find the right capital regulatory structure for insurance companies. BPC's Regulatory Architecture Task Force has been examining the entire financial regulatory structure in a post Dodd-Frank world. The task force's full report will be released this spring and will contain many recommendations for how we can improve our current regulatory structure. One recommendation will be to create a Federal insurance regulator and an optional Federal charter. This is particularly important given the ramifications of making a mistake by applying the wrong capital standards to a select set of insurers. As Roy Woodall, the independent FSOC member appointed specifically for his expertise in insurance, stated in his dissent on whether to designate an insurance company as a SIFI, FSOC's analysis was, and I quote, "antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the State insurance resolution and guaranty fund systems."

In conclusion, BPC's Financial Regulatory Reform Initiative has found that Dodd-Frank generally empowered financial regulators with substantial authority and flexibility to use their tools to improve regulation and achieve better regulatory outcomes. Treatment of insurance companies is an early and critical test case of financial regulators' ability to adhere in practice to the construct created in Dodd-Frank: that financial regulators can overcome bank centricity in handling their new-found responsibilities for nonbank financial companies. I hope that they are up to the test. The stakes are simply too high.

Thank you very much. I look forward to responding to your questions.

Senator BROWN. Mr. Klein, thank you.

Mr. Mahaffey, welcome. Thank you.

STATEMENT OF MICHAEL W. MAHAFFEY, CHIEF RISK OFFICER, NATIONWIDE MUTUAL INSURANCE COMPANY

Mr. MAHAFFEY. Chairman Brown, Ranking Member Toomey, and distinguished Members of the Subcommittee, thank you for the opportunity to appear before you and testify today.

My name is Michael Mahaffey, and I am the Chief Risk Officer for Nationwide Mutual Insurance Company. I am testifying on behalf of Nationwide but will also represent the perspective of a diverse group of insurers that fall under Federal Reserve supervision.

As Nationwide's Chief Risk Officer, I am responsible for overseeing the company's approach to managing its risk profile. A critical part of my role is to ensure that Nationwide meets its internal and external capital requirements so the company is always well positioned to honor its promises to our policy holders. As such, I believe I can offer a helpful perspective on appropriate capital regimes for insurers.

Nationwide is a Fortune 100 mutual insurance company based in Columbus, Ohio. Roughly half of Nationwide's revenue is derived from our property and casualty businesses, and half is derived from our life insurance and related businesses. Nationwide also provides banking products and services through Nationwide Bank, a Federal savings bank insured by the FDIC. While Nationwide bank is critical to our customers and business strategy, it represents less than 3 percent the total assets of the combined organization.

Nationwide is subject to the Collins amendment by virtue of being a savings and loan holding company, or SLHC. Nationwide Bank is also independently subject to the minimum capital standards in the Collins amendment. We support the application of the Basel banking capital standards to Nationwide Bank. Furthermore, we are not seeking to lower capital standards for Nationwide Mutual, and we do not oppose utilization of a group-wide capital framework. Capital strength is core to our business proposition, providing our policy holders financial protection when they need it most. We only seek to ensure that any capital standards established by the Federal Reserve are tailored to the business of insurance; we believe this is consistent with congressional intent.

The Federal Reserve has maintained an interpretation of the Collins amendment that constrains their ability to tailor these capital rules. We respectfully disagree with this interpretation, and we support Congress passing legislation to clarify that the Federal Reserve can and should establish a separate tailored capital framework for insurers that appropriately reflects the industry's unique business model, risk profile, and asset-liability management practices.

Specifically, we support S. 1369, legislation that would clarify that the Federal Reserve can appropriately tailor those capital rules for insurers, but continue to apply banking capital standards to depository institutions owned by insurers.

I would now like to turn to the problems with imposing a bank-centric capital regime on insurers. The Basel III capital regime was designed specifically for banks. This framework is focused on the asset side of a company's balance sheet, including the predominant banking risks of credit, market, counterparty, and liquidity risks.

Given this risk profile, systemic economic events can subject banks to destabilizing runs and force them to quickly sell assets at a loss to meet their demand deposit obligations and funding needs.

Conversely, the primary risks facing insurers, found on the liability side of the balance sheet, are generally not as sensitive to the same systemic economic risks. These liability risks include, for example, weather, mortality, morbidity, and longevity risks, which are not as highly correlated with macroeconomic cycles.

One example of the problem this framework poses for insurers is the 100-percent risk weight imposed on corporate bonds, an approach which fails to distinguish bonds based on the credit quality of the borrower. This charge overstates the risk associated with high-quality assets, particularly when compared to riskier commercial and industrial loans, which receive the same 100-percent risk weight. As of year-end 2012, corporate bonds comprised about 48 percent of insurer general account assets as compared to around 6 percent for banks. Thus, overstating the risk on such a substantial portion of an insurer's investment portfolio will likely have a significant impact.

Insurers subject to this regime could decide to take on additional credit risk by shifting their investment portfolios to higher yielding, lower-quality corporate bonds that receive the same 100-percent risk weight. This additional risk taking would appropriately require increased capital under the State RBC framework, but would be ignored under Basel III as proposed.

In addition, to the issue of corporate credit risk, the Basel framework's treatment of insurers' separate account assets is problematic. These separate account assets would potentially receive capital charges for risks not borne by the insurer, resulting in a substantial and unreasonable capital cost.

In summary, the risk weights applied to insurers in the Basel regime would overcharge for some risks, entirely ignore others, and thereby potentially incent poor risk-taking behavior, contribute to a contraction in credit, and/or negatively affect availability and affordability of important insurance products.

In conclusion, I would like to reiterate a few important points.

First, we are not objecting to group supervision by the Federal Reserve.

Second, we are not objecting to the concept of a comprehensive group capital requirement for SLHCs or SIFIs.

Third, we are not objecting to utilization of a Basel framework for our bank.

And, finally, we are not seeking lower capital standards. Indeed, we support strong capitalization as part of our core business proposition. We are simply advocating that there is no one-size-fits-all model for assessing risk and by extension no universally applicable framework for determining capital requirements. We believe strongly that the Federal Reserve should have the latitude to utilize any tool, or combination of tools, necessary to effectively assess the risk profile and capital requirements of a holding company, taking into account material differences in their business models.

We appreciate the leadership of Senators Brown, Johanns, and Collins on this important issue, and thank the Subcommittee for the opportunity to comment.

Senator BROWN. Thank you, Mr. Mahaffey, and thank you all for staying very close to the 5 minutes.

I am going to ask a series of questions which I would ask of each of you. I would like to ask for brief answers, if possible yes or no. At 11:30 there will be a series of votes on the floor, so I want everybody on the panel to get a chance to ask questions. So just go work from left to right. Ms. Wilson, do you agree that the insurance business has a different model from banking and presents different risks? Just yes or no from each on the panel.

Ms. WILSON. Yes.

Mr. SCHWARCZ. Yes.

Mr. COHEN. Yes.

Mr. KLEIN. Yes.

Mr. MAHAFFEY. Yes.

Senator BROWN. OK. Do you think, as suggested by Ms. Wilson, that applying Basel III to insurers would or could have a negative impact on the safety and soundness of these institutions? Probably not yes or no there, but brief answers, if you could. Ms. Wilson?

Ms. WILSON. Yes, I think it could, at least in part because it could sway the way that insurers make investment decisions for its investment portfolio.

Senator BROWN. Professor Schwarcz?

Mr. SCHWARCZ. Yes, I agree that applying mechanistically bank capital rules to insurers would not be appropriate.

Mr. COHEN. Yes, I would agree. Basel III is not directed to insurers but to banks.

Mr. KLEIN. Yes.

Mr. MAHAFFEY. Yes, I would agree. Anytime you have a system that under- or over-charges for risks and does not account for the nuances of a business model, you run that risk.

Senator BROWN. Thank you. Third question. Do each of you agree that we could address this by regulation without actually going the legislative route? Ms. Wilson?

Ms. WILSON. My lawyers have assured me that their interpretation of the Collins amendment suggests the Federal Reserve does have the authority to make accommodations for the other businesses that are incorporated in an insurance holding company.

Senator BROWN. Mr. Schwarcz?

Mr. SCHWARCZ. I would frankly just refer you to Mr. Cohen's legal analysis, which I think is superb and I, you know, independently agree with. I think that the language is pretty clear in context that regulation can solve the problem.

Senator BROWN. Mr. Cohen, would you like to respond to Mr. Schwarcz's assessment of your brilliant legal mind?

[Laughter.]

Mr. COHEN. Solely to thank Professor Schwarcz for his accolade.

Senator BROWN. Mr. Klein?

Mr. KLEIN. Yes, I think the Federal Reserve can fix the problem. I also point out that I think that FSOC could direct the Fed to fix the problem as well.

Senator BROWN. OK.

Mr. MAHAFFEY. And I would say yes, small asterisk, that I think ultimately if the interpretation remains different by the Fed, then I think that there has to be the possibility of another legislative action.

Senator BROWN. Thank you. And understanding that the solution that we ask for, whether it is legislative or the Fed, to tailor capital rules for SIFI insurers, would the Fed still have ample tools to regulate these institutions in other ways?

Ms. WILSON. The Fed absolutely has authority to supervise the entirety of the consolidated group, and so we think that they would be well positioned to carry out their responsibilities.

Mr. SCHWARCZ. I am not sure I totally understand the question.

Senator BROWN. If we move forward on legislation or the Fed makes this—follows the suggestions of this panel, would they still have the ample tools to regulate institutions in other ways?

Mr. SCHWARCZ. Well, I guess I would answer as follows: I think that one important element of what the Fed should do and needs to do under Dodd-Frank is to craft their own capital rules for insurance SIFIs. Those rules should not just be bank rules, but nor should they just be as, frankly, some of the legislation. And here is where I will disagree with Mr. Cohen. Some of his suggestions suggest that we should not just completely defer to State risk-based capital rules with respect to insurers. And here I would say that is actually quite important that, for entities that have been labeled as "systemically risky," we have capital requirements that are on a consolidated basis, including insurers, that take into account the specific systemic risks that are identified by FSOC that insurers pose.

So while I would agree that we need different capital rules, I would—I think actually it would hinder the Fed's ability to regulate insurance SIFIs if we mandated, as some of this legislation does, I believe, that they completely defer to the State risk-based capital rules with respect to the insurance entities.

Senator BROWN. Mr. Cohen?

Mr. COHEN. I actually would not disagree with Professor Schwarcz, because I do believe that the Federal Reserve has substantial authority, both under Section 165 and for the S&L holding companies under the Bank Holding Company Act, to incorporate whatever additional requirements it would deem appropriate for an insurer.

Senator BROWN. Mr. Klein?

Mr. KLEIN. Yes, the Fed does have the authority. Whether they have the expertise, capability, and understanding of the differences of insurance companies through the regional bank system and the Reserve Board is an open question.

Senator BROWN. Mr. Mahaffey?

Mr. MAHAFFEY. As to the question of whether they have the appropriate tools, I actually think that S. 1369 actually broadens the possible set of tools that they could use at their disposal. I think it is their current interpretation of Collins that, in effect, limits the toolkit that they are asserting they can use for this. So I would actually suggest that this in no way shape or form—at least 1369 would not limit them from continuing to, if they chose to do so, and I think all panelists would agree that would be a bad idea.

If they chose to continue to use Basel III as a consolidated framework, even under that bill they could choose to still do so. They are simply not required to as they interpret Collins to instruct them today.

Senator BROWN. One last question. I am sorry to go over my time a bit. For Mr. Cohen specifically, the Fed has taken regulatory steps, as you know, to address unintended consequences presented by the text of Dodd-Frank. For example, the text of the Volcker rule exempts insurance from the proprietary trading prohibition but does not exempt their general account investments from the covered funds prohibition. Regulators, including the Fed, have extended this exemption.

Section 716, the swaps pushout provision, applies to insured depository institutions, but the Fed extended its transition period in temporary relief to uninsured branches and branches of foreign banks based upon, among other things, legislative history.

My question is: Do you believe the Fed has the flexibility under Collins to deal with any issues that arise? And how do these past actions compare to the issue that we are dealing with here? Do they strengthen the case for the Fed to act?

Mr. COHEN. I think those are, in fact, perfect analogies, Senator. They show that the Fed has the capacity to act in statutory schemes, which are very complex and very technical, as Senator Collins testified, to deal with getting to the right solution, even if there is ambiguity in the statute. And, frankly, with respect to 171, I do not think there is that much ambiguity as to the Fed's ability to act.

Senator BROWN. Thank you.

Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

Well, I think that our witnesses today made a pretty bulletproof case that the nature of the insurance industry is sufficiently different from the nature of banking to merit a different capital regime. I completely agree.

Mr. Cohen, I know this is not central to the discussion of the hearing, and it is not included in your testimony, but I wonder if you would comment on this, which is it strikes me that the asset management business is also fundamentally different from banking in a variety of very important ways. And given that it, too, is different from banking, do you see problems in trying to apply bank-centric regulations to the asset management business as well?

Mr. COHEN. I would, Senator Toomey, and I think your analysis is correct. And, moreover, Congress explicitly notified the Federal Reserve and FSOC that asset managers were to be treated differently. There are two specific references in Section 165 itself to asset managers in the context of differentiation.

Senator TOOMEY. Thank you.

Does anybody disagree with Mr. Cohen's assessment there?

[No response.]

Senator TOOMEY. Great. Thank you.

A second question also for Mr. Cohen, and I think this would—I will ask anyone else to comment as well. But if an insurer is not designated as a SIFI, does everybody agree that it is the intent of Dodd-Frank that the insurer would then, therefore, be subject only to the various States—the State capital regimes? Mr. Cohen first.

Mr. COHEN. Yes, Senator, assuming that it is not a savings and loan holding company, you are exactly right. It would be just the State insurance regulations.

Senator TOOMEY. OK. Thank you.

Yes, go ahead.

Mr. SCHWARCZ. You just asked if anyone disagreed.

Senator TOOMEY. Sure.

Mr. SCHWARCZ. I just want to clarify. I think that it is a more—there is a difficult issue with respect to savings and loan holding companies and bank holding companies that are predominantly engaged in insurance and regulated by the Fed. And I do not think it is actually clear that Dodd-Frank would say, well, there is no role for the Fed to play there on a consolidated basis, because those entities are both insurance companies, but they are also bank holding companies or savings and loan holding companies. They are both.

And so I think that it is actually relatively clear from the text of Dodd-Frank that we need a capital regime that is appropriate to their insurance side of their business, but we also need a capital regime that is appropriate to the fact that they are a bank holding company or savings and loan holding company. And I guess that gives the analogy, if I am a lawyer, I am not an insurance agent; but if I wanted to become an insurance agent, I would need to be licensed as a lawyer and licensed as an insurance agent.

And so sort of the same thing. If you are doing two things, you need to comply with the appropriate regulatory rules with respect to both of those regimes.

Senator TOOMEY. OK. But you are focusing on exclusively those that have another charter, another—you know, in this case a savings and loan?

Mr. SCHWARCZ. Correct.

Senator TOOMEY. OK. Mr. Klein, a quick question for you, and this goes to the point I made in my opening comments. One of the things I have a concern about is the Financial Stability Board importing what is essentially a European or international capital approach to the American insurance industry, and I am concerned about this in part because it seems to me that the European insurance model is typically quite different from the American model in many ways, and so a capital regime that may be suitable over there may not be suitable here. And, in addition, the Europeans might very well view the role of capital differently than we have historically viewed it here.

Do you share this concern as well?

Mr. KLEIN. I do, Senator. In my written testimony, I make reference to the fact that one of the things Dodd-Frank did is try to create a unified international voice for insurance, which we were lacking, frankly, going into the crisis in a pre-Dodd-Frank world. And it created the Federal Insurance Office, or FIO, and actually specifically empowered FIO with that objective and a seat on the proper international board.

Subsequently, the Federal Reserve has now, to my understanding, applied for a similar seat on that board, which makes some amount of sense given the fact that the Fed has these responsibilities. On the other hand, it needs to be clarified—and I urge in my written testimony that the regulators do so—that FIO is the international voice for the United States on insurance matters, as made clear in Dodd-Frank.

Senator TOOMEY. Thank you very much.

Thanks, Mr. Chairman.

Senator BROWN. Thank you, Senator Toomey.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, panel, for excellent presentations.

Mr. Cohen, are you aware of any published memoranda by the Federal Reserve basically defending their position?

Mr. COHEN. No, Senator, I am not. This all seems to be in testimony by Governors.

Senator REED. So it is sort of colloquial, "We do not think we have it," but there is no official documentation you have seen?

Mr. COHEN. Not that I am aware of, Senator.

Senator REED. OK. One aspect, I think, that we have dwelled on is the difference and the distinct difference between the balance sheets and the operations of an insurance company and a bank holding company. But there are activities that could be in common, particularly on a consolidated basis, and I think Professor Schwarcz suggested this, that on a consolidated basis there is probably the issue of systemic risk; and, second, the obligation of the Fed to sort of control that risk. And your suggestion is it not be done through Basel III, which I think makes a great deal of sense, but it has to be done. Is that a fair approximation?

Mr. SCHWARCZ. That is exactly right, Senator. The point is that we now know that nonbank holding companies that are predominantly engaged in insurance can be systemically risky. We need to apply group capital requirements to them, and crucially, we cannot just carve out the insurers and say that our group capital requirements only apply to the part of the business that is not regulated by States. Because if you look at AIG, one of the big problems there was with the interactions among the different components of the company. The insurance companies were really used by other portions of the company for the securities lending problems. And there are also just many other systemic risks associated with insurance particularly.

Now, again, those are lesser than banks. We need to have a tailored regime for those. But where my concern is is that there is slippage. When we all agree—and we all agree in this room, I think—that we should not have bank capital requirements applied to insurers, there is slippage then to the conclusion that that means that the Federal Reserve should not apply its consolidated capital requirements to the portions of the insurance SIFI that are insurance companies.

Senator REED. Well, let me ask you all to comment on sort of a procedural approach, which seems to make sense to me, that if this was to be done, then it typically would be done through a proposal of a rule by the Federal Reserve allowing the industry to comment in detail about the specific application and also any general points they want to make. And that the rule would then be adopted going forward.

Is that a sensible approach that could be undertaken right now by the Federal Reserve? We will start with Ms. Wilson.

Ms. WILSON. It certainly could be, and I think many of the companies that are represented on this panel and in previous hearings have actually spent quite a bit of time with the agencies to try to help advance discussion about how regulations could be proposed.

Senator REED. Thank you.

Professor?

Mr. SCHWARCZ. Yes, absolutely, I think that the Fed can and should under its existing authority do what many of us are suggesting.

Senator REED. Mr. Cohen?

Mr. COHEN. Yes, Senator, I think they could do it, and it makes good sense to do it.

Senator REED. Thank you.

Mr. KLEIN. Yes, Senator, that is a wise and prudent course.

Senator REED. OK.

Mr. MAHAFFEY. I would concur.

Senator REED. Thank you very much. I know when to stop. Thank you very much.

[Laughter.]

Senator BROWN. Senator Johanns.

Senator JOHANNS. Thank you all for being here.

Just listening to your testimony, one of the things that occurs to me is how much agreement there is, and, you know, there are different viewpoints on this panel on probably many things, but it does strike me how much agreement there is.

One thing, though, I would like to explore a little further is this whole issue of how much authority the Fed has, because here is the problem I have as a lawmaker. In every possible way you can think of, we have asked the Fed if they have this authority. When Chairman Yellen was going through the confirmation process, tons of questions were sent her way, you know: Do you have the authority? Very consistently, the Fed has passed. They have said, "No, we do not."

And so we are kind of in this situation where we know the easy pathway would be for the Fed just to issue regulations that recognize the difference between insurance and banking. But it does not look like that is going to happen.

Under those circumstances would you agree with me—and I will just go down the line here—that legislative language is necessary then to give the Fed clear direction on this issue?

Ms. WILSON. I think the legislative approach would definitely make it clear that the authority exists in the Federal Reserve to do what is needed.

Senator JOHANNS. Professor?

Mr. SCHWARCZ. An appropriate legislative course would be wise, if that came to fruition.

Mr. COHEN. Senator, although one would hope that the Fed may be willing to reconsider after the unanimity expressed today to which you referred is so clear, in the absence of prompt action by the Federal Reserve, I fully agree that legislation is the only recourse.

Mr. KLEIN. Senator, as I mentioned before, I think in addition to the Fed having the opportunity to do the right thing, there is a role that FSOC could play in helping direct the Fed to do the right thing. Absent those two positions, then I would agree that legislation becomes necessary to avoid a problematic policy outcome, and that to some degree would be a little bit disappointing as this is one of the first areas where regulators are attempting to overcome their bank-centric nature in history to extend the provision of Dodd-Frank into a nonbank world.

Mr. MAHAFFEY. And I would agree. I think this has been the classic stumbling block, as we have all approached the Fed. I think if this issue does not get resolved, it is one thing for all of us to be unified in our opinion that the Fed has this discretion and current authority. But if this is not resolved, I think the only prudent path is to actually make clear through a legislative solution that they do have this authority. And, again, I think that actually broadens the toolkit they have at their discretion, and it does not remove anything that they have at their discretion today in the Collins amendment. So I think that might be the path that needs to take place.

Senator JOHANNS. Let me stay with you a second. One of the things that has occurred to me about the potential that bank-centric rules would be applied to insurance companies is that you could actually increase the risk that insurance companies are exposing their customers to, if you will. Do you agree with that analysis on my part?

Mr. MAHAFFEY. I think generally, yes. Anytime you apply a model that attempts to assess risk, and if that model ignores risks, underprices risks, or overprices risks relative to the model of the company you are trying to measure, then you can unintentionally create incentives for them to move the risk portfolio to comport with that model. So whenever you try and impose a capital charge that does not actually get to the economics underlying the business model, whether that is on the assets or liabilities, the answer is yes, you can actually have perverse incentives for them to take more risk rather than less risk.

Senator JOHANNS. Exactly. Let me just move down the line. I would like comments by others, just very brief comments about that.

Mr. KLEIN. Absolutely, Senator. The hallmark of every financial crisis is the mispricing of risk at its core, mixed with leverage. And it would seem to me that if one of the defenses against a financial crisis is appropriate risk-based capital, then applying inappropriate risk-based capital would exacerbate the possibility of a financial crisis.

Senator JOHANNS. Mr. Cohen?

Mr. COHEN. Senator, when you overprice risk, there is then a threat to the consumer as well, because that threatens to drive the insurer or any financial institution out of the product or service for which risk has been overpriced.

Senator JOHANNS. Professor?

Mr. SCHWARCZ. Let me just make one point. We are talking about two different sets of entities: insurance SIFIs and then savings and loan holding companies and bank holding companies that engage in insurance.

I actually think we need to disaggregate the analysis. I agree completely with respect to insurance SIFIs. With respect to savings and loan holding companies and bank holding companies that have insurance, they are bank holding companies, they are thrift holding companies. And so the question of whether or not they should get a special exemption from the rules that normally there is actually, I think, much more difficult.

So I think that it is true that you need absolutely an appropriate capital regime for the business you are dealing with, but recognize that bank holding companies and thrift holding companies that predominantly engage in insurance are bank holding companies and thrift holding companies, and we should regulate them as such.

Senator JOHANNS. If you can be very quick, because I am out of time, Ms. Wilson. I would like to hear your reaction to that.

Ms. WILSON. I would like to just echo Mr. Cohen's comment. The mis-assignment of risk to capital and requiring insurers to carry more capital than would otherwise be necessary is actually a disadvantage for our policy holders. They would get less attractive returns on their retirement funds with us if we were forced to go to a different part of the investment universe to deploy our resources.

Senator JOHANNS. Thank you.

Thank you, Mr. Chairman.

Senator BROWN. Thank you, Senator Johanns.

Senator Tester.

Senator TESTER. Thank you, Mr. Chairman.

This is a question for Ms. Wilson and Mr. Mahaffey. Assuming that Basel capital standards would be applied to your businesses—and I do not think anybody thinks that should be the case, but assuming they would be, could you tell us about the impact that would have on your ability to manage your assets and liabilities? You can go first, Ms. Wilson.

Ms. WILSON. Thank you for the question. We have a fairly sophisticated investment allocation algorithm, and if the risk capital charges are different than they currently are, we could potentially change the portfolio mix that we use to deliver on decade-long commitments to our policy holders. And that, as I think I just said to Senator Johanns, might reduce the amount of investment income that they would have to provide for their retirement security.

Mr. MAHAFFEY. Yes, and I would echo those comments. I would also add that it would force you to look at the total capital position. Nationwide holds substantially more capital than would be imposed upon us by Basel III, so, again, this is not about aggregate capital. But as you subdivide the organization and you get down to certain products, you would now be forced to sort of triangulate between an internal economic view of the risk we are taking when we write a product, the current State-based regulatory requirements for the risk we are taking in a product, rating agency views, and now you would layer in another view, all of those views likely resulting in very different answers as to how much capital.

And so back to the point of if you have the wrong model that does not take into account the real risks of the products and the assets that you are putting behind those products, then we would be forced to probably make modifications either to the price of the products or the lines of business that we choose to be in.

Senator TESTER. OK. Impact on the economy, you talked about the impact on potential retired folks. Any other impacts that come to mind? Go ahead.

Ms. WILSON. If I might, one of the important sources of strength for the economy during the economic downturn were large insurance companies that actually invested in infrastructure, long dated assets, because we did, in fact, have the capital strength to make long-term investments. Even when the market was sort of on its heels, we had net inflows in many cases. And so we were seen as a source of strength to the economy. We make very long term investments in things like bridges and highways and support municipal projects that need funding across the United States right now. And so it is not just the investment returns for our participants, it is also the macroeconomic impact that many of our investment portfolios support.

Senator TESTER. OK. This is a question for any witness or all witnesses that want to respond to it. It goes back to Senator Toomey's question on international efforts. Share your concerns about potential inconsistencies in coordination between international regulations and domestic, if you might.

Mr. COHEN. I would be glad to start, Senator.

Senator TESTER. Sure.

Mr. COHEN. I think that this is one of the most significant issues confronting the financial system, because we are a global system today, and the more we can do to have concerted action and collaborative action, the better off I think the financial institutions in the United States will be and the financial institutions outside the United States will be. There is a lot left to be done.

Senator TESTER. Anybody else want to respond?

[No response.]

Senator TESTER. Mr. Cohen, I will stay with you then. What can the Federal regulators do to ensure that the international negotiations do not disadvantage American insurers?

Mr. COHEN. I think it is extremely important that they not sacrifice what is the right solution for consensus. Sometimes there is a feeling that in the rush to get to consensus, the desire—which is certainly a key objective—that the best interests of the U.S. financial institutions are sacrificed, not in the sense of competitive best interests but just in what makes sense.

Senator TESTER. Go ahead, Mr. Klein.

Mr. KLEIN. I would add that it is very important when you are engaged in an international negotiation that you are able to speak with one unified voice, and Dodd-Frank clearly gave that voice to the Director of FIO in the Treasury Department, and that he should continue to serve that role, and the Fed and NAIC should make clear that that is his role in an international context.

Senator TESTER. OK. Anybody else?

[No response.]

Senator TESTER. One last question. This goes back to Ms. Wilson and Mr. Mahaffey. Nationwide has a bank, TIAA–CREF has a thrift. Can you describe what services your bank and thrift provide and why it is important to your ability to serve your policy holders and why you would not want to eliminate these offerings? You can go ahead and go first, Ms. Wilson.

Ms. WILSON. We have, as I mentioned in my opening statement, 3.9 million clients whose retirement funds are deposited with us. We believe that we can be much more helpful to them in building a life of financial stability if we can offer additional services like life insurance, savings accounts, mortgage loans, potentially car loans, things that are really retail nature but really speak to the needs of the average employee on our institutional clients' sort of workforces.

Senator TESTER. Good. Mr. Mahaffey, would you like to add to that?

Mr. MAHAFFEY. Sure, I will echo those comments, but I will also just give another example on the property/casualty side. So our bank, while it is small, it is critically important to our other policy holders. An example would be in the wake of a disaster we have the ability to issue rather than a bank draft, because of our bank we can issue a Nationwide bank debit card that gives our customers immediate relief and access to use those funds anywhere a credit card would be served. So we try and integrate it with our product portfolio. Our desire is not to build a big stand-alone bank but to use it as a way to serve our existing policy holders better.

Senator TESTER. I appreciate that, and I also appreciate all the testimony by all the folks on the panel today. This probably is not televised, Mr. Chairman, but it would have been nice if they could have seen——

Senator BROWN. It is in Billings.
Senator TESTER. It is in Billings?
[Laughter.]
Senator TESTER. Thank you.
Senator BROWN. I made special arrangements because I knew you were going to be here.
Senator TESTER. Thank you very much. But it would have been nice to have the Fed, and hopefully they will take a look at the testimony that you guys put forth, because I think it was very good. Thank you.
Senator BROWN. Thank you, Senator Tester.

There is a series of votes to be called around 11:30, so I will ask another couple of questions, and perhaps Senator Johanns if he wants, and we will see.

A follow-up, Mr. Mahaffey, on Senator Tester's question. Either Ms. Howe or somebody from Nationwide told us about what happened in Joplin, Missouri. If you could sort of illustrate more graphically your answer to Senator Tester's question about what that only $6 billion out of $180 billion—you are a $180 billion institution, $6 billion in your bank, how that plays out for your policy holders?

Mr. MAHAFFEY. Sure. And as you mentioned, we were an insurer that was able to help in the wake of the Joplin disaster. We happened to have a number of insureds that were there, and that was a good example of the use of this claims card, we call it, which allows our claims agents to be able to issue these pre-loaded debit cards on the spot for someone who suffered a loss in the wake of a disaster like Joplin. And that can be very helpful, rather than attempting to get a bank draft when your bank may not actually still be standing.

We have had a phenomenal response and feedback on that program, so it is just another example of a way in which we can provide a very value-added service, be there for our members when they need us most, and we view that as our model for the bank being integrated with the rest of our insurance organizations, not necessarily as a stand-alone bank.

Senator BROWN. Thank you. Last question. Professor Schwarcz raised concerns about systemic risk from insurers. His article highlights two specific activities that AIG engaged in: derivatives dealing and securities lending. Dodd-Frank imposes new regulations on derivatives. The CFTC is, as we know, implementing those for securities lending. Dodd-Frank gives FSOC the authority to regulate both entities, and activities—activity-based regulation is still in its early stages. Governor Tarullo of the Fed has proposed applying universal margin requirements to all securities financing transactions.

So, Mr. Cohen and Mr. Klein and Professor Schwarcz, if you would just answer a couple of questions. Does FSOC have the tools to address the issues that Professor Schwarcz raised? And, second, do you agree with Governor Tarullo's proposal as far as it goes now? And start with Mr. Cohen, then Mr. Klein, then Mr. Schwarcz, if you would.

Mr. COHEN. Senator, I do believe that the tools exist, through FSOC, through the Federal Reserve, to regulate on an activity or product basis. Whether or not this should take the form of increased margin requirements, which really is a macroeconomic approach rather than a micro, institution-specific approach, I think we just need to see what the Federal Reserve is going to propose here.

Senator BROWN. Mr. Klein?

Mr. KLEIN. I think, Mr. Chairman, the FSOC does have the tools to address it. It is critically important that they do. Activities-based regulatory authority was one of the major advancements, in my opinion, in Dodd-Frank. There has been a lot of focus spent on regulating institutions. It is what regulators know to do. But activities is fundamentally where problems tend to arise before they end up in institutions. And so I think they do have the tools. I think they ought to use them more.

I also think Professor Schwarcz was right to point out with AIG, during my time looking into their secured lending facility, there were significant problems there. It did highlight a weakness in the State-based insurance regulatory system, one of the reasons an optional Federal charter may make sense.

With regard to the point on Governor Tarullo on the margin requirements, I think it is still a little bit too early to tell if that is the right approach, but I think he and the Fed ought to be commended for pushing FSOC and going down the activities-based regulatory approach.

Senator BROWN. Professor Schwarcz, your last word.

Mr. SCHWARCZ. Sure. Two things.

The first is I think that the Fed does have the appropriate authority with respect to insurers that are designated as "systemically risky." I actually believe that there is systemic risk in the insurance industry that may not be captured by that. So, for instance, the recent report of the FIO pointed out mortgage insurers, and to me it does not make sense that mortgage insurers are regulated by States.

I also tend to think that it is true that we need a stronger, more robust Federal presence with respect to other systemic risks in the industry. I do not think the designation power is enough, and I go through that in the article.

The final thing I just want to say is I am wary—and I just want to emphasize this again. We have been conflating the SIFI issue and the issue of bank holding companies and savings and loan holding companies. Those are bank holding companies and savings and loan holding companies. And I do have concern with some of the legislative solutions that it could create regulatory arbitrage by saying certain bank holding companies or savings and loan holding companies can avoid the regulation intended for bank holding companies and savings and loan holding companies if they engage in insurance. That could encourage them to increase their insurance business, encourage them to create an uneven playing field among different types of bank holding companies and savings and loan holding companies.

So while my testimony for the most part was focused on insurance SIFIs, I just want to be clear, I think the issues are different for bank holding companies and savings and loan holding companies. And I think that some of the legislation, frankly, does not deal with that issue as well as I would like it to.

Senator BROWN. Well, thank you, Professor Schwarcz. Thanks to all five of you. If Members of the Subcommittee have questions they submit in writing, please answer them within 7 days, get them back; or if you want to do any addenda to your testimony or your comments, we would appreciate that.

I have statements submitted from the Property Casualty Insurers Association, the American Council of Life Insurers, the National Association of Mutual Insurance Companies, the American Insurance Association, the United States Chamber of Commerce, the National Association of Insurance Commissioners, a statement by the Financial Services Roundtable, and a letter from former Federal Deposit Insurance Corporation Chair, Sheila Bair, and I ask unanimous consent that they be entered into the record.

I thank all of you, Senator Johanns, especially thank all of you for joining us today.

The hearing is adjourned.

[Whereupon, at 11:34 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow]:

PREPARED STATEMENT OF GINA WILSON

EXECUTIVE VICE PRESIDENT & CHIEF FINANCIAL OFFICER
TIAA–CREF

MARCH 11, 2014

I. Introduction

Chairman Brown and Ranking Member Toomey, Members of the Subcommittee, thank you for providing TIAA–CREF with the opportunity to testify on a very important issue to both TIAA–CREF and the clients we serve.

Our testimony today focuses on the final rules governing capital standards and the Basel III accords issued by the Federal Reserve Board ("FRB") in conjunction with the Office of the Comptroller of Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively the "Agencies").[1] The final rule contained a number of changes from the proposed rulemaking, most notably it temporarily exempted bank holding companies subject to the FRB's Small Bank Holding Company Policy Statement and Savings and Loan Holding Companies ("SLHCs") substantially engaged in insurance underwriting or commercial activities. In statements accompanying the final rule, the FRB indicated that the temporary exemption for insurance SLHCs was provided in recognition of policy concerns expressed regarding the imposition of bank capital rules on insurance companies.

We appreciate the temporary exemption and its acknowledgment that the insurance business model is quite different from the banking model. However, given the FRB's public statements regarding their current interpretation of the Collins Amendment, we are concerned that any final rule will impose Basel III on insurance companies with only modest and incomplete adjustments from the proposed rule.

II. Background

TIAA–CREF is a leading provider of retirement services in the academic, research, medical and cultural fields managing retirement assets on behalf of 3.9 million clients at more than 15,000 institutions nationwide.[2] The mission of TIAA–CREF is "to aid and strengthen" the institutions we serve by providing financial products that best meet the needs of these organizations and help their employees attain financial well-being. Our retirement plans offer a range of options to help individuals and institutions meet their retirement plan administration and savings goals as well as income and wealth protection needs.

TIAA–CREF is comprised of several distinct corporate entities. Teachers Insurance and Annuity Association of America ("TIAA"), founded in 1918, is a life insurance company domiciled in the State of New York operating on a nonprofit basis with net admitted general account assets of $232 billion.[3] TIAA is a wholly owned subsidiary of the TIAA Board of Overseers, a special purpose New York not-for-profit corporation. The College Retirement Equities Fund ("CREF") issues variable annuities and is an investment company registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. TIAA–CREF also sponsors a family of equity and fixed-income mutual funds.

While we are primarily engaged in the business of insurance, TIAA and the Board of Overseers hold a small thrift institution within their structure and as a result are registered as SLHCs. This thrift provides TIAA–CREF with the ability to offer our clients deposit and lending products integrated with our retirement, investment management and life insurance products and enhances our ability to help them attain lifelong financial well-being.

Our status as a SLHC places us under the purview of the FRB and consequently subjects us to the proposed regulatory capital regime the Agencies have set forth. TIAA–CREF supports ongoing progressive financial regulation, including strong and appropriate capital standards that are consistent with SLHCs' operating models and the risks inherent in their business. It is equally important, however, to ensure the standards ultimately implemented by the Agencies fully account for the diverse business models under which different financial services organizations operate. In our analysis of the rules through the prism of a firm predominantly engaged in insurance, we have found the Agencies have taken a bank-centric approach with the final rule. Consequently, this approach does not account for the significant dif-

[1] 12 CFR Parts 208, 217, and 225. Regulatory Capital Rules: Regulatory Capital, Implementation of Basel II, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule.

[2] As of December 31, 2013.

[3] As of January 31, 2014.

ferences between insurers who hold thrifts, but maintain the overwhelming majority of their business in insurance products ("insurance-centric SLHCs"), and those firms that are primarily banking entities.

To be clear, we support appropriate capital regulations for banking organizations and are not seeking to exempt insurers from the tenets of the Dodd-Frank Act ("DFA"). Nevertheless, applying metrics designed for banks to an insurer would be inappropriate and could have a number of negative effects for insurers, customers, and the economy as a whole. TIAA–CREF is particularly concerned about the effects of the rule on our ability to continue providing our clients with a full menu of appropriate and reasonably priced financial services products.

The FRB can use the flexibility permitted by the DFA to tailor capital standards for the insurers that they oversee, which is key to resolving most of the potential negative repercussions that may result from imposing a bank-focused capital regime on insurance companies.

The FRB has taken the position that Section 171 of DFA (the "Collins Amendment"), which requires regulators to establish risk-based capital standards for banking organizations, prohibits the FRB from treating insurance assets differently from banking assets. We, as well as many of our peers, do not share this legal interpretation and instead believe the Collins Amendment provides banking regulators with the necessary flexibility to account for and integrate the existing U.S. insurance regulatory capital regime when developing their new model.[4]

III. Congressional Intent and the Collins Amendment

Congress clearly demonstrated throughout the DFA legislative process, and in the text of various provisions within DFA, its intent to allow insurance-centric SLHCs to continue to own thrifts and offer their customers banking products and services. During consideration of the DFA, Congress affirmed the importance of the SLHC structure by maintaining the thrift charter, ensuring SLHCs would not need to become Bank Holding Companies ("BHCs"), and maintaining the Gramm-Leach-Bliley ("GLB") grandfather provisions for nonbank activities of certain SLHCs and the qualified thrift lender ("QTL") test for SLHCs. Congress went so far as to instruct the FRB to:

> . . . take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies" in determining SLHC capital standards.[5]

Indeed, as demonstrated by the original Volcker Rule provisions in the DFA that created a number of insurance exemptions, Congress expected insurance companies to continue to own thrifts.[6] By taking these steps, Congress also confirmed that the public is entitled to more, not less, competition in the banking industry. Unfortunately, the application of the Basel III Capital Rules would make continued ownership of thrifts by insurance organizations economically prohibitive, effectively accomplishing through regulation what Congress not only did not intend to do by statute,[7] but what Congress specifically directed the FRB to avoid doing.

The Collins Amendment requires banking regulators to establish minimum risk-based and leverage capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies and nonbank financial companies supervised by the FRB (collectively, "Covered Companies"). However, nowhere in the language of the Collins Amendment is there a directive to ignore the differences between insurance companies and banks. Rather, the language only requires that the risk-based and leverage capital requirements applicable to covered companies shall not be:

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[4] Comment letter on Regulatory Capital Rules: 1 77 F.R. 52792 (Aug. 30, 2012); 77 F.R. 52888 (Aug. 30, 2012); 77 F.R. 52978 (Aug. 30, 2012), Submitted by Chief Financial Officers of Country Financial, Mutual of Omaha, Nationwide Mutual Insurance Company, Principal Financial Group, Prudential, TIAA–CREF, USAA, Westfield Group, October 22, 2012.

[5] Senate Report 111–176 at footnote 161 (April30, 2010)—discussion of Section 616 amending HOLA to clarify the FRB's authority to issue capital regulations for SLHCs where the Committee specifically notes:

It is the intent of the Committee that in issuing regulations relating to capital requirements of bank holding companies and savings and loan holding companies under this section, the Federal Reserve should take into account the regulatory accounting practices and procedures applicable to, and *capital structure of, holding companies that are insurance companies (including mutuals and fraternals),* or have subsidiaries that are insurance companies." [emphasis added].

[6] Section 619(d)(1)(F) of the DFA.

[7] "Dodd-Frank Amps Insurers for Banking Exit," *SNL Financial* (July 11, 2012).

1) Less than the generally applicable risk-based capital and leverage capital requirements, which shall serve as a floor for any capital requirements that the Agencies may require ("Bank Standard"); or
2) Quantitatively lower than the generally applicable risk-based capital and leverage capital requirements that were in effect for insured depository institutions as of the date of enactment of the DFA ("2010 Regulations").[8]

The Collins Amendment did not intend for banking regulators to ignore the differences between banks and insurance companies in formulating the capital standards for banking entities, nor for the standards applicable to other Covered Companies. In a letter to the Agencies on the proposed rules implementing capital standards, Senator Susan Collins (R–ME) stated, "it was not Congress's intent that Federal regulators supplant prudential State-based insurance regulation with a bank-centric capital regime."[9] Rather, the Bank Standard outlined in Section 171(a)(2) of the Collins Amendment, which sets a floor for SLHC risk-based capital standards, allows the FRB to specifically address insurance activities. The requirement of Section 171(b)(2) sets the "generally applicable risk-based capital requirements" floor and does not require an asset-by-asset testing of risk-weights.[10] Instead, the requirement speaks to a "numerator" of capital, a "denominator" of risk-weighted assets and a ratio of the two. The Collins Amendment also does not require asset-by-asset or exposure-by-exposure minimum requirements, but instead calls for holistic floors. The second requirement that the standards not be quantitatively lower than the 2010 Regulations can be satisfied by either following the terms of the 2010 Regulations or through a holistic quantitative analysis of equivalence with appropriate capital standards, which would meet the "not less than" language of the statute.

The FRB has stated publicly before the Committee and others that the business of insurance is different than that of banking, but the Collins Amendment ties their hands in addressing these differences. They believe the language imposes a consistent set of asset specific risk-weights for all covered companies. We have expressed to the FRB, both in person and in our comment letter (see *Appendix A*),[11] our view that the language of the Collins Amendment provides adequate flexibility to interpret the statute in a way that permits them to account for the differences between banking and insurance. This point of view is validated by nine leading law firms, which sent a letter to the Agencies concurring with our interpretation of the Collins Amendment (see *Appendix B*).[12]

Consequently, we support and applaud the efforts of Senators Sherrod Brown (D–OH) and Mike Johanns (R–NE) in introducing S. 1369 (Brown-Johanns), legislation to address the potential imposition of banking capital rules on insurance companies under the Collins Amendment. The Brown-Johann's bill would clarify that the Collins Amendment does not require the FRB to impose a banking capital regime by exempting insurers from the Collins Amendment, while leaving intact the FRB's other sources of legal authority to impose robust capital standards on federally supervised insurance companies. In addition, under Brown-Johanns, Basel III bank-centric capital standards would appropriately apply to any depository institutions owned by an insurance company. We strongly support this legislation and look forward to being part of the dialogue as the bill makes its way through the Senate.

IV. Macro-economic effects of the application of the Basel III standards on insurers

Bank-centric capital standards, which do not effectively recognize the long dated nature of insurance activities, would likely encourage insurers to modify certain practices and strategies that would be detrimental to their core activities. Fundamentally, banks' core business is lending and maturity transformation. As a result, insurers' investment portfolios involve duration matching of assorted longer term liabilities. That is, insurers match their long-term liabilities with long-term in-

[8] Section 171(b)(1) of the DFA.

[9] Letter to Agencies regarding proposed rulemaking for capital standards from Senator Susan Collins (R–ME), November 26, 2012.

[10] U.S. Senate Committee on Banking, Housing and Urban Affairs, "Oversight of Basel III: Impact of Proposed Capital Rules," Statement of Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, November 14, 2012.

[11] *See Appendix A.* Comment letter to Agencies on Regulatory Capital Rules, Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA–CREF, October 22, 2012.

[12] *See Appendix B.* Comment Letter and Cover to Agencies on Regulatory Capital Rules, Signed by attorneys specializing in regulatory advice to insurance companies from Arnold & Porter LLP, Gibson, Dunn & Crutcher, Venable, Wachtell, Lipton, Rosen & Katz, Winston & Strawn LLP, Shearman & Sterling, LLP, Dechert LLP, Debevoise & Plimpton LLP, and Paul Hasting LLP, March 20, 2013.

vestments. There are a number of distinct features that differentiate banks from insurers, including:

1) *Stable illiquid liabilities.* The stability of life insurance liabilities and their relative illiquidity is a fundamental difference from banking deposit liabilities.
2) *Long-term savings and asset protection products.* Insurance products serve long-term savings and asset protection goals, which are fundamentally different from the objectives of bank depositors.
3) *Long duration assets.* Based on the long-term nature of their liability structure, insurance companies invest for a longer duration than banks.
4) *Adverse Deviation.* The business of insurance is built on sound, well tested and proven actuarial science. Reserves are based on assumptions that are reasonably conservative and include provisions for the risk of unfavorable deviation from such assumptions (*i.e.,* mortality, interest rates, withdrawals, and expenses). Insurers apply this discipline to a large range of uncertain events in their long dated portfolios.
5) *Source of long-term funding for the economy.* Insurance companies are a significant source of long-term, stable funding for the corporate, real estate, and governmental sectors of the economy, while banks are primarily a source of short-term financing to these sectors.

Imposing a capital framework designed to address the maturity mismatch inherent to banking on an insurer would create an investment portfolio construction challenge where none previously existed. Under the Rules, certain long-term investments, which are typically less liquid than shorter-term investments, are discouraged. Because the Basel III capital framework focuses substantially on assets, rather than taking a holistic approach, it does not consider the importance of matching the duration of assets and liabilities. To ignore the fundamental importance of this concept challenges an insurer's ability to properly consider one of the most important elements of insurer risk management. The application of enhanced bank-focused standards as outlined in the Rules, without considering the existing strict capital rules to which insurers already adhere, would have a number of negative effects for TIAA–CREF and other insurance-centric SLHCs including:

1) Adherence to two regulatory reporting structures which have very different incentives surrounding liquidity and consumer protection;
2) Greater costs for insurance products;
3) Pressures on insurance reserve conservatism to meet bank definitions of capital; and
4) Recording unrealized gains/losses causing short term strategic capital management incentives.

Simply put, applying bank capital standards to an insurer would create a disincentive to invest in the very assets that most promote stability and solvency.

V. Conclusion

The Rules set forth by the Agencies, if applied to insurers, would have a detrimental effect on the insurers' ability to offer affordable financial products, which would in turn trickle down to individuals who utilize insurance products to help them build a secure financial future. The Rules also could have macroeconomic implications that, for example, would create disincentives for insurers to invest in asset classes that promote long-term economic growth such as long-term corporate bonds, project finance and infrastructure investments, commercial real estate loans, private equity and other alternative asset classes.

Strong capital standards are vital to strengthening the overall structure of the U.S. financial system. The existing capital regime under which insurers operate has served the industry well and proved extremely effective when put to the test during the recent financial crisis. We are confident the FRB can develop alternative proposals to ensure a strong capital regime that also accounts for the business of insurance. Indeed, in our comment letter to the FRB and in our subsequent conversations with them, we have proposed alternative methodologies for measuring an insurer's capital that support both the policy goals of the FRB and ensure a strong capital regime, while also accounting for the business of insurance. We hope as they continue to study the issue, regulators will find a sensible way to integrate a capital structure appropriately designed for insurers. In the meantime, we ask Congress to explicitly give the Agencies the ability to ensure capital standards are appropriately tailored for insurers.

Thank you again for the opportunity to testify. Given the potential affect the Rules could have on our business and our clients, we have been very active in our efforts to educate policymakers about our concerns and will continue to leverage all opportunities made available to us. We appreciate the Subcommittee taking an interest in this issue and having afforded us another venue in which to discuss our concerns.

PREPARED STATEMENT OF DANIEL SCHWARCZ

ASSOCIATE PROFESSOR AND SOLLY ROBINS DISTINGUISHED RESEARCH FELLOW
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MARCH 11, 2014

Chairman Brown, Ranking Member Crapo, and Members of the Subcommittee, thank you very much for this opportunity to discuss the appropriate capital standards to be applied to firms that are predominantly engaged in the business of insurance and subject to Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). I hope to make three primary points in this testimony, which draws substantially on a co-authored draft article, *Regulating Systemic Risk in Insurance.*[1] First, I will emphasize that the business of insurance can create important systemic risks to the larger financial system. The specific contours and magnitudes of these systemic risks are constantly evolving based on shifts in the insurance industry and its regulation. Second, I will suggest that, as contemplated by Dodd-Frank, these risks warrant the application of federally designed capital standards to nonbank financial companies primarily engaged in the business of insurance that the Financial Stability Oversight Council ("FSOC") designates as systemically risky ("Insurance SIFIs"). Unlike State risk-based capital rules, which focus primarily on consumer protection, these Federal capital standards should focus on the distinctive ways in which Insurance SIFIs can pose systemic risk to the larger financial system. This approach is perfectly consistent with Section 171. Third, I will caution against exempting bank/thrift holding companies from Section 171 simply because they or a large number of their subsidiaries are subject to State insurance capital requirements.

(1) Systemic Risk in Insurance

As exemplified by the dramatic failures of American Insurance Group ("AIG") and various financial guarantee insurers, insurance companies and their affiliates played a central role in the 2008 Global Financial Crisis.[2] It is now generally accepted that insurers and their affiliates that effectively provide insurance against the default of financial instruments—whether through formal insurance policies (as in the case of financial guarantee insurers) or through derivatives such as credit default swaps (as in the case of AIG)—can contribute to systemic risk.[3] Other "nontraditional" insurance activities, such as extensive use of securities lending (as in the case of AIG),[4] or mortgage guarantee insurance[5] can also prove systemically risky.[6]

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[1] *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance* (March 4, 2014), *available at http://ssrn.com/abstract=2404492* (arguing that systemic risk in insurance can arise due to correlations among individual insurers with respect to both their interconnections with the larger financial system and their vulnerabilities to failure, and that the Federal Insurance Office should consequently be empowered to supplement or preempt State law when States have failed to satisfactorily address gaps or deficiencies in insurance regulation that could contribute to systemic risk).

[2] Additionally, two holding companies principally engaged in the business of insurance received Federal funding in the midst of the financial crisis though the U.S. Department of the Treasury's Troubled Asset Relief Program. The Hartford Financial Services Group received $3.4 billion and Lincoln National Corporation received $950 million. Government Accountability Office, Insurance Markets: Impacts of and Regulatory Response to the 2007–2009 Financial Crisis (June 2013).

[3] The Geneva Association, Cross Industry Analysis, 28 G–Sibs Vs. 28 Insurers, Comparison of Systemic Risk Indicators (Dec. 11, 2012).

[4] A substantial contributor to AIG's woes was its securities lending program, which, while coordinated by a noninsurer affiliate of AIG, exploited securities owned by AIG's insurers. *See* William K. Sjostrom, Jr, *The AIG Bailout,* 66 Wash. & Lee L. Rev. 943 (2009).

[5] Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States, (December 2013) (suggesting the need for Federal regulation of the mortgage insurance industry).

[6] *See* J. David Cummins & Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector* (2011), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract__id=1725512.*

But in the last several years, a narrative has emerged suggesting that these risks are vanishingly small. This argument emphasizes that very few traditional insurers actually failed during the financial crisis.[7] It also stresses that AIG Financial Products—the division of AIG that was principally responsible for writing the credit default swaps that were the primary (though not sole) source of the company's problems—was not regulated as an insurance company, in large part due to Federal law.[8] Finally, it argues that insurers, unlike banks, do not have a mismatch in their assets and liabilities.

This narrative, however, ignores important linkages between the insurance industry and the rest of the financial system as well as insurers' potential vulnerabilities to catastrophic events. Although the insurance industry is indeed less systemically risky than the banking and shadow banking sectors, it is also structurally capable of posing a variety of systemic risks to the larger financial system. Perhaps even more importantly, the magnitude and character of these risks are themselves constantly evolving and shifting. A decade ago, the notion that a company within an insurance group could threaten the global financial system through its portfolio of credit default swaps would have been viewed—perhaps accurately, at the time—as preposterous. The lesson is that the regulation of systemic risk in insurance must be designed to proactively identify, assess, and manage new potential sources of systemic risk in the industry. With this in mind, consider several specific ways in which insurers could potentially threaten the stability of the broader financial system.

Demand for Assets that Spread Systemic Risk: Insurers are among the largest and most important institutional investors domestically and internationally.[9] They own approximately one-third of all investment-grade bonds and, collectively, own almost twice as much in foreign, corporate, and municipal bonds than do banks. Their holdings of corporate and foreign bonds exceed those of mutual funds and pension funds combined.

Insurers' massive role as investors in financial instruments does not just mean that they can be passive victims of financial instability. Financial markets, as with all markets, are impacted both by supply side forces and demand-side forces. Thus, when insurers collectively demand certain types of financial assets, the amount supplied and prices of these assets will increase. In fact, recent evidence shows the insurance industry played a major role in stoking demand for mortgage-backed securities and related instruments in the years leading up to the financial crisis.[10] By 2007, life insurers held approximately $470 billion in these securities, accounting for about 25 percent of the total market. Their demand for these securities skyrocketed in the years preceding the crisis, in large part due to unrealized losses in variable annuity products and State capital standards that treated highly rated structured securities as very low risk.

Insurers were thus substantially responsible for fueling the demand for structured finance securities. And, of course, the explosion in these instruments has been blamed for indirectly helping to fuel the pre-crisis housing bubble.[11] Notably, insurers' contribution to systemic risk in this example occurred even though the terms of their assets and liabilities were well matched and most of them ultimately avoided failure.

Asset Fire Sales: Insurers' massive role as institutional investors also means that they can pose systemic risks by triggering or exacerbating a "fire sale" of specific

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[7] Government Accountability Office, Insurance Markets: Impacts of and Regulatory Response to the 2007–2009 Financial Crisis (June 2013).

[8] *See American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation:* 110th Cong. (2009) (Statement of Eric Dinallo, Superintendent New York State Insurance Department).

[9] This is much more true of the life insurance industry than the property/casualty insurance industry. Accordingly, commentators are likely correct that the former poses more systemic risk than the latter. *See, e.g.,* Steven Weisbart & Robert P. Hartwig, 2011, *Property/Casualty Insurance and Systemic Risk* (2011).

[10] Craig Merrill, Taylor D. Nadauld, & Philip Strahan, *Final Demand for Structured Finance Securities,* (Working Paper, January 17, 2014) *available at http://ssrn.com/abstract=2380859.* For evidence that insurers can play a similar role in misallocating credit in corporate bond markets, *see* Bo Becker, & Victoria Ivashina, *Reaching for Yield in the Bond Market,* Journal of Finance (forthcoming), *available at http://www.hbs.edu/faculty/Publication%20Files/12-103_c2425c59-1647-42df-8d1b-7b8ed433fb76.pdf.*

[11] Facing substantial demand to originate mortgages so that they could be packaged together and securitized, banks and other mortgage originators increasingly loosened credit standards, allowing more and more people to buy houses with loans they ultimately could not afford. *See* Kathleen Engel & Patricia McCoy, the Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps (2011).

securities or types of securities.[12] Emerging evidence suggests that insurers did stoke fire sales in mortgage-backed securities and related instruments in 2008, when many insurers attempted to sell these securities in response to regulatory, rating agency, and market pressures.[13] In offloading these securities in a coordinated fashion, insurers contributed to the sudden illiquidity of these instruments, causing unrelated financial institutions holding these or similar assets to face tremendous liquidity pressures. Indeed, the inability of firms to sell or price such "toxic assets" was the key reason for the failure or near failure of numerous banks and investment banks, including Lehman Brothers.[14]

As above, insurers' seeming role in contributing to fire sales of mortgage-backed securities occurred notwithstanding the matching of their assets and liabilities or their ultimate avoidance of failure. Ironically, insurers' very success in limiting their exposure to "toxic assets" in the early stages of the crisis, and thus safeguarding their own financial strength, may have actually exacerbated the liquidity troubles of unrelated firms. But just like the first people in line during a run on a bank, while insurers may have gotten through the financial crisis relatively unscathed, that does not mean that they were not instrumental in causing the crisis in the first place.

Simultaneous Failure of Several Large Insurers: Although insurers need not fail in order to contribute to systemic risk, the converse is not true: substantial failures of several large insurers could well disrupt the financial system as a result of insurers' status as massive investors. In certain cases, an insurance company could be required to quickly liquidate a substantial portion of its portfolio.[15] This might occur if it failed due to a catastrophic event triggering an unmanageable numbers of claims, a failure of a reinsurer, or a "run" on products that permitted policyholders to withdraw funds or take out loans against their policy. If many insurers simultaneously experienced this type of distress, this could trigger, or exacerbate, the types of distortions in capital markets that were witnessed in 2008.

The failure of several large insurers is hardly unimaginable.[16] Insurers are potentially subject to a wide array of catastrophe risks that could trigger a wave of claims across numerous insurers within a short timeframe. And while insurers attempt to safeguard against such risks through policy exclusions, reinsurance, and other risk-management techniques, these efforts are hardly fail-safe. For instance, prior to 9/11, commercial property insurance policies did not contain any explicit exclusion for terrorism insurance and insurers did not even include this risk in their calculations of premiums. After 9/11, insurers insisted that terrorism risk was so large and incalculable that they could not provide coverage at all, at least without an explicit Federal backstop.[17] Similarly, life insurers face potentially massive exposure to a global pandemic such as the Flu of 1918, which killed between 20 and 40 million people within a single year.

Interconnectedness through Reinsurance: Although insurers attempt to manage catastrophe risk through reinsurance arrangements, the reinsurance industry itself is potentially subject to catastrophe risk. The reinsurance industry is extremely concentrated in a few massive firms, such as Swiss Re, Munich Re, and Berkshire Hathaway. In 2009, for instance, five reinsurance groups provided approximately 60

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[12] Andrew Ellul, Chotibhak Jotikasthira, & Christian T. Lundblad, *Regulatory Pressure and Fire Sales in the Corporate Bond Market,* 101 J. Financial Econ. 596 (2011).

[13] Craig B. Merrill, Taylor D. Nadauld, Rene M. Stulz, & Shane Sherlund, *Did Capital Requirements and Fair Value Accounting Spark Fire Sales in Distressed Mortgage-Backed Securities?,* NBER Working Paper No. 18270 (Aug. 2012), *available at http://www.nber.org/papers/w18270;* Andrew Ellul, Pab Jotikasthira, Christian T. Lundblad, Yihui Wang *et al., Is Historical Cost Accounting a Panacea? Market Stress, Incentives Distortions, and Gains Trading* (NYU Working Paper, 2012), *available at http://ssrn.com/abstract=1972027.*

[14] National Commission on the Causes of the Financial and Economic Crisis in the United States, the Financial Crisis Inquiry Report (2011).

[15] Of course, there are also cases in which an insurance company's failure does not result in an immediate need for the company or its receiver to liquidate much of its portfolio. *See Insurance Oversight and Legislative Proposals: Testimony Before H. Fin. Subcomm. on Ins., Hous. and Cmty. Opportunity,* 112th Cong. 9 (2011) (Statement of Peter Gallanis, National Organization of Life and Health Insurance Guaranty Associations) *available at https://www.nolhga.com/pressroom/articles/HFSCnolhgaTestimonyNov15_2011.pdf.*

[16] For instance, in 1991 six major life insurers, each with over $4 billion in assets, failed as a result of their common exposures to commercial real estate and junk bonds. *See* Scott Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation,* 15 Regulation 27 (1992).

[17] Although the massive losses that insurers incurred in connection with 9/11 did not substantially destabilize the industry, insurers' sudden and dramatic shift in their willingness to provide this coverage suggests that they might well have had events transpired differently or had they occurred at the same time as preexisting financial instability.

percent of the world's reinsurance capacity.[18] This concentration creates deep interconnections among insurers, such that the failure of one or two major reinsurers could simultaneously impact a substantial segment of the insurance industry at once.[19] This risk is exacerbated by the fact that reinsurer financial strength is itself highly opaque, and reinsurers often reinsure risks with one another, creating the possibility that one reinsurer's failure could have a domino effect on other reinsurers.[20]

Exposure to Policyholder Runs: Despite their frequent protestations to the contrary, life insurers are also not immune to the possibility of a run on their products. While this is certainly much less likely for life insurers than banks, a significant number of many life insurers' policies are subject to early withdrawal and include a significant cash surrender value.[21] Growing competition from life-settlement companies—which offer policyholders the option of selling their policies for cash—will likely increasingly pressure life insurers to allow policyholders to cash out of their policies with smaller penalties. This, in turn, may make life insurers more susceptible to the possibility of a policyholder run. So too might the increasing trend among life insurers to make payouts through "retained asset accounts" that function almost identically to bank accounts.[22] The risk of a policyholder run is exacerbated by the fact that State insurance guarantee funds do not generally fully guarantee the value of most insurance policies, cannot be spread among companies or policies to increase limits (unlike FDIC insurance), and are much less financially credible than FDIC insurance as they are not pre-funded or explicitly backstopped by the Federal Government.

Systematic Under-Reserving: There is a real risk that insurers may systematically underestimate reserves for certain types of policies or losses. Indeed, a recent proposal by a subcommittee of the Financial Research Advisory Committee noted that the "cyclicality of the insurance industry's profits between hard and soft markets implies specific periods during which underpricing of risk becomes an industry-wide phenomenon."[23] In the past, such systematic errors in reserving have been limited in the life insurance domain, because life insurers have historically faced rigid and conservative reserving rules for their products.

However, two recent, and related, developments suggest that this longstanding history of conservative reserving in life insurance may not extend into the future. First, in the last decade or so, life insurers have increasingly used captive insurance companies to escape regulatory rules governing reserve setting, a process that some have referred to as "shadow insurance."[24] Recent estimates conclude that "shadow

[18] International Association Of Insurance Supervisors, Reinsurance And Financial Stability (July 2012).

[19] *See* J. David Cummins & Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector* (2011), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1725512* ("Reinsurance is the primary source of interconnectedness within the insurance industry.").

[20] Group of Thirty, Reinsurance and International Markets (2006).

[21] *See* FSOC, Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial Inc. (Sept. 19, 2013). The most substantial policyholder run on a U.S. insurance company involved Executive Life, where policyholder cash surrenders exceeded over $3 billion in the year prior to its failure. Although this run was more a product of Executive Life's tenuous financial position than the cause of its tenuous position, it did indeed have the effect of forcing Executive Life to liquidate a substantial percentage of its portfolio. *See* Scott Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation,* 15 Regulation 27 (1992).

[22] *See* Texas Department of Insurance, Retained Asset Accounts Survey (2011), *available at http://www.tdi.texas.gov/reports/life/documents/raareport.pdf* (finding in a survey of 160 life insurers open retained asset accounts totaling $2.3 billion with respect to policyholders living in Texas).

[23] *See* Financial Research Advisory Committee Research Subcommittee, *OFR Study on the Insurance Sector Recommendation, available at http://www.treasury.gov/initiatives/ofr/about/Documents/FRAC%20Research%20OFR%20Study%20on%20the%20Insurance%20Sector%20Recommendation.pdf.*

[24] *See* NY Department of Financial Services, Shining a Light on Shadow Insurance (June 2013). Traditionally, captive insurance was simply a way for a traditional noninsurance company, such as Coca Cola or GM, to self-insure its risks rather than purchase conventional insurance. But life insurers realized that they could exploit the rules governing captive insurers to avoid what they deemed to be "excessive" reserve requirements. To do this, the life insurer transfers some of its risk to the captive insurer via a reinsurance transaction. This transaction can reduce reserves because insurers do not need to reserve against risks that are transferred to reinsurers (even if they are affiliated). Meanwhile, captive insurers are subject to a much looser set of solvency rules than ordinary insurers and can generally choose their regulator among any of the States. According to the New York Attorney General, "shadow insurance . . . puts the stability of the broader financial system at greater risk." *See* Benjamin M. Lawsky, N.Y. Superintendent of Fin. Serv., Remarks at the 22nd Annual Hyman P. Minsky Conference

insurance reduces risk-based capital by 53 percentage points (or 3 rating notches) and raises impairment probabilities by a factor of four."[25] Second, State insurance regulation is currently embarking on a fundamental change to its regulatory approach, which would grant insurers broad discretion to use internal models to set reserve levels. The extensively documented inability of Federal regulators to fully understand financial firms' internal risk models suggests that large scale errors in life insurer reserving could be a problem in the future. This is particularly so given that State regulators currently lack sufficient technical expertise or resources to undertake a reasonable evaluation of these models on a firm-by-firm basis.[26]

Ultimately, it is surely true that the insurance industry currently poses less systemic risk than the banking sector or the shadow-banking sector, as many commentators have emphasized.[27] At the same time, however, the insurance industry is a crucial and dynamic component of the American and international financial system, a fact that has been documented by various studies quantifying the connections between insurers and the rest of the financial system based on historical stock prices and similar metrics.[28] As such, the insurance industry can indeed present a meaningful source of systemic risk that cannot be easily limited to a pre-defined set of activities.

(2) Appropriate Capital Requirements for Insurance SIFIs

As contemplated by Dodd-Frank, Federal regulators should design, implement, and regularly reassess distinct capital and leverage standards for insurers that are particularly likely to pose systemic risk, including Insurance SIFIs.[29] A central tenet of federalism is that regulatory responsibilities should be assigned, at least in part, to the unit of government that best internalizes the full costs of the underlying regulated activity.[30] The rationale for this principle is that government entities will only have optimal incentives to take into account the full costs and benefits of their regulatory decisions if the impacts of those decisions are felt entirely within their jurisdictions. Given that systemic risk in insurance is a negative externality whose effects are inherently felt nationally and internationally, national and international regulatory bodies should play a role in regulating insurance SIFIs.

Federal involvement in designing capital requirements for Insurance SIFIs is particularly important because State risk-based capital rules are focused predominantly on consumer protection rather than systemic stability.[31] But the regulatory objective of a risk-based capital regime has important implications for how that regime should be constructed. *In other words, capital regimes focused on systemic risk can,*

on the State of the U.S. and World Economies in New York City (April 18, 2013) *available at http://www.dfs.ny.gov/about/speeches_testimony/sp130418.htm.*

[25] *See* Ralph S.J. Koijen and Motohiro Yogo, *Shadow Insurance* (NBER Working Paper No. 19568, (2013), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2320921.*

[26] Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States, (December 2013).

[27] *See* Scott Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation,* 76 J. Risk & Ins. 785 (2009).

[28] Monica Billioa, Mila Getmanskyb, Andrew W. Loc, & Loriana Pelizzona, *Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors* 104 J Fin. Econ. 535 (2012); Faisal Balucha, Stanley Mutengab & Chris Parsons Baluch, Insurance, Systemic Risk and the Financial Crisis, 36 The Geneva Papers 126 (2011); Viral Acharya, Lasse Heje Pedersen, Thomas Philippon, & Matthew P. Richardson, *Measuring Systemic Risk* (2010), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573171.*

[29] Nonbank financial companies predominantly engaged in the business of insurance and designated as systemically significant by FSOC—which I label as Insurance SIFIs—are not necessarily the only insurers who may pose systemic risks. For instance, mortgage insurers may post systemic risks because of their prominent role in the housing market. *See* Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States, (December 2013). Additionally, as I have argued elsewhere, entire segments of the insurance industry may pose systemic risks because of correlations among individual insurance companies with respect to both their interconnections with the larger financial system and their vulnerabilities to failure. For this reason, I believe that a broader Federal role in regulating the insurance industry beyond that established in Dodd-Frank is appropriate. *See* Daniel Schwarcz & Steven L. Schwarcz, Regulating Systemic Risk in Insurance (March 4, 2014), *available at http://ssrn.com/abstract=2404492.* But because Federal regulation in these domains is not authorized by current law and is not the subject of this hearing, I do not discuss these issues further in the body of my testimony.

[30] Wallace E. Oates, Fiscal Federalism (1972).

[31] Thus, in a Report of the NAIC and the Federal Reserve Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage (2002), a working group of insurance and banking regulators explained the core differences between risk-based capital rules in insurance and banking by noting that "Insurance company regulators place particular emphasis on consumer (policyholder) protection" while "banking regulators focus on depositor protection and the financial stability of regulated entities on a going concern basis."

and should, be designed differently than capital regimes focused on consumer protection. Consider several examples of this important point.

First, while a risk-based capital regime designed to address systemic risk should focus on aggregate capital levels of an entire holding company, a capital regime oriented toward consumer protection can rely on entity-level capital regulation with strong ring-fencing rules. Because of its consumer protection orientation, State insurance regulation embraces the latter model: capital requirements are imposed solely on individual legal entities, and regulators attempt to protect these entities from affiliate or holding company risk. By contrast, a capital regime focused on systemic risk demands group-wide capital requirements. This is because risk-management, investment and business strategies are all generally determined at the holding company level.[32] Group capital rules can also limit the prospect of other problems that may have systemic consequences, such as double or multiple gearing.[33]

Second, a capital regime that is focused on systemic risk might well be less dependent on credit-rating agencies in setting capital charges for assets than would a capital regime focused on consumer protection. Currently, State insurance regulation relies substantially on rating agencies in determining capital charges for individual assets.[34] Recent changes in State rules regarding credit for reinsurance also place a renewed regulatory emphasis on rating agencies' assessments of reinsurers' financial strength.[35] But as has now been widely recognized, regulatory reliance on rating agencies can increase systemic risk for a variety of reasons. It can lead to the systematic underpricing of risk, dull the incentives of rating agencies to correctly assess risk, and play a role in triggering fire sales by producing coordinated investment decisions across a wide number of firms. For these reasons, Dodd-Frank substantially limited reliance on credit ratings by all Federal (but not State) regulators.[36]

Third, a capital regime focused on systemic risk must be sensitive to the possibility that it might inadvertently contribute to financial instability. As described above, emerging evidence suggests that State regulatory capital rules may have played a role in encouraging insurers to both invest in mortgage-backed securities and to offload them when they were downgraded (or when such downgrades were anticipated). Although the literature on how, and when, capital rules and related accounting standards can have inadvertent adverse effects on systemic risk is still developing, systemic risk regulators must pay acute attention to this issue.

Group-wide capital rules that limit their dependence on credit-rating agencies and reduce distortions in firm behavior are thus crucial for any capital regime that is principally oriented toward guarding against systemic risk. But various more specific rules might well be appropriate for capital regimes that are designed to guard against systemic risk associated with insurance. For instance, such a regime might well impose higher capital charges on long-term assets with short-term volatility or deep illiquidity relative to an insurance capital regime oriented only toward consumer protection. This is because a central concern from the perspective of systemic risk is that a systemically risky insurer could face sudden liquidity demands for a variety of reasons notwithstanding insurers' usual matching of the duration of their assets and liabilities. Such liquidity pressures could stem from collateral calls associated with derivatives activities or securities lending, mass policyholder withdrawals, a sharp increase in claims due to catastrophe, or the failure of a reinsurer.

Similarly, a capital regime designed to guard against systemic risk related to insurance might well resist some of the recent developments that could weaken life insurer reserve practices. Thus, such a regime could reject principles-based reserving in favor of the traditional approach to setting life insurers' reserves, given the prominent role that reliance on financial firms' own internal models for purposes of setting capital played in triggering the 2008 financial crisis. Or, it might restrict the

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[32] *See* Elizabeth F. Brown, *The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?,* 60 AM. U. L. REV. 1339 (2011).

[33] Bank for Int'l Settlements, Principles for the Supervision of Financial Conglomerates Consultative Document (2011). Double or multiple gearing involves scenarios in which the same capital is used as a buffer against risk by two entities at the same time, such that the "net" solvency of the group is less than the sum of the capital of the group's individual entities.

[34] Although State insurance regulation has limited its reliance on private rating agencies in assessing structured finance vehicles, it still relies enormously on private rating agencies to assess the quality of insurers' assets. *See* John Patrick Hunt, *Credit Ratings in Insurance Regulation: The Missing Piece of Financial Reform,* 68 Wash. & Lee L. Rev. 1667 (2011).

[35] Credit for Reinsurance Model Law, § 2(b)–(c), adopted Nov. 6, 2011, *available at http://www.naic.org/documents/committees_e_reinsurance_related_docs_preface_adopted_ex_plenary_111106.pdf.*

[36] Dodd-Frank Act § 939A.

credit that insurers can receive by using "shadow insurance" to reduce their liabilities.

To be sure, capital requirements for Insurance SIFIs need not—and, indeed, should not—mechanistically mirror the capital rules that are applied to other types of financial firms. As emphasized in a recent letter of Members of Congress, "Strong capital standards need to be consistent with the business models of the industry to which they are applicable."[37] The systemic risks posed by Insurance SIFIs are both different than, and likely less severe than, those posed by large bank holding companies, and an appropriate capital regime for Insurance SIFIs should reflect these facts. At the same time, an appropriate capital regime for Insurance SIFIs should also reflect the fact that the central goal of imposing capital requirements on these entities at the Federal level is different than the goal of State capital requirements. As such, the Federal capital regime applicable to Insurance SIFIs cannot merely replicate or defer to the consumer protection oriented State capital regime. Capital regimes should be designed not only according to the industry to which they apply, but also to the regulatory goal that they seek to achieve.

My understanding of Section 171—based on publicly available legal analysis of the provision and several letters from Members of Congress—is that it advances these goals. The provision gives the Board of Governors of the Federal Reserve System ("Fed") substantial flexibility in determining how to calculate Insurance SIFIs' risk-based capital and leverage limits so as to account for the particular risks that these entities present.[38] At the same time, it appropriately seeks to ensure that, however these calculations are performed, they do not fall below minimum levels.

(3) Appropriate Capital Requirements for Bank/Thrift Holding Companies that Substantially Engage in the Business of Insurance

Bank and thrift holding companies have long been subject to Federal capital and leverage requirements because of the unique risks associated with owning an FDIC insured institution. Section 171 requires the Fed to ensure that these requirements are no less than those applicable to ordinary small banks. This, in turn, helps to ensure that holding companies of banks and thrifts do indeed serve as a source of strength for their FDIC insured subsidiaries, as has long been intended by the larger Federal banking regime. Proposed S. 1369 would exempt bank/thrift holding companies from the Section 171 floor if they directly, or through their subsidiaries, derive a substantial percentage of their consolidated revenues from the business of insurance. This would be a mistake.

As discussed above, State insurance capital rules and bank/thrift capital rules have fundamentally different regulatory objectives. While the former focuses on protecting policyholders, the latter aims principally to limit the exposure of taxpayers to bank failures and minimize the prospect of systemic risk. And, as described above, these different orientations have important implications for how the corresponding capital regimes are, and should be, structured.

For these reasons, the fact that a holding company of a depository institution is itself subject to State insurance capital requirements or derives a substantial amount of its revenue from State-regulated insurers does not mean that it should be exempted from the minimum floors required by Section 171. Such an entity raises *both* the consumer protection concerns that motivate State insurance regulation and the systemic risk/taxpayer protection concerns that motivate the need for capital/leverage rules for bank/thrift holding companies. It therefore stands to reason that it should be subject to both sets of capital rules, as well as to the Section 171 floor. Establishing a special rule allowing certain bank/thrift holding companies to avoid Section 171 would not only create an uneven playing field, but it could encourage regulatory arbitrage by allowing holding companies of FDIC insured institutions to avoid regulatory requirements by increasing their ownership of insurance entities or their own insurance activities.[39] This, in turn, could have the effect of increasing the size of bank/thrift holding companies.

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[37] Letter from Members of Congress to Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System (Dec. 11, 2012).

[38] Letter from H. Rodgin Cohen to Ricardo Anzaldua, Executive Vice President and General Counsel of MetLife Inc., (May 20, 2013), *available at http://www.federalreserve.gov/SECRS/2013/May/20130523/R-1438/R-1438_052313_111291_554506713029_1.pdf.;* Letter from Members of Congress to Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System (Dec. 11, 2012).

[39] An additional concern I have with proposed S. 1369 is that it could have the effect of exempting a company from Section 171 on the basis of activities that are not subject to State insurance capital requirements. S. 1369 incorporates the definition of "business of insurance" in Dodd-Frank: "the writing of insurance or the reinsuring of risks by an insurer, including all acts

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Exempting from Section 171 bank/thrift holding companies that derive a substantial percentage of their revenue from insurance operations but are not themselves regulated as insurance companies would be particularly bad policy.[40] As described above, the State insurance capital regime does not apply to holding companies of insurance entities. A bank/thrift holding company that derived a substantial percentage of its revenue from the insurance operations of its subsidiaries, but was not itself an operating insurance company, would therefore not face any capital requirements at the holding company level under State insurance law. There is consequently no justification for providing such entities with a special exemption from Section 171.

PREPARED STATEMENT OF H. RODGIN COHEN

SENIOR CHAIRMAN, SULLIVAN & CROMWELL LLP

MARCH 11, 2014

I. Introduction

Chairman Brown and Ranking Member Toomey, and distinguished Members of the Subcommittee, I am honored to be with you today to discuss the application of the capital standards in Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1] to a subset of insurance companies.[2] Let me begin by commending you for the leadership you have shown and for your efforts and attention to this important issue.

Section 171, which is commonly known as the "Collins Amendment", after its primary sponsor, Senator Collins, establishes certain capital standards for designated financial institutions. It is a part of Title I, Subtitle C of Dodd-Frank, which includes enhanced prudential standards and differentiation mandates in its principal provision, Section 165. The insurance companies subject to Section 171, which I will refer to as *"Covered Insurance Companies",* are either savings and loan holding companies ("SLHCs") or have been designated by the Financial Stability Oversight Council ("FSOC") for supervision by the Board of Governors of the Federal Reserve System ("Federal Reserve") pursuant to Section 113 of Dodd-Frank.[3]

Stated simply, the core question raised by the application of Section 171 to Covered Insurance Companies is whether they should be subject to the same capital framework as that which applies to banks (which I will refer as the "Bank Capital Framework").

What is most striking about this question is that I do not know of a single legislator or regulator, including the Federal Reserve, who believes that, as a matter of policy, the Bank Capital Framework should be automatically imposed on insurance companies. Nor do I know of a single Member of Congress who maintains that Congress actually intended to impose the identical capital regime on these two very different businesses. As twenty-four Senators from both parties wrote to the heads of the three Federal banking agencies on October 17, 2012: "Congress did not intend for the Federal regulators to discard the State risk-based capital system in favor of a banking capital regime".[4]

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necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons." Dodd-Frank § 1002. This definition is not explicitly tethered to State insurance regulation, as is the proffered rationale for exempting bank/thrift holding companies predominantly engaged in insurance from Section 171. It therefore may be possible under proposed S. 1369 for a bank/thrift holding company to avoid Section 171 on the basis of activities that fall within this broad definition of insurance, but are not subject to State capital requirements.

[40] In the case of a bank/thrift holding company that was itself regulated as an insurance company, State capital rules would apply to the holding company entity. However, such regulation would still not account for the distinctive risks associated with owning an FDIC insured institution.

[1] Pub. L. No. 111–203 (2010).

[2] Section 171 is codified at 12 U.S.C. § 5371.

[3] Sullivan & Cromwell represents Covered Insurance Companies and other insurance companies.

[4] Letter to Ben. S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from Twenty-Four U.S. Senators (Oct. 17, 2012) (the *"October 17, 2012 Letter"*). *See also,* a December 11, 2012 letter (the *"December 11, 2012 Letter"*) from Thirty-Three Members of Congress of both parties to former Chairman Bernanke which explained (in the context of the Federal banking agencies' proposed rule to apply the Bank Capital Framework to insurance companies) that "[t]he bank-centric approach of the proposed rules is inconsistent with the unique nature of insurance and contradicts the intent of Congress."

Senator Collins herself has made clear that it was not the intent of Congress to "supplant prudential State-based insurance regulation with a bank-centric capital regime".[5] Instead, Senator Collins explained, "consideration should be given to the distinctions between banks and insurance companies. I believe it is consistent with my amendment that these distinctions be recognized in the final rule."[6]

Accordingly, we are not debating what the result should be. Both as a matter of policy and in terms of carrying out Congressional intent, there should be tailored and differentiated capital requirements for insurance companies. Instead, the question is how best to achieve that result under Section 171.

My testimony today is divided into four parts. First, I will summarize the terms of Section 171. Second, I will outline the relevant policy issues. Third, I will attempt to explain why I believe that, as a legal matter, the Federal Reserve already has sufficient authority to deal appropriately with these issues. Fourth, in the event that the Federal Reserve elects not to exercise that discretion, I will explain briefly why Congressional action to deal with this matter is both necessary and appropriate.

II. Section 171

Section 171 of Dodd-Frank does not prescribe specific capital requirements, but provides two general mandates for both risk-based and leverage capital requirements. First, the capital requirements applied to companies subject to Section 171 may not be *"less than"* the capital requirements applied to banks now or in the future. Second, those requirements may not be *"quantitatively lower"* than the bank capital requirements in place as of the date of the enactment of Dodd-Frank. Presumably, the first mandate incorporates the so-called Basel III capital framework, as implemented by the Federal banking agencies, and the second mandate incorporates the Basel I capital framework, as previously implemented by the agencies.

Section 171 is a part of Subtitle C of Title I of Dodd-Frank, entitled "Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies". The key operative provision of Subtitle C is Section 165, which establishes "enhanced prudential standards" for "systemically important financial institutions", *i.e.,* bank holding companies with total consolidated assets of $50 billion or more ("BHC SIFIs") and nonbank financial companies designated by FSOC under Section 113 of Dodd-Frank for supervision by the Federal Reserve ("Nonbank SIFIs").[7]

III. Policy Issues

At the outset, it is seemingly inconceivable that Congress, or any regulator, could conclude that the same capital requirements should logically or appropriately apply to all financial services companies that are deemed systemically important. Various types of financial services companies have different business purposes and asset and liability structures, and they are exposed to different types of risk. As explained in the December 11, 2012 Letter from 33 Members of Congress, "[s]trong capital standards need to be consistent with the business models of the industry to which they are applicable". Nonetheless, some have read Section 171, in isolation, to require the Federal Reserve to apply automatically the same capital framework applicable to banking organizations to all the Covered Insurance Companies, as well as all other Nonbank SIFIs.

It is important to stress that the policy issue is not about the need for robust capital requirements for Covered Insurance Companies. The conclusion that such requirements are essential should be beyond disagreement. Indeed, the insurers themselves, in comment letters to the Federal Reserve and other banking agencies, have supported strong capital requirements for the industry.[8]

The real policy question is how best to implement robust capital requirements for Covered Insurance Companies. Is it preferable to import the Bank Capital Framework into the regulatory regime for Covered Insurance Companies or instead to rely

[5] Letter to Ben S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from Senator Susan Collins (Nov. 26, 2012).

[6] *Id.*

[7] Section 165 does not expressly apply to SLHCs. As discussed in note 16 *infra,* however, the Federal Reserve has, in effect, made the enhanced prudential standards applicable to SLHCs with total consolidated assets of $50 billion or more and a significant depository subsidiary, as well as to other SLHCs as determined by the Federal Reserve.

[8] *See, e.g.,* Letter to Jennifer J. Johnson from MetLife, Inc. (April 30, 2012); Letter to Ben S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from MetLife, Inc. (Oct. 22, 2012); Letter to the Office of the Comptroller of the Currency, Jennifer J. Johnson and Robert E. Feldman from Prudential Financial, Inc. (Oct. 22, 2013); and Letter to Jennifer J. Johnson, Thomas J. Curry and Robert E. Feldman from State Farm Insurance Companies (Oct. 19, 2012).

principally upon substantive regulation under State insurance law, including, most pertinently, the risk-based capital requirements developed pursuant to the National Association of Insurance Commissioners' Risk-Based Capital ("RBC") framework?

The application of the Bank Capital Framework to Covered Insurance Companies would be inappropriate, redundant and punitive, not only because it is a second capital regime (in addition to the RBC framework), but because the Bank Capital Framework was not designed to, and does not, take into account the critically significant differences between the business of banking and the business of insurance. This essential point is reflected in comment letters to the Federal Reserve by many Members of Congress, including Senator Collins and Members of the Senate Banking Committee.[9]

Let me summarize the fundamental difference between the balance sheets and business models of banks and insurance companies and why that difference compels the conclusion that the Bank Capital Framework is not the appropriate framework to govern insurance company capital.

Banks perform the crucial role in our economy of maturity transformation, in which deposits and other short-term liabilities are invested in longer-term loans and other assets. This essential role, however, creates the potential for a loss of liquidity at banks in the event of a loss of this short-term funding. Consequently, in addition to enhanced liquidity requirements, the current regulatory framework for banks includes a substantially enhanced set of capital requirements (and related stress tests) that are designed to create a high level of loss-absorbing capital to help ensure that banks can withstand losses on assets and resultant strains on liquidity.

In contrast, insurance companies do not engage in maturity transformation and, generally, have long-term liabilities. Moreover, historical experience, and the nature, structure and design of insurance products, indicate that there is no meaningful risk of "policyholder runs". Among other factors, even if an insurance policy can contractually be surrendered, the policyholder may find that a comparable policy is not readily available (for example, because of age, health, *etc.*), and the switch could be time-consuming and will involve "breakage" costs—all in contrast to the ease of switching a bank deposit. As a result, capital requirements tailored for banks that are funded, in large part, through short-term liabilities do not constitute an appropriate framework for the businesses of insurers, which are liability-driven and have longer-term assets and liabilities.

This fundamental difference between the business models and liability mixes of banks and insurers, and the consequences for capital requirements, was thoughtfully articulated by Federal Reserve Governor Daniel Tarullo in testimony before the Senate Banking Committee:

> The problem here, Mr. Chairman, comes I think on the liability side of the balance sheet. Bank-centered capital requirements are developed with an eye to the business model of banks and the challenge that the FDIC would have in resolving a bank, or now a systemically important banking organization that would be in deep trouble.
>
> The more or less rapid liquidation of a lot of those claims and the runs on a lot of the funding of that institution, lie behind the setting of the capital ratio. But the liability side of an insurance compan[y's] balance sheet, a true insurance company [like] somebody selling life insurance for example, is very different. There's not a way to accelerate the runs of those, of that funding.[10]

Likewise, Federal Reserve Chair Janet Yellen testified before the House Committee on Financial Services that "[w]e understand that the risk profiles of insurance companies really are materially different . . .".[11]

It is highly relevant that Congress explicitly recognized that the evaluation of the risk of assets could not be separated from consideration of the method by which those assets are funded. Section 165(b)(3)(A) of Dodd-Frank expressly requires the Federal Reserve to consider differences between Nonbank SIFIs and BHC SIFIs and, in particular (through incorporation of Section 113(a)), the nature of the institution's assets and liabilities, including its reliance on short-term funding. Likewise, former Federal Reserve Chairman Bernanke testified that "insurance companies

[9] *See, e.g.,* Letter to Ben S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from Senator Susan Collins (Nov. 26, 2012) and the December 11, 2012 Letter.

[10] Mitigating Systemic Financial Risk: Hearing Before the S. Banking, Housing and Urban Affairs Comm., 113th Cong. (July 11, 2013) (testimony of Daniel K. Tarullo).

[11] Monetary Policy and State of the Economy: Hearing Before the H. Financial Services Comm., 113th Cong. (Feb. 11, 2014) (testimony of Janet L. Yellen).

have both a different composition of assets and a different set of liabilities, and appropriate regulation needs to take that into account."[12]

In *Appendix A* to this testimony, I have described three specific examples of issues that would arise from trying to force Covered Insurance Companies into a bank-centric capital regime. These examples are intended to be illustrative of the fundamental problem I have just described, but should not be taken to suggest there is a finite list of issues that if "fixed" would eliminate all the negative consequences that would result from applying the Bank Capital Framework, even on a "retrofitted" basis. These are merely symptomatic of the larger issue of applying the Bank Capital Framework to insurance companies for which it was never intended or designed.

The examples do illustrate how the application of the Bank Capital Framework would require Covered Insurance Companies to hold capital that is not correlated to the risk profile of their underlying liabilities and assets. The result would be to impose upon Covered Insurance Companies lower returns on equity, both in absolute terms and in relation to their peer firms (both domestic and international), as well as unnecessary regulatory costs. Because lower returns do not constitute a viable strategy for Covered Insurance Companies (or their investors), their only option to retain marketplace vitality would be to increase the costs for their insurance products and services and cease offering some products altogether because of the uneconomic capital charge. Not only is such an approach obviously antithetical to the best interests of consumers and other customers, but it would also create a substantial competitive disadvantage for Covered Insurance Companies. As set forth in the October 17, 2012 Letter from twenty-four Senators, "applying a bank-focused regime to insurance companies could undermine potential supervision and unintentionally harm insurance policyholders, savers and retirees".

Let me deal briefly with three arguments made against differentiation. The first is that we need simplicity in our capital rules, and, once we start distinguishing among financial institutions, it will not be possible to stop. Simplicity is a legitimate goal, but it should not degenerate into simplemindedness if it produces illogic, inequity and redundancy. And we are not talking about fine distinctions, but an obvious and palpable dichotomy. As the December 11, 2012 Letter argues persuasively, "it is not workable to have one uniform capital standards regulation to apply across the whole spectrum of financial services companies . . . [I]nsurers have a completely different business model and capital requirements than banks, which must be appropriate recognized in the [capital rules applied to Covered Insurance Companies]".

The second argument is that an asset should receive the same capital charge irrespective of the type of financial services company that holds the asset. Although this argument may have an appealing simplicity, it results in a divorce of capital from risk because it fails to take into account both sides of the balance sheet. It fails to consider either the purpose for which the asset is held or the institution's ability, due to its liability structure, to hold the asset in times of stress. As I just discussed, the risk weighting developed for bank assets was not designed to reflect that purpose or capability in the context of insurance companies.

Third, some may argue that any concern about the application of the Bank Capital Framework to Covered Insurance Companies is misplaced because "more capital is always better". That argument can only be valid, however, if a company's appeal to investors is, contrary to all evidence, divorced from return on equity and its pricing of a product is likewise divorced from the capital assigned to it. To the contrary, capital requirements that are higher because they are not correlated to risk, produce marketplace and competitive distortions. Such uncorrelated capital requirements can increase the cost of financial products and services and even reduce the availability of lower-margin products and services. Once again, the debate is not about whether we should have robust capital requirements for all participants in the financial services industry—2008 should have resolved that debate once and for all. Instead, the only legitimate debate is whether the same capital framework should be artificially imposed without regard to the nature of the financial services company.

IV. The Federal Reserve's Authority To Tailor the Application of Section 171

As discussed, there has been an extraordinary "meeting of the minds" among Members of Congress, regulators and the insurance industry that, as a policy matter, the Bank Capital Framework should not be applied to Covered Insurance Com-

[12] Monetary Policy and the State of the Economy: Hearing Before the H. Fin. Services Comm., 112th Cong. (July 18, 2012) (testimony of Ben S. Bernanke).

panies. To date, however, the Federal Reserve has expressed a concern that the language of Section 171 significantly constrains its interpretative ability.[13]

The Federal Reserve may be reluctant to be seen as usurping a Congressional prerogative and intervening in an area where Congress has legislated. It is also understandable that an administrative agency would take the position that, if there is an ambiguity or error in what Congress has drafted, the agency should not act until Congress has had the opportunity to resolve the issue. Nonetheless, as I have previously written in a letter available on the Federal Reserve's Web site, I believe that there is sufficient flexibility in the statutory language of Dodd-Frank for the Federal Reserve to determine that Covered Insurance Companies should not be bound by the same capital regime that applies to banking organizations.

I will now explain why the Federal Reserve has this interpretative authority, and can exercise that authority while at the same time maintaining fidelity to the plain language of Dodd-Frank and to Congressional intent. The analysis of the issue can be best understood by dividing it into three parts: the specific language of Section 171; the broader context of the Dodd-Frank Act as a whole, in particular, Section 165; and what I believe to be the most direct approach the Federal Reserve could take to resolve this issue.

A. Section 171 Language

As noted earlier, Section 171 does not prescribe specific capital requirements, but provides that the capital requirements applied to companies subject to Section 171 be (i) not *"less than"* the capital requirements applied to banks now or in the future nor (ii) *"quantitatively lower"* than the bank capital requirements in place as of the date of the enactment of Dodd-Frank.

What is striking about the language of Section 171 is the *absence* of a precise and simple statement that Nonbank SIFIs should be subject to the Bank Capital Framework. If that were what Congress intended, it would have been a simple matter for Congress to have said so. Rather, the language of Section 171 calls for a comparability analysis between the capital regime imposed by the Federal Reserve on Covered Insurance Companies and the Bank Capital Framework, and provides only broad guidance as to how the Federal Reserve is to conduct this analysis.

Because Section 171 is not prescriptive as to how the Federal Reserve is to conduct the comparability analysis, the Federal Reserve is authorized to adopt a reasonable interpretation of Section 171 to fill in these gaps. As the Supreme Court has made clear, in circumstances where "the subject matter . . . is technical, complex, and dynamic . . . as a general rule, agencies have authority to fill gaps where statutes are silent."[14] This fundamental principle of regulatory authority applies with full force here. It is presumably beyond debate that Section 171 is "technical" and "complex". It is likewise "dynamic" because the bank capital rules will continue to evolve, as will the assessment of "comparability". In dealing with subject matter of this nature, it was not error, but logical, for Congress to grant significant discretion to the Federal Reserve in implementing Section 171.

Indeed, in a demonstration of this discretionary latitude, the Federal Reserve and the other Federal banking agencies have appropriately exercised this discretion in at least one case. In the agencies' rules implementing Basel III, the agencies provided that the assets in separate accounts that are not guaranteed would generally receive a risk weight of 0 percent.

Accordingly, even reading Section 171 in isolation, the Federal Reserve has flexibility to apply capital requirements to Covered Insurance Companies that are appropriately tailored for the business and risk profile of these institutions.

B. Section 171 in the Broader Context of Subtitle C of Title I of Dodd-Frank

This conclusion is even more compelling when Section 171 is read in context with the overall statutory scheme of which it is a part. It is a fundamental canon of statutory construction, mandated by the Supreme Court, that individual provisions of a statute must be read in the context of the overall statutory scheme.[15] Accordingly,

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[13] For example, although in recent testimony before the Senate Banking Committee, Federal Reserve Chair Janet Yellen recognized the "very significant differences between the business models of insurance companies and banks," she continued that "the Collins Amendment does restrict what is possible for the Federal Reserve". (Semiannual Monetary Policy Report to the Congress: Hearing Before the S. Banking, Housing and Urban Affairs Comm., 113th Cong. (Feb. 27, 2013) (testimony of Janet L. Yellen)).

[14] *Nat'l Cable & Telecommunications Ass'n, Inc.* v. *Gulf Power Co.,* 534 U.S. 327, 339 (2002).

[15] *FDA* v. *Brown & Williamson Tobacco Corp,* 529 U.S. 120, 133 (2000) (citations omitted) ("It is a 'fundamental canon of statutory construction that words of a statute must be read in their context and with a view to their place in the overall statutory scheme.' . . . A court must therefore interpret the statute 'as a symmetrical and coherent regulatory scheme' . . . and 'fit, if pos-

Section 171 must be read as part of the entirety of Subtitle C of Title I of Dodd-Frank, which establishes a new, comprehensive framework for the Federal supervision of BHC SIFIs and Nonbank SIFIs in order to address the risks posed by such institutions to financial stability.

A central tenet of Subtitle C is that there must be both robust regulation and differentiated regulation. Not only are these two objectives not inconsistent, but they are mutually reinforcing because regulation that is directed to the actual risk involved is inherently more robust than regulation divorced from risk. Therefore, when Section 171 is read in the context of the other provisions of Subtitle C, it must be interpreted consistently with Congress's intent that the capital and other requirements for Covered Insurance Companies, and other Nonbank SIFIs, be applied in a tailored and flexible manner.

The cornerstone of Subtitle C's regulatory framework is the "enhanced prudential standards" in Section 165. Section 165 gives the Federal Reserve broad authority to apply these standards to Nonbank SIFIs, including Covered Insurance Companies,[16] in a tailored manner. Indeed, differentiated application is not merely acceptable but required.

In requiring the Federal Reserve to develop enhanced prudential standards for Nonbank SIFIs, Section 165 is replete with instructions that the Federal Reserve apply these standards through a differentiated approach that takes into account the nature of the institutions and the risks they present. Section 165(a)(2)(A) is titled "Tailored Application", and it expressly authorizes the Federal Reserve to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity . . . and any other risk-related factors that the [Federal Reserve] deems appropriate".

Three other provisions of Section 165 reinforce this differentiation approach.

- First, Subsection 165(b)(3)(A) requires the Federal Reserve, in applying enhanced prudential standards, to take into account differences between Nonbank SIFIs and BHC SIFIs, including the following factors:
  - whether the institution is already regulated by a primary financial regulator;
  - the nature and mix of the institution's activities;
  - the amount and nature of the institution's liabilities, including the degree of reliance on short-term funding; and
  - other appropriate risk-related factors, as determined by the Federal Reserve.[17]
- Second, Section 165(b)(3)(D) explicitly requires the Federal Reserve to "adapt the required standards as appropriate in light of any predominant line of business".
- Third, Section 165(b)(4), as applicable to Covered Insurance Companies, requires the Federal Reserve to consult with the insurance commissioner representative on the FSOC prior to implementing enhanced prudential requirements under Section 165 to the extent those requirements are likely to have a significant impact on Covered Insurance Companies.

These multiple provisions of Section 165 make clear that Congress expected the Federal Reserve to tailor its enhanced prudential standards to the particular circumstances of insurance companies (and other Nonbank SIFIs), including with respect to capital requirements.

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sible, all parts into an harmonious whole . . . '"). *See also Conroy* v. *Aniskoff,* 507 U.S. 511, 515 (1993) (Looking to the "text and structure of the [statute] as a whole" and following "the cardinal rule that a statute is to be read as a whole . . . since the meaning of statutory language, plain or not, depends on context." (internal quotations omitted)).

[16] Section 165 applies, by its terms, only to BHC SIFIs and Nonbank SIFIs. It does not expressly apply to SLHCs. As a result, one could argue that, as a technical matter, Section 165 is inapposite to the application of Section 171 to SLHCs. In its recent rulemaking implementing the enhanced prudential requirements of Section 165, however, the Federal Reserve, relying on its general authority under the Home Owners' Loan Act to regulate SLHCs, indicated that it would expect to apply enhanced prudential requirements to any SLHC that has both $50 billion or more in total consolidated assets and a significant depository subsidiary. The Federal Reserve indicated that it would also apply enhanced prudential requirements to any other SLHC as the Federal Reserve considers appropriate. As a result of this Federal Reserve position, any argument based on the statutory language that Section 165 cannot be read to inform Section 171 with respect to insurance-based SLHC is not viable.

[17] Section 165(b)(3)(A), as applicable to Covered Insurance Companies, incorporates Section 113(a), which lists the considerations FSOC must take into account when determining whether to designate an institution as a Nonbank SIFI.

In addition to Section 165, Section 169, which applies independently to modify both Section 165 and Section 171, requires the Federal Reserve to "take any action" that it "deems appropriate" to avoid imposing requirements that are duplicative of requirements already imposed on institutions by other provisions of law. It is difficult to imagine a clearer instruction, a broader grant of discretion to a Federal banking regulator or a provision that more directly applies to the treatment of Covered Insurance Companies under Section 171. Given that Covered Insurance Companies are already subject to the comprehensive RBC framework under State insurance law, imposing the Bank Capital Framework on Covered Insurance Companies would be not merely duplicative of, but would be at odds with, the State law capital requirements. Accordingly, even if Section 171 could otherwise be read to require the application of the Bank Capital Framework to Covered Insurance Companies (which, as noted, I believe it should not), Section 169 is such a clear and broad grant of authority that it would override any such requirement and would require the Federal Reserve to take action to avoid imposing the Bank Capital Framework on Covered Insurance Companies.

Another fundamental canon of statutory construction that is directly relevant to this analysis is that different statutory provisions must be read consistently rather than in conflict.[18] Indeed, the Federal Reserve and the other banking agencies have acknowledged that "the relationship between the requirements of section 171 and other aspects of [Dodd-Frank], including section 165, must be considered carefully and . . . all aspects of [Dodd-Frank] should be implemented so as to avoid imposing conflicting or inconsistent regulatory capital requirements".[19] It is seemingly incontrovertible that reading Section 171 to preclude differentiation would conflict with the basic mandate in Section 165 to require differentiation. Likewise, such a reading of Section 171 would conflict with the Section 169 requirement to avoid duplication.

Moreover, there is no indication in Section 171 itself, or elsewhere in Subtitle C, that Section 171 was intended to "override" Congress's basic instructions in Sections 165 and 169 for the development and application of capital and other prudential standards for Covered Insurance Companies in a tailored, flexible and nonduplicative manner. Sections 165, 169 and 171 can only be reconciled if Section 171 is interpreted to require a *comparable* capital regime as opposed to an *identical* capital regime. This approach would fulfill the objectives of all three provisions, whereas any more prescriptive reading of Section 171 would undermine the Section 165 requirements of tailoring and differentiation and the Section 169 restrictions on duplication. Any more prescriptive reading is also illogical. It would imply that Section 171 imposed more stringent capital requirements on Covered Insurance Companies than Section 165, even though Section 165 is the key provision that is supposed to impose enhanced (*i.e.,* more stringent) capital and other requirements than those generally applied under Section 171.

There is one other issue of statutory consistency. Both Section 5(c)(3) of the Bank Holding Company Act[20] and the McCarran-Ferguson Act of 1945[21] codify the longstanding Federal policy that State laws are to regulate the business of insurance. A reading of Section 171 that overrides this policy would create a conflict that is not necessary.

Thus, upon analyzing Section 171 in context of Subtitle C as a whole, in particular, Sections 165 and 169, and other statutory schemes, the Federal Reserve is clearly authorized to apply the requirements of Section 171 to Covered Insurance Companies in a tailored, flexible and nonduplicative manner that recognizes and accounts for the differences between Covered Insurance Companies and banks.

C. A Solution Consistent with the Plain Language of Section 171 and Subtitle C

The Federal Reserve may have several options to interpret Section 171 in a way that is both consistent with its terms and maintains fidelity to Subtitle C as a whole. The solution, however, that I will now describe may be the most direct and consistent approach. There are two steps.

First, the Federal Reserve would make a determination that the RBC framework that already applies to the insurance operations of Covered Insurance Companies is comparable to the Bank Capital Framework. If, however, the Federal Reserve were to conclude, after consultation with insurance regulators, that the existing

[18] *See* note 15 *supra. See also Watt* v. *Alaska,* 451 U.S. 259, 266–67 (1981) ("[W]e decline to read the statutes as being in irreconcilable conflict without seeking to ascertain the actual intent of Congress . . . We must read the statutes to give effect to each if we can do so while preserving their sense and purpose.") (citations omitted).

[19] 76 Fed. Reg. 37,620, 37,626 (June 28, 2011).

[20] 12 U.S.C.§ 1844(c)(3)(A).

[21] 12 U.S.C. § 1012(b).

minimum capital levels required under the RBC framework are not sufficiently stringent for "enhanced prudential standards", the answer is not to substitute an entirely different capital framework. Rather, the Federal Reserve can simply require that Covered Insurance Companies maintain some percentage greater than 100 percent of the RBC framework's required capital levels to achieve a level of stringency deemed appropriate to support such operations.

Second, the Federal Reserve would apply the Bank Capital Framework on a consolidated basis to the top-tier holding company of a Covered Insurance Company, but with what is in effect an adjustment for the insurance operations. Any assets of the top-tier holding company held in an insurance company that complies with the RBC framework (as it may be modified by the Federal Reserve) would receive a risk weight of 0 percent and the RBC capital attributable to those insurance company assets would be deducted from total capital. Under this approach, the holding company's noninsurance assets and activities (including parent company only assets), *i.e.,* those not regulated under the RBC framework, would continue to be subject to the existing Bank Capital Framework and would require separate and appropriate levels of capital to support such activities. A similar approach could be applied to the leverage requirements.

This approach would not only assure robust and differentiated capital requirements and reconcile the various relevant provisions of Subtitle C, but also would have several other advantages. First, it would apply the Bank Capital Framework to the parent company entity on a consolidated basis, which conforms with Section 171. This result also addresses directly the concern that Senator Collins and former FDIC Chairman Bair identified as an impetus for Section 171—that, in the financial crisis, holding companies were a source of weakness, rather than strength, to their operating subsidiaries.[22] Second, it would be grounded in the Federal Reserve's existing authority, which the Federal Reserve has exercised previously,[23] to modify risk weights in the existing Bank Capital Framework in order to tailor those requirements for insurance company assets. Third, it would satisfy the not "less than" and not "quantitatively lower than" requirements in Section 171 by leaving in place the numerical ratios underlying the Bank Capital Framework (that is, the numerical ratio requirements under Basel I and Basel III). Fourth, it would build on the existing RBC framework tailored to Covered Insurance Companies, and thereby satisfy the mandate in Section 169 for the Federal Reserve to take action to avoid imposing duplicative requirements on Covered Insurance Companies.

This suggested approach would also give effect to Congressional intent, as evidenced both in the comments of Senator Collins and in the December 11, 2012 Letter in which thirty-three Members of Congress asked the Federal banking agencies to ensure that the capital requirements for Covered Insurance Companies "consistently reflect congressional intent by incorporating the State risk-based capital system and applying capital standards that accommodate the existing framework for companies engaged in the business of insurance".

Finally, this approach could be implemented by relying solely on the flexibility inherent in the language of Section 171. That is, by applying the numerical ratios in the Bank Capital Framework, the Federal Reserve would be quite literally imposing capital requirements that are not "less than" nor "quantitatively lower than" the bank capital requirements referred to in Section 171. This approach becomes even more compelling when considered in the context of the broader statutory scheme in Subtitle C, where tailoring and avoiding duplication are the repeated and unambiguous instructions from Congress.

V. Congressional Action

Even though, as just discussed, I believe the Federal Reserve has the authority to resolve this issue, and there are solutions available to the Federal Reserve in the exercise of that authority, there is obviously a distinction between having the authority to take an action and having a statutory requirement to do so. Moreover, in the Federal Reserve's recent promulgation of its rules under Section 165, it postponed a decision on the capital requirements applicable to Covered Insurance Companies to further study the issue. I hope that during this additional period of study, and in view of the firm Congressional support for resolution of the issue, the Federal Reserve will move expeditiously to find an interpretative solution to the problem, whether in the way I have suggested or in some other way.

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[22] 156 Cong. Rec. S3459, 3460 (daily ed. May 10, 2010).

[23] As the Federal banking agencies have recognized, Congress did not forbid the agencies from modifying, over time or in response to changes in circumstances, the calculation of the components of the numerical ratios in the bank capital requirements. *See* 77 Fed. Reg. 52,888, 52,892 (Aug. 30, 2012).

If, however, the Federal Reserve is not prepared to act promptly, I would strongly urge Congress to act to prevent a result that is so clearly unwarranted and potentially so damaging. The legislation previously proposed by Senators Brown and Johanns, and today by Senator Collins, represents a sound basis for moving forward. In asking for Congress to act in this matter, I realize that it may seem a "heavy lift", not because of the substance, but because of a reluctance to permit any amendment to the Dodd-Frank Act. The concern is apparently that any amendment would open the door to further amendments that are much more controversial and divisive.

But certainly Dodd-Frank is not such a perfect piece of legislation that any and all amendments should be resisted for all time. When the absence of an amendment would result in perpetuating an adverse result that Congress has clearly stated, on a bipartisan basis, it did not intend, Congress should not be irrevocably barred. Indeed, Congress would be departing from its own fundamental principles if it sought to bind future Congresses from absolutely any reconsideration of what was legislated by its predecessors.

I do recognize the concern about "opening up" Dodd-Frank when there has not been sufficient time to evaluate its impact. But, if there were ever to be any change, this is the time and place to do so. An amendment to clarify Section 171 would be both surgical and noncontroversial; of most importance, it is the right result.

VI. Conclusion

In summary, given the virtually unanimous support for finding a solution to the policy issue raised by Section 171, and the flexibility the Federal Reserve has under the terms of Section 171 and Subtitle C, the Federal Reserve can, and should, act to avoid the negative consequences of applying the Bank Capital Framework to Covered Insurance Companies. In the absence of prompt Federal Reserve action, I urge Congress to act.

Appendix A

1. Policy Loans:

As a service to its customers, an insurance company may loan a life insurance policyholder up to the existing cash surrender value of his or her policy, secured by the cash surrender value of the policy. The cash surrender value of the policy is a liability on the insurance company's balance sheet. In this way, the loan is fully collateralized, but unlike a collateralized bank loan, the insurance company is not subject to the risk that the collateral will not cover its exposure under the loan. If the policyholder defaults, the insurance company will reduce the benefits it pays to the policyholder, which will result in the insurer reducing the liability it records for the policy. An insurance company can always recoup a $100 policy loan default by reducing its liability to the customer under the policy by $100.

Despite the fact that the policy loan never exposes the insurance company to credit or market risk, under the Bank Capital Framework—with the mindset of a traditional collateralized bank loan—would require an insurance company to hold Tier 1 capital against the loan at a risk weight of 20 percent.

2. Guaranteed Separate Accounts:

Many insurance companies offer an insurance product that allows a customer to place funds with an insurance company to be invested and managed by the insurance company, separately from its general assets, with the goal of providing the customer with the income stream from the investments, often upon retirement. These so-called "separate accounts" may be in guaranteed or nonguaranteed form and have varying features and conditions. The basic concept is that, with a guaranteed account, the insurance company guarantees the customer a fixed income stream, with the insurance company exposed if the value of assets in the account drops below a guaranteed amount at the end of the investment period. Annuities are frequently in the form of a guaranteed separate account.

In the banking context, a guarantee is viewed as a contingent liability that may become fully due at any time. In the insurance context, the separate account products such as annuities are typically structured in such a way that the full liability is not all due at once; the period over which the guaranty payment is made is both long (often 15–20 years) and requires a long waiting period (often 10 years) before any payment is made. This contractual protection substantially eliminates the liquidity concern that the insurance company would need to draw on its own assets to make up for the full amount of the shortfall all at once.

The Bank Capital Framework includes no tailoring for insurance company guaranteed accounts with these protective features. Moreover, because U.S. generally accepted accounting principles require a provision to be made on the insurance company's books to reflect the amount of the insurance company's exposure for the guarantee, requiring additional capital be held against not just the exposure but the entire account results in double-counting.

3. Corporate Bonds:

The Bank Capital Framework is, in a number of respects, tailored for the types of assets held by banks in relatively large amounts. For example, there are different, tailored risk weights for mortgage loans (based on the quality of the loan), sovereign debt (based on categories for various countries), exposures to other U.S. depository institutions and credit unions and exposures to U.S. public sector obligations (based on whether the obligation is general or revenue).

Insurance companies generally hold a significant portion of their assets in corporate bonds—and a greater portion than do banks because bond maturities better fit the insurance company's asset-liability matching and investment needs. Yet, the Bank Capital Framework is not tailored for corporate debt, so, unlike the RBC framework, there is no distinction between higher and lower quality bonds (as there is for mortgage loans and sovereign debt under both the Bank Capital Framework and the RBC framework), subjecting all corporate bonds to a 100 percent risk weight. This relatively crude approach is understandable when corporate bonds represent only a small portion of the assets that banks hold, but not when they represent a much larger portion at insurance companies. This exemplifies how the Bank Capital Framework simply was not designed to be applied to insurance companies.

PREPARED STATEMENT OF AARON KLEIN

DIRECTOR, FINANCIAL REGULATORY REFORM INITIATIVE
BIPARTISAN POLICY CENTER

MARCH 11, 2014

Chairman Brown, Ranking Member Toomey, Members of the Subcommittee, thank you very much for the opportunity to testify at this hearing of the Subcommittee on Financial Institutions and Consumer Protection. I have tremendous respect for the critical role this Committee plays in shaping the financial regulatory and economic policies that have an enormous effect on the lives of all Americans. I am especially honored to appear before you, having served for over 8 years on the professional staff of the Committee on Banking, Housing, and Urban Affairs, mostly as Chief Economist for former Chairmen Sarbanes and Dodd.

Bipartisan Policy Center Financial Regulatory Reform Initiative (FRRI)

I serve as the Director of the Financial Regulatory Reform Initiative at the Bipartisan Policy Center. Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, BPC is a Washington-based think tank that actively seeks bipartisan solutions to some of the most complex policy issues facing our country. In addition to financial regulatory reform, BPC has ongoing projects in housing, immigration, and the Federal budget. The Financial Regulatory Reform Initiative's overarching objective is to promote policies that balance financial stability, economic growth, and consumer protection. Finding the right capital regulations for insurance companies under the Dodd-Frank Act is a critically important issue. I commend you for focusing the Committee's attention on the issue. My testimony will focus on the following four key points:

1. The business of insurance is fundamentally different from that of banking and hence must be subject to appropriate yet different capital standards.
2. Regulators need to overcome their "bank-centric" approach when regulating insurance companies.
3. The Dodd-Frank Act envisions regulators overcoming bank-centricity and empowers them to do so.
4. A more optimal regulatory approach should include a Federal insurance regulator and optional Federal charter. The benefits of such a regulator grow if the Federal Reserve is unable to adjust its bank-centric approach to insurance companies.

Insurance and Banking are Fundamentally Different Businesses, With Different Balance Sheets, Business Models, and Risk Profiles

To understand why it is so important that insurance companies be subject to insurance-based capital regimes, not bank-based capital regimes, one must first appreciate the fundamental differences in their business models, balance sheets, and risk profiles.

The Business of Insurance

At its core the business of insurance is about aggregating risks and matching assets to liabilities. Insurance companies are in the business of taking on risk of different tenures and matching assets and reserves against this risk. The precise approach varies tremendously by the type of insurance product. A company that provides auto insurance, usually on a 6- or 12-month basis, has to have a different asset and liquidity structure than a company that provides life insurance, which is often issued on a multi-decade contract.

Aggregating risk avoids adverse selection by offering highly competitive products that attract broad market share and a large pool of customers to minimize risks. Insurance companies that are able to capture more of a given market are able to more accurately protect themselves against adverse selection and statistically unlikely outcomes. By accumulating and pooling risk, insurance companies allow people to transfer the financial risk of getting into a car accident, losing a loved one, or outliving their assets to a broad risk pool. Aggregating appropriate risk thus paradoxically makes insurance companies safer.

The Business of Banking

Unlike insurance companies, which agglomerate and manage risk, banks are in the business of mitigating risk. Over-concentration in a specific business line is a classic "red flag" for regulators of safety and soundness problems. A key purpose of banks is to transfer timing risk; banks allow depositors to instantly access their funds, while using deposits to make longer-term loans to consumers and businesses. This process is often referred to as maturity transformation. As the Bipartisan Policy Center's Failure Resolution Task Force found, "maturity transformation is the socially beneficial process by which financial institutions fund themselves with short-term borrowings and use these funds to make longer-term loans or investments in other illiquid assets. Without maturity transformation, our modern economy would grind to a halt."[1]

Can Banking and Insurance Coexist?

Some economists and policymakers have argued that there are economies of scale in mixing the provision of banking and insurance services. This theory was prominent in the 1990s and was one of the driving forces behind the Gramm-Leach-Bliley Act, which repealed the prohibition on the mixing of banking and insurance. The theory was tested more than 15 years ago on a large scale with the merger of Citicorp and Travelers Group. Many commentators at the time expected more mergers and the creation of "financial supermarkets" to provide both services. At the time, Travelers CEO Sanford Weill said that the merger would create "a model of the financial services company of the future," a sentiment shared by others in the industry.[2]

As an empirical economist, I check to see how well reality has matched theory. In the case of the proposed value of combining banking and insurance businesses, the expected benefits have not materialized. With one important exception, which I will discuss in a moment, there are no examples in the United States of mixing banking and insurance on any significant commercial scale, although there are examples of successful acquisitions of smaller banks and thrifts. The Citi-Travelers merger has been unwound and, in the absence of other similar mergers, it seems as if these businesses do not mix, even without regulatory barriers.

A model exception has been the successful provision of banking and insurance services by USAA. What is interesting about USAA is that it operates its business on a field-of-membership basis, more analogous to a credit union than to a bank. Technically, USAA has a thrift regulated by the Office of the Comptroller of the Currency (OCC) and a thrift holding company regulated by the Federal Reserve. The membership requirement involves family military service. The reputation of the company providing both services is also extremely high,[3] although I would not know firsthand, as I am not eligible for its insurance or for its bank lending activity.

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[1] John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, *"Too Big to Fail: The Path to a Solution,"* Bipartisan Policy Center, May 2013, p. 17. *Available at: http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf.*

[2] Yvette D. Kantrow and Liz Moyer, "Citi, Travelers: A Global Leader Takes Shape," *American Banker,* April 7, 1998. *Available at: http://www.americanbanker.com/175/citi-travelers-a-global-leader-takes-shape-1041890-1.html.*

[3] *See* Tempkin Group, Net Promoter Score Benchmark Study, 2012, October 2012. *Available at http://www.temkingroup.com/research-reports/net-promoter-score-benchmark-study-2012/.*

Can Regulators Overcome Bank-Centricity To Properly Regulate Insurance Companies?

Dodd-Frank Empowers the Federal Reserve To Provide Capital Regulation for Insurers

Dodd-Frank decided to treat thrifts and thrift holding companies nearly the same way it treats banks and bank holding companies, moving their supervision to the OCC for thrifts and the Federal Reserve at the holding company level.[4] Whether the continued bifurcation of regulation between holding company and insured depository is a wise decision is beyond the scope of this hearing, but is something that the Bipartisan Policy Center's Regulatory Architecture Task Force is examining and will discuss in a report to be released this spring.

The Federal Reserve is the regulator for a diverse set of insurance companies under Dodd-Frank. It is unclear how broadly appreciated that was during consideration of all of the aspects of Dodd-Frank, including the adoption of the Collins Amendment. What is clear is that Dodd-Frank's decision to move the regulatory responsibility for thrift holding companies and nonbank SIFIs to the Federal Reserve was given along with the ability and responsibility for the Federal Reserve to recognize differences between these entities and develop appropriate capital structures, tailored to each entity or separate class of institutions. The broad authority to tailor was codified in Title I, Subtitle C of the Dodd-Frank Act.[5]

The Importance of Tailoring Capital Standards for Insurance

The economic rationale for capital regulation and for tailoring is clear but bears repeating. Capital regulation is necessary for many purposes, including, to ensure the safety and soundness of financial institutions so that customers can use these products efficiently and effectively. There are two main approaches to quantifying capital regulation for any financial institution. The first is a nonrisk-sensitive approach, the leverage ratio, which creates a ceiling on total risk-taking. However, using the leverage ratio alone can have the perverse effect of encouraging institutions to take on more risk by treating all liabilities as equally risky and requiring the same amount of capital. Thus, a risk-based method of capital regulation is required to quantify risk levels for various assets and liabilities and require appropriate capital.

The financial crisis demonstrated the problems inherent with over-reliance on risk modeling. The mispricing of risk is one of the hallmarks of financial crises. Institutions, regulators, markets, and models are all susceptible to this mistake. I cannot predict in which area we will misprice and incorrectly evaluate risk in the future, but I am certain that it will happen again.

The fundamental question is now how to develop appropriate metrics for both leverage and risk-based capital as it applies to insurance companies. Insurance companies differ fundamentally from banks in how one measures risk and leverage; thus a different capital system, specifically tailored for insurance companies, is necessary. A Bloomberg Government report studying this question concluded that: "the risks that insurers face are different from banks, and that regulating insurers as if they are banks may be inappropriate and unfair to insurance companies."[6]

Did Regulators Draw the Right Lessons from the Crisis for Insurers?

An example of the difference in regulatory mindset necessary for insurance companies can be seen by the treatment of separate accounts. Regulators made a key mistake in the run-up to the financial crisis by allowing banks to keep structured investment vehicles (SIVs) off their balance sheets, exempting SIVs from capital reserve requirements. The SIVs were "canaries in the coal mine" before the last financial crisis. Assets that were supposed to be low risk were in fact risky and required banks to raise significant capital during stressed periods—just at the moment that capital was especially costly. Post financial crisis, regulators have altered their approach, allowing fewer SIVs to be classified as "off balance sheet." For this, regulators should be commended.

Regulators, particularly the Federal Reserve, have also seen their post-crisis power broadly expanded. The Federal Reserve Board now has supervisory authority

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See also David Rohde, "In the Era of Greed, Meet America's Good Bank: USAA," *The Atlantic,* January 27, 2012. *Available at http://www.theatlantic.com/business/archive/2012/01/in-the-era-of-greed-meet-americas-good-bank-usaa/252161/.*

[4] 12 U.S.C. § 5412 (b)(2)(B) and 12 U.S.C. § 5412 (b)(1)(A).

[5] 12 U.S.C. § 5365(a)(2)(A).

[6] Christopher Payne, "Basel Capital Rules May Hinder U.S. Insurers," *Bloomberg Brief: Financial Regulation,* April 26, 2013. *Available at: http://www.bloombergbriefs.com/files/Financial_Regulation_042613_p1.pdf.*

over many insurance companies as well as all SIFIs. As the Board's authority expands, it is encountering new products that banks don't offer and are accounted for differently, such as separate accounts. As defined by the Office of Financial Research (OFR), separate accounts are those "in which an asset manager selects assets on behalf of large institutional investors or high net-worth individuals under mandates defined in an investment management agreement. Clients retain direct and sole ownership of assets under management."[7]

Insurance companies use these separate accounts for products such as variable annuities. The question is whether these accounts are treated as "on" or "off" balance sheet for regulatory purposes. To answer this, regulators must consider the risks separate accounts carry for insurance companies. Historically, insurance has been regulated by the States, which have recognized that funds in separate accounts are more analogous to stock market accounts. Stock brokers are not required to hold capital against their clients' accounts since the assets in those accounts do not belong to the broker. Banks, on the other hand, must retain capital against deposits, since the deposits are liabilities for banks, and are subject to runs.

A question remains as to whether Federal regulators such as OFR, the Federal Reserve, and the Financial Stability Oversight Council (FSOC) will draw the appropriate line with respect to separate accounts. If the regulators discover that a nonbank is putting its own solvency at risk and not accounting for separate accounts properly that would merit new regulatory treatment. So far, data from OFR and from the States' historical experience regulating insurance companies does not support that conclusion. Instead, it raises concerns that bank regulators are misapplying bank-centric lessons into a nonbank world without a clear understanding of the different risks, balance sheets, revenue streams, and business models.

The Right Way to Think About Capital Standards

Good regulatory structures involve both minimum capital requirements through leverage limits and more sophisticated risk-based capital structures. Both need to be targeted and tailored to the business that they are regulating. As we have seen, insurance and banking are fundamentally different businesses with different risk profiles. Therefore, they require different capital regulatory and supervisory structures. The Dodd-Frank Act anticipated this and provided the Board with the necessary flexibility to tailor prudential standards accordingly to different businesses.

There is broad agreement that tailoring is the right approach. Federal Reserve Board Chair Janet Yellen said it best: "[T]here are very significant differences between the business models of insurance companies and the banks that we supervise and we are taking the time that is necessary to understand those differences and to attempt to craft a set of capital and liquidity requirements that will be appropriate to the business models of insurance companies."[8] The question is whether the Board will follow through on Chair Yellen's wise words with carefully considered, differentiated capital standards for insurers that recognize they are not banks.

Dodd-Frank Envisions and Empowers Regulators To Overcome Bank-Centricity

Dodd-Frank made clear in several of its provisions the importance and need for Federal regulators to develop and implement nonbank capital regimes for regulated nonbank entities, and the ability for them to do so. These provisions can be found, for example, in sections 112, 120, 165, and 616.[9] These themes were reiterated to regulators by Chairman Johnson (D–SD) and Ranking Member Crapo (R–ID) in their letter to regulators last year: "In setting the new capital rules for the United States institutions, your agencies face a formidable task to carefully tailor the new rules to the unique risks of institutions while neither hampering lending nor undermining the strength of our financial system."[10]

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[7] Office of Financial Research, "Asset Management and Financial Stability," September 2013. *Available at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR__AMFS__FINAL.pdf.*

[8] *Victoria Craig, "Janet Yellen Talks Disappointing Data, Weather on Capitol Hill," Fox Business,* February 27, 2014. *Available at: http://www.foxbusiness.com/economy-policy/2014/02/27/janet-yellen-talks-dissapointing-data-weather-on-captiol-hill/.*

[9] 12 U.S.C. § 112 (a)(2)(I); 12 U.S.C. § 120 (b)(2)(B); 12 U.S.C. § 165 (b)(1)(A)(i); 12 U.S.C. § 165 (b)(1)(B)(i); 12 U.S.C. § 165 (c)(1); 12 U.S.C. § 616 (d)(b).

[10] U.S. Committee on Banking, Housing, and Urban Affairs, "Johnson and Crapo Urge Regulators to Address Concerns on Basel III," February 13, 2013. *Available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord__id=f321c69d-e901-e0ee-14eb-2ae6b730ee91&IsPrint=1.*

I am not an attorney and will not venture an opinion on how the Federal Reserve should interpret these provisions as they relate to section 171, often referred to as the Collins Amendment. I will point out however, that there is broad support, with which I concur, that capital standards should be tailored for different business models with different risk profiles. This was the clear intention of Dodd-Frank.

Even if individual bank regulators are unable or unwilling to use a tailored approach, the FSOC could solve this problem without additional legislation. Among the duties imposed upon the FSOC in section 112 is the duty to make recommendations to: (1) member agencies on general supervisory priorities and principals that reflect the outcome of discussions among the member agencies; (2) the Board concerning the establishment of heightened prudential standards, including capital standards, for nonbank financial companies supervised by the Board; and (3) primary financial regulators to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and U.S. financial markets.[11]

If these two preferred approaches are not implemented—the following of the intention of Congress by the Federal Reserve, or the use of FSOC's authority to make recommendations that the Fed could then adopt—I would then support a legislative solution to this problem such as the one proposed by Senators Brown and Johanns in S. 1369.

The Case for Federal Insurance Regulation in a Post-Dodd-Frank World

BPC's Regulatory Architecture Task Force has been examining the entire financial regulatory structure, as it exists in a post Dodd-Frank world. The task force's report will be released next month and will contain many recommendations for how we can improve our current regulatory structure. One of those recommendations will be to create a Federal insurance regulator and an optional Federal charter. This recommendation follows previous bipartisan calls for a Federal insurance regulator, including legislation introduced by now Chairman Tim Johnson (D–SD) and then Senator John Sununu (R–NH),[12] as well as the comprehensive regulatory restructuring plan issued by the Treasury Department under Secretary Henry "Hank" Paulson, Jr.[13] It is also consistent with the framework proposed by Secretary Timothy Geithner in the 2009 Treasury White Paper, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation."[14]

Dodd-Frank did not follow those calls, but did create a new Federal Insurance Office (FIO) within the Treasury Department in order to build Federal expertise in insurance. The FSOC was given the authority to designate any insurance company as a SIFI and hence transfer regulatory authority to the FRB. An independent voting member was also created for the FSOC with the requirement that s/he have insurance expertise.

How has this worked so far? We have limited data as Dodd-Frank is not yet 4-years old, but the data we do have indicates disagreement and a lack of consistency. The only public disagreement so far in the designation process among FSOC members was in the designation of Prudential, Inc. Roy Woodall, the independent commissioner with insurance expertise, dissented on the vote to designate Prudential and was joined by the acting FHFA director. In his dissent, Commissioner Woodall said that the FSOC's analysis underlying the decision to designate Prudential was, "antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the State insurance resolution and guaranty fund systems," and that the designation, "will ultimately lead to the imposition of requirements that are by all indications ill-suited for insurance companies."[15]

The upcoming report from BPC's Systemic Risk Task Force will analyze the FSOC process, focusing particularly on questions regarding the FSOC's authority and its desire to regulate entities and institutions as compared to the regulation of activities. As long as designation of entities remains the main tool at the FSOC's disposal,

[11] 12 U.S.C. § 5322 (a) (2).

[12] The National Insurance Act of 2007, S. 49, 110th Congress, 2007.

[13] The Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure." March 2008. *Available at: http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.*

[14] The Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," June 17, 2009. *Available at: http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.*

[15] S. Roy Woodall, Jr., dissent to the FSOC's designation of Prudential, Inc. delivered to Council members, September 19, 2013, pp. 1, 7–8. *Available at: http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.*

it would be reasonable to expect a continued focus on designation. To a person with a hammer in his hand, problems tend to look like nails.

Has Dodd-Frank Created a Unified Voice for the United States on an International Basis?

One of the major goals in creating the FIO was to establish a unified Federal voice on insurance for international regulatory purposes. Dodd-Frank gave the FIO the authority "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors [IAIS]."[16] The Treasury Department echoes this, stating that a goal of the FIO is "to represent the United States on prudential aspects of international insurance matters, including at the International Association of Insurance Supervisors."[17] However, the Federal Reserve, citing its newly acquired regulatory responsibilities over many insurance companies, recently applied for a seat on the IAIS. The Board's decision to request a seat is understandable given its desire to acquire additional knowledge and expertise on insurance. However, it also sends an unclear signal to the international community as to who speaks for the United States between the chair of the Federal Reserve Board, the director of FIO, or the NAIC, which represents State insurance commissioners, the functional regulators for insurance companies today. The Federal Reserve should publicly affirm that the FIO is the lead representative for the United States on the IAIS. This remains an example of the effect of the duplicative and unclear delegation of authority over regulation of insurance companies.

Conclusion

BPC's Financial Regulatory Reform Initiative has found that Dodd-Frank empowered financial regulators with substantial authority and flexibility to use their tools to improve regulation and achieve better regulatory outcomes for both financial services providers and end users of those financial services. We have seen multiple examples of regulators doing just that, ranging from the Federal Deposit Insurance Corporation's Single Point of Entry approach to the Consumer Financial Protection Bureau's use of an open and transparent rulemaking process. We have also found multiple instances where regulators could have taken a better approach, such as the Volcker Rule. And, we have found several instances where additional statutory changes are required, including the need to add a chapter to the Bankruptcy Code to complement Title II of Dodd-Frank, and the desirability of an independent inspector general for the CFPB. However, our work has shown that regulators have significant tools at their disposal to get things right.

It is clear that banks and insurance companies are fundamentally different businesses, which require substantially different capital regimes. In my opinion, Dodd-Frank gave the Federal Reserve Board the necessary authority to the tailor its capital rules for insurance companies. The law clearly supports a tailored approach for insurance companies as well as all nonbank SIFIs. Dodd-Frank envisions a less bank-centric regulatory approach to the nonbanks the Board regulates after FSOC designation. It also empowers the FSOC as it relates to authorities as well as institutions. And, it empowers the Federal Reserve and FSOC as it relates to capital rules for nonbanks such as insurers.

If the Federal Reserve Board is unwilling, or unable, to implement the tailoring regime required in Dodd-Frank to insurance companies, I would support a legislative solution such as S. 1369 as introduced by Senators Brown and Johanns. This would be a prominent example of the inability of regulators to adhere in practice to the construct created in Dodd-Frank. Whether this signals an isolated instance or a larger problem remains to be seen. It would add credence to the already strong argument in favor of some form of dedicated Federal insurance regulation that recognizes and understands the uniqueness of the insurance industry and its importance to our economy.

[16] 12 U.S.C. § 313 (c)(1)(E).

[17] U.S. Department of the Treasury, "About: Domestic Finance—Federal Insurance Office." *Available at: http://www.treasury.gov/about/organizational-structure/offices/Pages/Federal-Insurance.aspx.*

PREPARED STATEMENT OF MICHAEL W. MAHAFFEY

Chief Risk Officer, Nationwide Mutual Insurance Company

March 11, 2014

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for the opportunity to appear before you to discuss the critical issue of the appropriate capital framework for insurers supervised by the Federal Reserve. My name is Michael Mahaffey and I am the Chief Risk Officer for Nationwide Mutual Insurance Company (Nationwide). I am testifying on behalf of Nationwide but will also represent the perspective of a diverse group of insurers that fall under Federal Reserve supervision. Those insurers include both insurance savings and loan holding companies (SLHCs) and insurance companies that have been or may be designated by the Financial Stability Oversight Council (FSOC) as systemically important financial institutions (SIFIs).

As Nationwide's Chief Risk Officer, I am responsible for overseeing the company's approach to managing its risk profile, including the key functions of Stress Testing and Enterprise Risk and Capital Modeling, Measurement and Management. A critical part of my role is to ensure that Nationwide meets its internal and external capital requirements so the company is always well positioned to honor its promises to our policyholders. In my capacity as Nationwide's Chief Risk Officer, I believe I can offer a helpful perspective on appropriate capital regimes for insurers and the consequences of imposing bank-centric capital rules on companies like Nationwide.

About Nationwide

Nationwide is a Fortune 100 mutual insurance company based in Columbus, Ohio. For almost 100 years Nationwide has been helping our policyholder members protect what is most important to them through our property and casualty and life insurance businesses.

Roughly half of Nationwide's revenue is derived from our property and casualty businesses, and half is derived from our life insurance and related businesses. As a result, Nationwide is representative of both the property and casualty and the life insurance industries. Nationwide Mutual and its property and casualty insurance subsidiaries primarily provide personal auto, homeowners, and commercial insurance products to households and businesses all across the country. In addition, Nationwide Life Insurance Company, a subsidiary of Nationwide Mutual, primarily provides life insurance, individual annuities, and private and public-sector retirement plans. Nationwide also provides banking products and services through Nationwide Bank, a Federal savings bank insured by the FDIC.

As of December 31, 2013, Nationwide had approximately $183 billion in combined assets, while Nationwide Bank had approximately $6 billion in assets. While Nationwide Bank is critical to our customers and our business strategy, it is important to note that it represents less than 3 percent of the total assets of the combined organization.

Notwithstanding the bank's *de minimis* relative size, by virtue of its ownership of Nationwide Bank, Nationwide is registered as an SLHC. As an SLHC, Nationwide is now subject to Federal Reserve supervision and regulation pursuant to the Dodd-Frank Act, including new prudential requirements designed to enhance the safety and soundness of banking organizations. These include the Collins Amendment's consolidated capital requirements, capital stress-testing requirements, and the Volcker Rule.

The Applicability of the Collins Amendment to Insurers

Pursuant to the Dodd-Frank Act, two categories of insurance companies came under Federal Reserve supervision—insurers that own depository institutions (and are thus SLHCs) and insurers that are designated by the FSOC as nonbank SIFIs. The Dodd-Frank Act conferred authority on the Federal Reserve to establish group capital requirements for both categories of companies. Section 616 of Dodd-Frank granted the Federal Reserve the authority under the Home Owners' Loan Act (HOLA) to establish group capital requirements for insurance SLHCs. Likewise, Section 165 of the Dodd-Frank Act provided the Federal Reserve authority to establish group capital requirements for insurance SIFIs.

Insurance SLHCs and insurance SIFIs are also subject to the minimum group capital requirements as set forth in the Collins Amendment. The Collins Amendment establishes a "generally applicable" minimum capital floor that is no lower than that which was in effect for banks at the time Dodd-Frank was enacted.

As an SLHC, Nationwide is subject to the Collins Amendment. In addition, our depository institution, Nationwide Bank, is also independently subject to the minimum capital standards in the Collins Amendment. We support the application of the Basel banking capital standards to Nationwide Bank and we are not seeking to exempt Nationwide Bank from the Collins Amendment or in any way alter the capital requirements as applied to Nationwide Bank.

Furthermore, we do not oppose utilization of a group-wide capital framework for insurance SLHCs and insurance SIFIs. Capital strength is core to our business proposition—providing our policyholders with financial protection when they need it the most.

However, it is critically important that any capital framework established by the Federal Reserve for insurance SIFIs and insurance SLHCs utilize the appropriate tools. These institutions are predominantly insurance organizations and it would be inappropriate to measure their capital needs using a tool that is designed for banks.

By way of analogy, it would be wholly inappropriate to apply an insurance-centric capital framework on a group-wide basis to bank holding companies, bank SIFIs like JP Morgan or Wells Fargo, or to banks that each happened to own small insurance operations.

The Statutory Construction Issue

As you know, the purpose of the Collins Amendment is to ensure that certain financial institutions are subject to a minimum capital requirement. The economic crisis underscored the need to ensure that financial institutions hold enough capital to weather severe economic stress. We wholeheartedly support strong capital rules, which protect financial institutions, the broader economy, and everyday Americans.

Again, we are not seeking lower capital requirements for insurers or their depository institution subsidiaries. We only seek to ensure that any capital standards established by the Federal Reserve utilize appropriate methodologies and accurately reflect the risks inherent in the business of insurance, which we believe is consistent with Congress' intent in adopting the Collins Amendment.

We also believe that the plain language of the Collins Amendment permits the Federal Reserve to establish a separate, tailored, group capital framework for insurance SLHCs and insurance SIFIs. However, the Federal Reserve has maintained an interpretation of the Collins Amendment that constrains their ability to tailor the rules and would require the imposition of bank-centric Basel capital rules on insurance SLHCs and insurance SIFIs. Despite this interpretation, Federal Reserve officials have repeatedly agreed with policymakers and industry officials that a one-size-fits-all approach is undesirable.

We respectfully, but strongly, disagree with an interpretation of the Collins Amendment that would prevent the Federal Reserve from establishing a separate capital framework that is appropriately tailored to the risks inherent in the business of insurance. Our company and trade association comment letters articulate this view in detail, as do several comment letters from respected attorneys who are experts in the field. Of prominent note, the author of the Collins Amendment, Senator Susan Collins, has stated that "it was not Congress's intent that Federal regulators supplant prudential State-based insurance regulation with a bank-centric capital regime . . . [C]onsideration should be given to the distinction between banks and insurance companies . . . I believe it is consistent with my amendment that these distinctions be recognized in the final rules."[1] We are pleased that the Federal Reserve is still examining this issue carefully and are hopeful that the agency will ultimately agree that the existing statutory language provides sufficient flexibility to establish a capital framework for insurance SLHCs and insurance SIFIs that more accurately accounts for the unique risk and capital profiles of insurers.

Support for a Legislative Solution

However, we are cognizant that if the Federal Reserve continues to hold the view that the Collins Amendment prevents the agency from establishing a tailored capital framework for insurance SLHCs and insurance SIFIs, the result will be the application of bank standards on insurers. This could have unintended negative consequences for consumers, the insurance market, and the economy. For these reasons, we support Congress passing legislation to clarify that the Federal Reserve, consistent with the original intent of the Collins Amendment, can and should establish a separate, tailored capital regime for insurers that appropriately reflects the industry's unique business model, risk profile, and asset-liability management practices.

Specifically, we support S. 1369, legislation introduced by Senators Brown and Johanns last year which has a broad, bipartisan group of cosponsors. S. 1369 would clarify that the Federal Reserve is not required to impose a bank regime on insurers

[1] Letter from Senator Susan Collins to the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, November 26, 2012.

by exempting insurers from the Collins Amendment. The bill would leave intact Sections 616 and 165 of the Dodd-Frank Act, which are the Federal Reserve's two other sources of legal authority to impose robust capital standards on insurers supervised by the Federal Reserve. In addition, under the Brown-Johanns bill, Basel III banking standards would continue to appropriately apply to depository institutions owned by an insurance company. Simply put, the Brown-Johanns bill would not affect the Federal Reserve's ability to impose group capital requirements on insurers; it would only clarify that the agency has the authority to tailor those standards to insurers' business models by utilizing the appropriate tools.

We strongly support this legislation and applaud the bill's sponsors for their leadership on this issue. We also greatly appreciate the helpful involvement of Sen. Collins in the legislative effort. We look forward to being part of any sensible solution that protects policyholders without subjecting our companies to a capital framework that was designed for banks and which is inappropriate for our business model.

The Role of Nationwide Bank in Nationwide Enterprise

As an SLHC, Nationwide is subject to the Collins Amendment by virtue of its ownership of Nationwide Bank. The same is true for the other SLHCs, including TIAA–CREF, who is also testifying today.

As an insurance SLHC, Nationwide has opted to continue to offer competitively priced, reliable banking products despite the obvious regulatory costs. Nationwide's online bank represents a way to supplement the insurance services we provide to our life and property casualty members.

As an example, Nationwide Bank played a critical role in the aftermath of the tornado that devastated Joplin, Missouri in 2011. Nationwide was able to quickly make insurance claims payments through Nationwide Bank debit cards issued to its policyholders who did not have access to bricks-and-mortar banks and who desperately needed these insurance payments in the wake of the disaster. The ability to offer this type of product through Nationwide Bank helps our policyholders get back on their feet sooner during a difficult situation.

Other insurance SLHCs have similar stories—we are not striving to become large commercial banks, but rather, to provide important complementary products to our insurance customers. Some insurers have divested their banks; however, we believe strongly that it is in the best interest of our customers (and indeed the banking system) to have access to affordable retail banking products from the strong insurance companies they trust.

The Bank-centric Basel III Framework is Inappropriate for Insurers

I'd now like to turn to why imposing a bank-centric capital regime on insurers is inappropriate for assessing their capital adequacy.

The Basel Committee on Banking Supervision developed the Basel banking capital regime, including its most recent iteration, Basel III, specifically for banks and not insurers. At a very high level, the Basel framework is almost entirely focused on the asset side of a company's balance sheet, because in the banking industry, that is primarily where risk resides. The predominant risks facing a banking organization include credit risk, market risk, counterparty risk and liquidity risk. As a result, an asset-based capital framework that is primarily focused on a these risk types is suitable for assessing capital for a banking organization.

However, Basel III, as implemented in the United States does not provide for critically important differences in company liability structures, liquidity profiles, or asset-liability management requirements. Consequently, such banking frameworks are not appropriate for insurers because they do not capture important liability based insurance risks (and associated risk management practices) that must be considered when determining capital requirements for such companies.

Relative to insurers, banking organizations tend to hold riskier assets that are funded by short-term liabilities, making the traditional banking model more sensitive to changes in asset prices and vulnerable to a risk of runs on deposits and a pull-back from short-term creditors in a very short period of time. Consequently, systemic economic events can subject banks to destabilizing "runs" and force them to quickly sell assets at a loss to meet their demand deposit obligations and funding needs. Furthermore, without a sufficient level of loss-absorbing capital, these banks would likely be unable to act as a source of credit to the U.S. economy. Without an appropriate level of capital, the fire sale of assets and pull-back of credit could have further systemic implications. This occurred during the most recent financial crisis due to the interconnectedness of the banking industry with the rest of the financial system.

Conversely, the primary risks facing insurers, found on the liability side of the balance sheet, are generally not as sensitive to the same systemic economic risks.

These insurer liability risks include, for example, weather risk, mortality risk and morbidity risk. Both life and property and casualty insurers invest upfront premium payments in assets to satisfy liabilities that, by their nature, are generally longer-term and typically dependent upon the occurrence of uncertain events that are not highly correlated to macroeconomic cycles.

While insurers are subject to asset risks based on the investments held to meet long-dated liabilities, these risks do not expose insurance companies to the same "run" scenarios as found in banking. These asset risks manifest themselves in different ways for insurance companies due to the nature of the insurance liabilities and asset liability management practices which include accepting premiums up front and investing them to meet future liabilities.

Again, property and casualty and life insurance policies are typically payable only upon the occurrence of a certain idiosyncratic trigger event not tied to economic cycles. While premature surrenders of life insurance policies can occur, significant penalties discourage this behavior and mitigate its impact. As a result, insurance policies are not prone to sudden and widespread "withdrawals" as bank deposits can be and, therefore, insurer liability and asset risks do not pose the same systemic risk implications that are found in the business of banking.

Imposing the Basel III Banking Framework Would be Potentially Harmful to both the Insurance Industry and the Economy

In addition to being inappropriate for insurers, the Basel regime is potentially harmful when applied to these companies because of their distinct business models. Insurers hold longer duration assets than banks. Insurers are significantly less reliant than banks on borrowed debt, especially short-term debt, and do not require the same level of liquidity as banks. However, insurance companies must engage in careful asset-liability management to ensure policyholder are protected, a business need the Basel regime also ignores.

One salient example of the inappropriateness of the Basel III capital framework as applied to insurers is its 100 percent risk weight to all corporate exposures, which fails to distinguish corporate exposures based on the credit quality of the borrower. As has been raised in comment letters, a 100 percent risk weight for investment-grade corporate bonds held by insurers overstates the risk associated with these assets, particularly when compared to a bank's commercial and industrial loans, which are materially more risky but which receive the same 100 percent risk weight. The insurance industry writ large has substantially larger holdings of corporate bonds than banking, and is, in fact, the largest investor in corporate bonds in the entire U.S economy. As of year-end 2012, corporate bonds comprised about 48 percent of life insurer general account assets as compared to around 6 percent for banks. Corporate bonds can provide an effective investment for meeting a long-dated policyholder obligation. Thus, overstating the risk on such a substantial portion of an insurer's investment portfolio will have a significant impact on insurance SLHCs and insurance SIFIs. These companies would be required to hold more capital for these high-quality investments, which could in turn impact the affordability and availability of insurance products with long-term liabilities.

As an alternative to incurring high capital charges for investment-grade corporate bond holdings, insurers subject to a Basel regime could decide to take on additional credit risk by shifting their investment portfolios to higher-yielding, lower-quality corporate bonds that would receive the same 100 percent risk weight under the Basel III final rule. Taking on additional credit risk would, as one would expect, worsen the insurer's capital position under the State risk-based capital framework, even though the insurer's capital adequacy would be unchanged under the Basel III framework.

Simply put, the Basel III framework's 100 percent, "one-size fits all" risk weight for corporate exposures provides a clear example of a framework that was designed for banks, which do not invest heavily in corporate bonds, and which is inappropriate for assessing the capital needs of an insurance company.

The risk-weight for corporate bonds is just one example of why the Basel regime is inappropriate and harmful as applied to insurers. There are many others, including the regime's treatment of insurer separate accounts, which we believe receive inappropriate treatment under the Basel regime. These separate account assets would potentially receive capital charges for risk not borne by the insurer, resulting in a substantial and unreasonable capital cost which likely would impact insurers' ability to offer these important products. Furthermore, the risk weights applied in the Basel regime would over-charge for some risks, entirely ignore others and potentially incent the wrong risk measurement and therefore the wrong risk taking behavior. In total, it is likely some insurers would be forced to hold excessive capital that could cause a contraction in credit, and negatively affect availability and affordability of many insurance products.

The State Risk-Based Capital Regime

The regulatory cornerstones to any discussion of group-wide insurance capital requirements are the State risk-based capital (RBC) models. Insurance is already heavily regulated by State law. Shortly after the United States adopted the Basel I framework for banks in 1989, insurers became subject to the State RBC regime. The State RBC framework actually consists of three distinct capital models, each tailored to the unique risk profiles of life, property and casualty, and health insurers separately. Each model determines the amount of risk-based capital required by an insurance company given its investment portfolio, business activities, and the liability risks it has assumed. Regardless of what regime the Federal Reserve imposes on insurers that are federally supervised, we will also continue to be subject to State RBC requirements. We strongly support the RBC regime and the appropriate capital standards it requires for each of the life, property and casualty, and health insurance business models.

The RBC system places particular emphasis on policyholder protection and the important differences between insurance business risks. The purpose of the RBC regime is to provide customers and regulators with a high degree of confidence that an insurer can pay all claims over the entire duration of its insurance contracts in force.

Under the State RBC system, insurers hold capital to appropriately reflect the risks of their assets and their liabilities (and indeed potential mismatches between the two). The value of certain insurance company liabilities (current and future claims) are measured by the probability and severity of likely claims over a given period of time. While insurance companies are in the business of managing risk, and most do an excellent job of it, any capital regime such as Basel III that does not properly reflect insurer liabilities and the insurance business model has the potential to increase risk, not contain it.

Conclusion

Again, thank you for the opportunity to appear before you to discuss our views on the appropriate capital regime for insurers. In conclusion, I would like to reiterate a few important points. First, we are not objecting to group supervision by the Federal Reserve. Second, we are not objecting to the concept of comprehensive group capital requirements for SLHCs or insurance SIFIs. Third, we are not objecting to utilization of the Basel III framework for our bank. Finally, we are not seeking lower capital standards—indeed we support strong capitalization as part of our core business proposition. We are simply advocating that there is no "one size fits all" model for assessing risk and by extension no universally applicable framework for determining capital requirements, that can be effectively applied regardless of business model. We believe strongly that the Federal Reserve should have the latitude to utilize any tool (or combination of tools) necessary to *effectively* assess the risk profile, and therefore capital requirements, of a holding company, taking into account material differences in their business models. Therefore, we strongly urge the passage of legislation that clarifies that the Federal Reserve has the flexibility to tailor capital rules to insurance companies under the agency's supervision. We thank you for the opportunity to comment, and look forward to being part of a bipartisan policy solution to this important issue.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

SUSAN M. COLLINS

United States Senate

WASHINGTON, DC 20510-1904

November 26, 2012

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

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20551

The Honorable Thomas J. Curry
Comptroller
Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

RE: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (RIN 3064-AD95)

Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (RIN 3064-AD96)

Regulatory Capital Rules: Advanced-Approaches Risk-Based Capital Rule; Market Risk Capital Rule (RIN 3064-AD87)

Dear Chairman Bernanke, Acting Chairman Gruenberg, and Comptroller Curry:

I am writing to comment on the proposed rules implementing the Basel III regulatory capital framework.

As the author of Section 171 (the "Collins Amendment") of the Dodd-Frank Act, I believe strongly that capital requirements must ensure that firms have an adequate capital cushion in difficult economic times, and provide a disincentive to their becoming 'too big to fail.' To achieve this, Section 171 requires that large bank holding companies be subject, at a minimum, to the same capital requirements that small community banks have traditionally faced.

During consideration of the Dodd-Frank Act, I supported modifications to the final language to Section 171 to ensure a smooth transition to increased capital standards. Among these modifications were provisions to delay, for five years, the application of new capital requirements for savings and loan holding companies ("SLHCs"), and for certain foreign-owned bank holding companies. See subsections (b)(4)(D) and (E) of Section 171. These modifications were intended to allow these entities the time they need to adjust their balance sheets and capital levels in order to come into compliance with the new capital standards. The proposed rules implement the five year delay provided to foreign-owned bank holding companies by Section 171 (b)(4)(E), but neglect to implement the nearly identical delay for SLHCs provided by Section 171 (b)(4)(E). I do not understand why the proposed rules fail to implement this provision, as required by Congressional intent and the clear language of the statute.

I am hopeful, too, that in crafting final rules, you will give further consideration to the distinctions between banking and insurance, and the implications of those distinctions for capital adequacy. It is, of course, essential that insurers with depository institution holding companies in their corporate structure be adequately capitalized on a consolidated basis. Even so, it was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime. Instead, consideration should be given to the distinctions between banks and insurance companies, a point which Chairman Bernanke rightly acknowledged in testimony before the House Banking Committee this summer. For example, banks and insurers typically have a different composition of assets and liabilities, since it is fundamental to insurance companies to match assets to liabilities, but this is not characteristic of most banks. I believe it is consistent with my amendment that these distinctions be recognized in the final rules.

I am hopeful you will keep these concerns in mind as you continue to implement the Dodd-Frank Act and the proposed rules referenced above implementing the Basel III regulatory capital framework.

Sincerely,

Susan M Collins

Susan M. Collins
UNITED STATES SENATOR

Sheila C. Bair

March 10, 2014

Chairman Sherrod Brown
Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Financial Institutions and Consumer Protection
534 Dirksen Senate Office Building
Washington, DC 20510

Re: Subcommittee Hearing: "Finding the Right Capital Regulation for Insurers"

Dear Chairman Brown and Members of the Subcommittee:

Thank you for the opportunity to present my views on the appropriate capital framework for insurance companies under the Dodd-Frank Act. I understand the insurance industry has expressed concerns about the potential treatment of insurance companies by the Federal Reserve in its establishment of consolidated capital standards for bank holding companies and nonbank financial institutions designated for heightened supervision. I agree that the Federal Reserve can and should craft a capital framework appropriate to insurance products, and should have the discretion to defer to state insurance regulators in establishing capital standards for the insurance activities which they regulate. However, I also believe that the Federal Reserve already has ample authority to do so without undermining important safeguards.

I am concerned however, that S. 1369 may unintentionally go beyond legitimate concerns about protecting the integrity of state regulation of insurance. As drafted, S. 1369 would provide a wholesale carve-out from common sense protections contained in the Section 171 of Dodd-Frank, also known as the Collins' amendment, for insurance conglomerates, including their banking and derivatives activities. This would give insurance giants a significant competitive advantage over banking organizations engaged in the same activities, and leave the door open to the kinds of highly leveraged risk-taking which contributed to the 2008 crisis. We should not forget that in 2008 AIG was also an insurance company, which took excessive risks in its non-state regulated affiliates.

A better approach would afford the Federal Reserve the opportunity to use the public notice and comment process to issue a proposal and then assess the extent to which the Federal Reserve has appropriately addressed the risks posed by these companies. To the extent Congress acts, it should only do so in a way that retains the essential protections of Section 171 of the Dodd-Frank Act: namely by clarifying the Federal Reserve's discretion to credit effective and applicable insurance capital regimes established by state insurance regulators over regulated insurance companies. Congress should not establish a wholesale carve out from Section 171's common sense capital floors.

The Collins Amendment (Section 171 of the Dodd-Frank Act) is a vital safeguard against capital arbitrage and excessive leverage. It helps protect markets, ensure a level playing field and avoid many of the regulatory mistakes that contributed to the recent financial crisis.

In the years leading up to the financial crisis, federal (and international regulators) established a series of complex, model-driven capital rules for the world's largest, most complex firms. Not only did these complex capital regimes create a host of perverse incentives that encouraged institutions to use risky-synthetic products (like synthetic CDOs) over "real" traditional alternatives (like whole mortgages), they created regulatory advantages for large firms relative to small firm competitors, fueling size, complexity and ultimately too big to fail. Section 171 helps address that risk by requiring that the largest, most complex bank holding companies and systemic institutions meet the same basic "generally applicable" capital standards that apply to other bank holding companies.

This "generally applicable" standard is not set in stone. If, at any point, regulators want to change how they create and measure that standard, they can, but they must make sure that the largest and most systemic firms can meet the same basic capital floor that applies to the smaller, less systemic ones and they must make sure that any new standards are not weaker than those standards in effect when Dodd-Frank was enacted. As discussed below, this is not a high hurdle. This floor is a common sense protection so that regulators do not again create affirmative incentives for firms to become big, levered and risky or to escape leverage constraints by moving risky activities into more lightly regulated venues.

Section 171 only applies to (1) institutions that own banks or thrifts (so called bank (or thrift) holding companies); and (2) potentially systemic institutions whose failure could pose a threat to financial stability.

To the extent insurance companies are subject to this safeguard, it is only because they are also bank/thrift holding companies or so large that they pose a potentially systemic threat. Any company can avoid complying with these basic leverage constraints by not engaging in the business of banking (i.e., not owning a bank) or not being large and potentially systemic (like AIG).

Fairness (and effective regulation) would treat all institutions engaging in the same activity the same way. If an insurance company chooses to become a bank/thrift holding company, it is reasonable that, as a bank/thrift holding company, it follow the same rules. Carving out "insurance bank holding companies" from "bank holding company" requirements would create a competitive advantage for these firms (1) when they engage in the business of banking; and (2) when traditional bank holding companies engage in the business of insurance. This dynamic also facilitates a race to the bottom that ultimately hurts their customers (who should be protected by the holding company capital buffer), the markets, and potentially taxpayers (who could suffer from the failure and cleanup).

Section 171 standards are basic, minimum, capital floors. They are not onerous and they continue to permit high leverage.

As interpreted by the Federal Reserve, Section 171 establishes the generally applicable "adequately capitalized" standards for banks as the floor. These standards are far from onerous. A 4% leverage limit for on balance sheet assets still permits debt to equity ratios of 25 to 1. Though banks are also subject to a "risk-based" capital floor, the federal banking regulators are free to craft risk weights to appropriately address insurance products, so long as the same minimum rules apply to institutions large and small. Though minimal, these Section 171 floors are still quite robust compared to the excessive levels of leverage used prior to the crisis, where large investment banks and others took on debt to equity ratios of 40 and even 50 to 1. Moreover, aggregate capital levels reported by industry trade associations such as the ACLI suggest capital ratios significantly in excess of these minimums. Thus it is hard to understand why these constraints are raising such alarm.

Capital is important for any financial institution. It protects an institution's customers – be they depositors or policy holders – by absorbing unexpected losses from bad investment or lending decisions. It protects the public by reducing the risk of destabilizing failures. And it protects government safety net programs like deposit insurance and state guarantee funds which must step in to protect the public when institutions fail. The relevant standard applicable under Section 171 is the basic standard that applies to even small community banks. This floor exists so that regulators do not again provide artificial capital advantages to large and complex bank holding companies or systemic firms, unintentionally fueling risk that create market asymmetries and imbalances. Though, the existing risk-based standards might be considered "bank-centric," they could be tailored for state regulated insurance subsidiaries under the Federal Reserve's existing authority.

Section 171 does not change state insurance capital requirements.

Banks and insurance companies are different and they continue to be treated differently under the law. Nothing in Section 171 changes the state regulation or state capital requirements of regulated insurance companies. States continue to set capital for regulated insurance company subsidiaries, just as bank agencies set capital requirements for individual bank subsidiaries. If a company lacks sufficient capital at the individual insurance company level, state rules apply. The key issue here is meeting the minimum consolidated (group) capital requirement when there is a bank/thrift holding company or a systemic institution that also has an insurance business.

The Federal Reserve has not yet even published its specific rules on this topic, making legislation premature, at best.

To its credit, the Federal Reserve understands the concerns and has stated, that in crafting specific rules, it does not believe a "one size fits all approach" is appropriate. As Federal Reserve Chairman Janet Yellen stated on Feb. 27, before the full Committee:

"We are looking very carefully to design an appropriate set of rules for companies with important involvement in insurance to recognize that there are very significant differences between the business models of insurance companies and the banks that supervise and we are taking the time that is necessary to understand those differences and to attempt to craft a set of capital and liquidity requirements that will be appropriate to the business models of insurance companies."

Given this ongoing regulatory process, Congress should wait to review and assess the Federal Reserve's rules. Though I understand the Federal Reserve has stated that it is also constrained by Section 171, absent a rule, the nature and potential impact of any constraint remains theoretical.[1] Though it is true that Section 171 applies to a bank/thrift holding company and a systemically important institution, even if it is predominantly engaged in insurance, the Federal banking agencies have broad authority to establish risk weights that credit the state-regulated insurance activities while still capturing the other, banking and potentially risky unregulated activities as they would with a bank holding company.

***If Congress ultimately decides to legislate, I strongly urge it to do so only in the most-narrow way: providing Federal Reserve with discretion to give credit for the effective and applicable capital standards of state insurance regulators*.**

This narrow approach would provide the clarity and flexibility needed without undermining the essential safeguard for holding companies and unregulated affiliates. It would also help ensure that there is a "cop on the beat" (i.e., the relevant state insurance regulator) who is accountable for his/her capital regime and for the protection of state insurance policyholders. To the extent a firm is also engaged in non-insurance activities, or other AIG like synthetic risk-taking, it should not be carved out from this common sense capital floor just because it also has a large insurance business. It should apply equally to all firms engaging in the same activity.

***Unfortunately S. 1369 is too broad and would undermine the protections afforded by Section 171 and create a host of artificial advantages for these firms that could reduce their safety and soundness and set the stage for more AIG-type failures*.**

S. 1369 goes well beyond clarifying the Federal Reserve's authority and would instead provide a wholesale carve out, not just for state regulated insurance subsidiaries, but for all activities if the consolidated entity is "primarily engaged in the business of insurance." Given the broad definitions, I fear that even AIG, in 2008, might have been carved out under this broad approach because it had a large insurance business.

[1] I agree with many commenters that the Federal Reserve has significant authority to address reasonable issues. See e.g., Letter from 30 Members of Congress to Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, December 11, 2012; Letter from A. Patrick Doyle, Arnold & Porter LLP et. al, to Scott Alvarez, General Counsel, Federal Reserve Board, Mar. 20, 2013 at 5; and Letter from H. Rodgin Cohen, Sullivan & Cromwell to MetLife, May 20, 2013;

Moreover, even today – with AIG being designated by the FSOC for heightened prudential standards – they might be carved out from Section 171 if they meet the broad "primarily engaged" test. Though Section 165 of the Dodd-Frank Act could be used to recapture the systemic firms, eliminating the capital floor leaves open the possibility that regulators could again impose lower/weaker standards at large, systemic firms as they did before the financial crisis. If stronger protections and higher capital are needed for large, potentially systemic financial institutions (and I believe they are), why remove the floor that helps provide basic protections and a level playing field?

While I understand there maybe disagreements about whether individual insurance companies are potentially systemic, once a firm is designated, there is no reason why they should have lower capital standards than bank holding companies – or even community banks – under the basic "generally applicable" standards simply because they are "primarily" insurance. Permitting the Federal Reserve to credit effective capital standards established for state regulated insurance subsidiaries is one thing: a wholesale carve out from these minimum standards for all activities, is another, particularly in light of the lessons learned from AIG in 2008.

Insurance companies are not risk-free

Though insurance companies are different than banks, it is important to remember that they put their money in many of the same assets: government and corporate bonds, mortgage-backed securities, and real estate loans. Indeed, according to the American Council of Life Insurers' data, life insurers have over a trillion dollars in real estate exposure, including $600 trillion in mortgage-backed securities and $354 billion in commercial and residential mortgages. Though their run-risk may be different from banks, it is real. While banks hold short-term deposits, most are backed by the FDIC, and are quite stable, as we saw during the crisis. Even if we concede these differences, insurance policy holders can "run," just differently. A life insurance policy is not indentured servitude. Policyholders can cash out whole life and annuity products, and halt premium payments on term products. Indeed, one of the biggest life insurance failures – $15 billion Executive Life – suffered debilitating policy surrenders contributing to its failure in 1991.

I question the argument that insurance organizations should have weaker bank/thrift holding company protections because their insurance policy holders can't easily cash out if they make bad investments. This holding company capital is there to absorb unexpected losses, capture risks in their unregulated entities, and protect customers and the markets from their potential failure. All these risks exist in a bank/thrift holding company or a systemically important financial institution, even if that firm also happens to have a large insurance business. Moreover, given the long-term nature of life insurers' obligations to their policy holders, they are exposed to substantial risk based on market fluctuations and turns in the economic cycle. Thus, it could be easily argued that they need more, not less, capital than banks based on the long tail of their liability structure.

A more valid argument is that state regulated insurance companies are already subject to oversight by state regulators who are experts in the risk of insurance. Therefore, these institutions do not need another layer of federal standards. This argument would be more compelling if the Federal Reserve had already written rules and if they needed a narrow clarification of authority.

To go beyond a narrow clarification would undermine federal capital standards for all their businesses, including their unregulated U.S. affiliates, their overseas activities and their banking business. We should remember it was not AIG's state-regulated insurance business that got it into trouble; it was its derivatives business in London.

Conclusion

During the years leading up to the crisis, there was a substantial amount of regulatory arbitrage between bank holding companies and nonbank institutions (investment banks, GSEs, AIG), as well as between large and small banking institutions, with complex, mega institutions being able to operate with thinner capital cushions than the average community bank. The Collins Amendment/Section 171 was designed to strengthen the integrity of capital standards by imposing a generally applicable floor that would constrain destabilizing leverage for all systemic institutions, regardless of business model, so that they would have to hold at least as much capital as that generally required of smaller banks.

Though I understand the desire to proactively address an issue that could become a problem, there are substantial downside risks for consumers and the markets. As it moves forward, I hope the Committee will go slow and consider the risks and tradeoffs before changing this important safeguard. To its credit, Congress has thus far chosen not to reopen Dodd-Frank, and instead has afforded regulators the opportunity to implement its provisions through an open rulemaking process before considering changes. I believe that legislation is unnecessary and that the Federal Reserve has ample discretion under current law to craft appropriate capital rules for insurance companies that are systemic or that are bank/thrift holding companies. If the Congress ultimately decides to legislate, I strongly urge it to do so only in the most-narrow way: providing Federal Reserve with discretion to give credit for the effective and applicable capital standards of state insurance regulators.

In considering legislation in this area, the key question for Congress to consider is whether systemic institutions, as well as those with access to the federal safety net through their ownership of a federally insured bank, are sufficiently capitalized. If a company lacks sufficient capital to meet the Fed's basic (and still undefined) standards – Congress should then examine whether requiring additional capital of that institution is an undesirable policy result. Millions of Americans rely on these companies to safeguard their assets, and fulfill their legal obligations to them. It would be a terrible mistake to eliminate an important safeguard only to later learn that firms are, or became, more risky than had been previously assumed.

Respectfully,

Sheila C. Bair

Sheila C. Bair

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

R. BRUCE JOSTEN
EXECUTIVE VICE PRESIDENT
GOVERNMENT AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D.C. 20062-2000
202/463-5310

March 10, 2014

The Honorable Sherrod Brown Chairman Subcommittee on Financial Institutions and Consumer Protection Committee on Banking, Housing, and Urban Affairs United States Senate Washington, DC 20510	The Honorable Patrick J. Toomey Ranking Member Subcommittee on Financial Institutions and Consumer Protection Committee on Banking, Housing, and Urban Affairs United States Senate Washington, DC 20510

Dear Chairman Brown and Ranking Member Toomey:

The U.S. Chamber of Commerce, the world's largest business federation representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and dedicated to promoting, protecting and defending America's free enterprise system, thanks you for holding a hearing entitled *Finding the Right Capital Regulations for Insurers*.

The Chamber would like to bring your attention to several issues of importance. Capital requirements, if applied judiciously and appropriately, can be a pro-growth tool to promote stability and reasonable risk taking in the banking system. This is why the Chamber proposed using capital requirements as an alternative to the Volcker Rule. However, the use of capital requirements in the context of regulating systemically important non-bank financial companies can be a mismatch of policy and marketplace realities that may in fact harm the American economy. This is particularly true of the insurance industry.

Insurers must match their assets with potential liabilities over a long-time horizon. This system has worked well, and insurers have historically not been subject to runs—exactly the types of situations that capital requirements and similar tools are designed to prevent. Using bank centric capital requirements on insurance companies hampers the ability of insurers to efficiently match their assets with their liabilities. Placing capital requirements on insurance companies tries to solve a problem they do not experience and destabilizes their business model, endangering the ability of insurers to meet the needs of the insured. Insurers are also the largest long-term investors in the global economy, providing the resources and liquidity used by the business community to grow and create jobs.

Accordingly, the use of bank style capital requirements on insurance companies will harm insurers, imperil the ability of the insured to mitigate their risk, and restrict liquidity, making the capital markets inefficient. None of these outcomes will promote financial stability.

The Chamber believes that capital requirements for non-bank financial companies designated as being systemically important financial institutions ("SIFIs") should be tailored to fit the business model of those businesses. Furthermore, Congress recognized this principle with the passage of the bipartisan Pryor-Vitter amendment to the Dodd-Frank Act, which limited the consideration of SIFI designation of non-bank financial companies to specific banking activities.

The Chamber asks you to consider these issues as you hold this important hearing and looks forward to working with the Subcommittee to implement solutions that appropriately tailor capital requirements to business models, thereby enhancing financial stability and preserving the reasonable risk-taking needed for businesses to grow and create jobs.

Sincerely,

R. Bruce Josten

R. Bruce Josten

cc: Members of the Subcommittee on Financial Institutions and Consumer Protection

AMERICAN ACADEMY *of* ACTUARIES

U.S. Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on
Financial Institutions and Consumer Protection

Hearing on
Finding the Right Capital Regulation for Insurers

Submitted Testimony of

William C. Hines, MAAA, FSA
Vice President, Risk Management and Financial Reporting
American Academy of Actuaries

March 11, 2014

The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Chairman Brown, Ranking Member Toomey, and distinguished members of the committee, on behalf of the American Academy of Actuaries, I appreciate the opportunity to provide you with the following written testimony to inform your hearing on "Finding the Right Capital Regulations for Insurers."

Central to the work of actuaries is the evaluation of risk, primarily in the context of financial security programs such as those offered by insurance organizations. Members of the American Academy of Actuaries have worked closely for decades with insurance and other financial service regulators in developing various prudential regulations including solvency measures such as required capital. With this wealth of knowledge as background, we offer the following views on developing required capital for insurers. This testimony is intended to speak only to the matter of capital requirements in place under state laws and how the current risk-based capital (RBC) system works.

Overview

- Capital requirements should protect an insurer's ability to fulfill its obligations to its policyholders against losses incurred from its exposure to material risks ranging from investment losses to high levels of claims.
- Minimum capital requirements define the minimum amount of funds an insurer should have to safely discharge the obligations of the insurance company.
- The calculation of capital requirements should measure an insurer's exposure to material risks and allow the regulator to identify weakly capitalized insurers. The level of required capital should distinguish the risks of one insurer from another.
- The level of capital held should pre-fund risks according to the statistical confidence over a defined time period defined by the prudent regulator (e.g., pre-fund risks expected to materialize over a 10-year time horizon with a 95 percent probability).
- On their own, capital requirements cannot be expected to fully cover all risks. Capital funds are not the only or best way to address every company risk, and the impact of some risks is difficult to measure credibly and pre-fund. Other regulations and company practices often augment capital requirements and could do a better job in mitigating certain risks (e.g., liquidity vehicles, reserve requirements).
- The capital requirements for insurers must be defined within the broader context of regulating an insurer's solvency position, including conservative accounting and valuation standards, financial examinations, regulatory approval of certain transactions, and required disclosures regarding an insurer's financial position.
- Insurance companies may choose to, and generally do, hold capital in excess of regulatory requirements.
- Further, the capital requirements for insurers must be established in recognition of the nature of the business of insurance as distinct from other financial services. The business models for insurance companies and other financial institutions are very different in terms of the needs of the consumers, the nature of the risks transferred, and the timing and certainty of generating profits. Banks and insurance companies operate under different accounting regulations and regulatory systems.

- While the calculation of risks and the associated capital requirements can be very sophisticated and complex, capital regulations are only effective if coordinated with available supervisory resources. If there are not sufficient regulatory resources available to facilitate a complex framework, then the benefits of a more sophisticated approach will be minimized and the capital regulation less effective.
- There are, of course, economic factors that require a balanced focus. Attempting to ensure insurer solvency can result in conservatively high requirements if overly stringent capital requirements are imposed. This in turn could damage policyholder interests in the long term by impeding competition and potentially creating affordability and accessibility problems. For instance, in health care, when carriers have to meet high standards, especially those based on health care costs, they have to meet surplus requirements through profits or other means. This could cause some carriers that do not have access to capital markets (e.g., not-for-profit companies) to be unable to compete. Many carriers could attempt to meet increased surplus requirements by raising premiums. In the case of health insurers, the federal medical loss ratio rebate formula requires premium rebates if profits are too high and, therefore, may make increased solvency requirements difficult or impossible to meet in the short term.

Development of Risk-based Capital Regulation

The National Association of Insurance Commissioners' (NAIC) Risk-Based Capital (RBC) system for property/casualty, life, and health insurers was developed in the early 1990s. From the beginning, actuaries were involved in designing the methodologies needed to put into place a uniform system for regulators and insurance company management to assess the risks and act appropriately in the case of inadequately capitalized insurers. The main purpose of this system was and is to define a minimum capital level used as an early warning tool to identify weakly capitalized companies and to establish solvency levels that trigger regulatory actions. The RBC formula, in conjunction with the rest of the solvency regulatory structure, has likely served an important role in limiting the number and financial costs of insolvencies in the insurance industry.

The objectives, as generally accepted, for the RBC system during its development were as follows: create a relatively simple formulaic structure that would identify potentially weakly capitalized companies; design a formula that would be applied to all companies based on publicly available information; provide a regulatory tool that requires more extensive review of an individual company's risks and capital (including proprietary models and other detailed analysis) for those companies that were likely to be, or are, weakly capitalized to determine if corrective actions are needed; and establish an objective standard for triggering regulatory action, including the authority to take over a company under certain conditions, such as falling below a certain capital level.

In the years since RBC has been in place, other benefits have been observed, including, in some cases, motivating insurers to avoid undesirable levels of risk (from a policyholder perspective) and promoting a risk measurement and management culture within a company. Most insurers look to establish a level of capital to achieve or maintain their desired credit rating in addition to satisfying regulatory minimums and internal company standards. A company will use certain metrics to establish a target for the level of capital held. Considerations in establishing such metrics include: 1) ease of access to external capital; 2) organic growth needs; 3) mergers and acquisitions plans; 4) parental guarantees; 5) support of affiliated insurers; 6) capital investment needs; 7) return on capital profit targets; 8) availability of funds from parent or affiliates; 9) perceived volatility in reserves or operating results; and others

The three RBC formulas (i.e., P/C, life, health) are different according to the nature of the inherent risks brought on by particular insurance products sold by insurers as well as the business models unique to each of the insurances types. In other words, the formula is used to capture the material risks that are common for the particular insurance type. For example, interest rate risk is included in the life RBC formula because for life insurers, there is material risk of losses due to changes in interest rate levels for many of the life insurance products they sell.

Risks included in the RBC formulas include:[1] Asset Risk – Affiliates; Asset Risk-Other (including credit risk, interest rate risk, and market risk); Underwriting Risk or Insurance Risk; and Business Risk.[2]

By estimating the risks faced by an insurer, company management and regulators are able to see how its risk profile measures up to the minimum required capital. In more technical terms, they are comparing the insurer's *Total Adjusted Capital* to its *Authorized Control Level*. The outcome of this leads to one of the five following actions.

- Take no action: Total Adjusted Capital of 200 percent or more of Authorized Control Level (ACL) results in "no action."
- Company Action Level (200 percent of ACL)
- Regulatory Action Level (150 percent of ACL)
- Authorized Control Level (100 percent of ACL)
- Mandatory Control Level (70 percent of ACL)

Throughout the 20-plus years that the RBC system has been in place in the U.S., the factors underlying each of the formulas have been examined by the NAIC, and many have been adjusted to reflect evolving product designs, evolving knowledge of risks themselves, risks that were missing from the formulas, and consideration of the appropriate impact of the correlation of risks. In recent years, there have been innovations in the life formula on a more principle-based approach to determining capital through modelling that tailor the risk-based capital to the specific risks to which a company is exposed. The P/C formula has been under scrutiny because it does not include natural catastrophe risk, and discussions are ongoing to bring that risk into the formula. The health formula is currently being reviewed in light of potential risks from the difficulty in estimating risk adjustment receivables or

[1] For more complete information on risk factors broken out by insurer type, see Appendix.
[2] Operational risks are also inherent in several aspects of RBC and statutory accounting.

payables, reinsurance receivables from the transitional reinsurance program, and receivables and payables from the risk corridor program by issuer.

When looking at capital regulation considerations in the U.S., it is instructive to look at other available tools, such as those coming out of new solvency regimes, some of which are occurring internationally, and which are also taking root in the U.S. These solvency guideposts can provide more information on insurer risk. While RBC defines the minimum requirements using a simplified measurement of an insurer's risks, risk-focused regulatory examinations and own-risk and solvency assessment (ORSA) filings provide additional information to the regulator on an insurer's unique risk profile.

These mechanisms fill out a range of tools that U.S. regulators have available to them to gain further information on individual and group insurers' overall risk positions. Actuaries are working on these and other ways to provide solutions in these areas of emergent public policy. The American Academy of Actuaries commits to be of service to you in your exploration of regulation of insurer capital. Thank you for your interest and consideration of these remarks.

Appendix

Each of the three NAIC RBC formulas includes a covariance calculation of their respective risk factors, identified by unique codes as identified below. Covariance is a process of taking into account interdependence of the risks and of combining risk charges into one:

Life risk-based capital formula includes:

C0 – Asset Risk – Affiliates;
C1 –Asset Risk – Other;
C2 – Insurance Risk;
C3 – Interest Rate Risk, Health Credit Risk, and Market Risk;
C4 - Business Risk.

Property/Casualty risk-based capital formula includes:

R0 – Asset Risk – Subsidiary Insurance Companies;
R1 – Asset Risk – Fixed Income;
R2 – Asset Risk – Equity;
R3 – Asset Risk – Credit;
R4 – Underwriting Risk – Reserves;
R5 – Underwriting Risk – Net Written Premium;
R6 – Catastrophe Risk – Earthquakes (not yet adopted by the NAIC);
R7 – Catastrophe Risk – Hurricanes (not yet adopted by the NAIC).

Health risk-based capital formula includes:

H0 – Asset Risk – Affiliates;
H1 – Asset Risk - Other;
H2 – Underwriting Risk;
H3 – Credit Risk;
H4 – Business Risk.

Each of the broad categories of risk charges identified above includes a number of specific risk factors that can affect the solvency of an insurance company.

The existence of three separate formulas reflects some fundamental differences in the way life, health, and property/casualty insurance companies operate and the risks to which they are exposed.

ACLI
Financial Security...for Life.

Statement for the Record
U.S. Senate Committee on Banking, Housing & Urban Affairs
Subcommittee on Financial Institutions and Consumer Protection
Hearing titled "Finding the Right Capital Regulations for Insurers"

March 11, 2014

The American Council of Life Insurers (ACLI) is pleased to submit this statement for the hearing record expressing the concerns of the life insurance industry regarding the application of bank capital standards such as Basel III to insurers.

The American Council of Life Insurers is a Washington, D.C.-based trade association with more than 300 legal reserve life insurer and fraternal benefit society member companies operating in the United States. ACLI advocates in federal, state and international forums. Its members represent more than 90 percent of the assets and premiums of the U. S. life insurance and annuity industry. In addition to life insurance, annuities and other workplace and individual retirement plans, ACLI members offer long-term care and disability income insurance, and reinsurance. Its public website can be accessed at www.acli.com.

Through authorities provided in the Dodd-Frank Act, the Federal Reserve Board (FRB) regulates at the holding company level a number of companies that are primarily life insurers. The Dodd-Frank Act granted the FRB new supervisory authority over savings and loan holding companies (SLHC's), many of which are, or own, life insurers. The Dodd-Frank Act also authorized the FRB to supervise nonbank financial companies designated as systemically important by the Financial Stability Oversight Council (FSOC), some of which may be insurers. Section 171 of the Dodd-Frank Act (the Collins Amendment) authorizes the FRB to establish capital standards for these insurance companies.

In July 2013 the FRB issued a final rule implementing Basel III for Bank Holding Companies and Savings & Loan Holding Companies. The rule included a temporary exemption for insurers that are or are owned by SLHCs to allow for further evaluation of appropriate consolidated standards for those companies. Similarly, the FRB's February 2014 rule implementing enhanced prudential standards for systemically important financial institutions (SIFI's) (Section 165 of the Dodd-Frank Act), explicitly does not apply to insurers so that the FRB can study and develop appropriate standards for those companies. However, as a result of section 171 of the Dodd-Frank Act, it remains unclear how or if the FRB will apply Basel III to those insurers. The ACLI is strongly opposed to the application of bank-centric capital standards such as Basel III to insurance companies.

Life Insurers Strongly Support Appropriate Capital Standards

The ACLI strongly supports appropriate rules intended to ensure the capital adequacy of insurance companies. The ACLI believes that any consolidated capital standards developed by the FRB for insurance companies should be insurance-based capital standards modeled on the current insurer risk-based capital system (RBC). RBC was specifically designed by insurance regulators for insurance company entities and is a holistic and comprehensive measure of their unique risks.

RBC recognizes the unique characteristics of insurance companies' business models and balance sheets, which are very different from those of banks. Specifically, it recognizes that premiums are collected in advance and invested ahead of anticipated claims, that insurers have relative predictability of those claims, and that products have safety mechanisms such as surrender charges to protect against illiquidity. Unlike banks, which are typically exposed to large amounts of highly liquid demand deposits, insurers have longer-term liabilities and therefore find that longer-term assets, even those with higher short-term volatility, pose less risk and are a key component to the long-term viability and financial strength of an insurer.

In addition to capturing credit risk of fixed income investments and the risk of fair value losses from equity (and similar) investments, RBC also captures many other risks, such as asset risk, insurance/underwriting risk, interest rate risk, and business risk, as well as differentiating between insurance industry structures (life, property & casualty, and health). Over more than twenty years, RBC has been and continues to be repeatedly reviewed and refined, reflecting changing conditions and increasing sophistication of modeling techniques.

The foundation of RBC is statutory accounting where both assets and liabilities are valued conservatively. This results in an appropriately prudent measure of surplus as the starting point for the RBC calculation. Statutory accounting also takes a long-term oriented asset/liability matching posture that appropriately incents companies to invest for the long term. It intentionally avoids application of fair value accounting rules to most life insurance company assets, thereby avoiding unwarranted volatility in regulatory capital. Such short-term volatility is usually inappropriate, particularly for life insurers that typically have long-term and inherently stable liability structures.

All U.S. insurance companies currently prepare statutory accounting statements, as is required by law, whereas many life insurance companies do not prepare GAAP-based financial statements. Requiring GAAP-based financial statements coupled with a bank-centric capital adequacy regime would unnecessarily result in an additional and competing set of financials and capital measures for many companies.

The ACLI believes the insurance-based principles and methodologies of RBC should be the model for any FRB rulemaking on consolidated capital standards for the insurance companies under its supervision. Insurance-based capital standards would provide the FRB with the best measure of the capital adequacy and risks unique to insurance operations.

Bank Standards are Wrong for Insurers and Insurer Supervision

The Basel capital framework is a capital framework designed specifically for banks by bank regulators. It was never intended to be applied to insurance companies and it would be inappropriate to do so. A bank-centric Basel framework is disconnected from the risks specific to insurance and would provide a distorted view of the financial strength or weakness of an insurance company. In short, life insurance companies have significantly different business models, risk profiles, and capital structures than banks.

Life insurers provide coverage to customers for their long-term risks, and their regulation requires them to match those long-term, illiquid liabilities with appropriate assets to ensure that those liabilities can be met. Current life insurer capital requirements directly reflect the level to which an insurer has matched the duration of its assets to the duration of its liabilities. This business model is fundamentally different than that of banks, where assets and liabilities are not matched and where the institutions are more dependent on short-term, on-demand funding, and are thus potentially subject to a "run" in periods of stress. Banking capital requirements implicitly assume this inherent mismatch. The business models, risk profiles and capital structures of life insurers and banks are so divergent that it would be incongruous to attempt the application of a single, one-size-fits-all capital standard to both.

The application of a bank-centric Basel framework to insurers would very likely have the opposite effect of that intended, disrupting sound insurance companies and incentivizing the wrong activity. The application of bank-centric capital standards to insurance companies would harm the risk management frameworks that insurers have in place to manage the risks that arise from their traditional business. Bank-centric standards would harm the ability of life insurers to perform their fundamental business of delivering long-term, guaranteed financial security products to millions of families and retirees. Disrupting the operations of well-run life insurance companies is completely at odds with the purposes of the Dodd-Frank Act and should not be permitted to occur.

The Dodd-Frank Act Authorizes the FRB to Apply Equally Robust Insurance Capital Standards

The ACLI believes that Section 171 of the Dodd-Frank Act authorizes the FRB to apply insurance-based capital standards to meet the requirements under that section. Section 171 provides that the risk-based and leverage capital requirements "shall not be less than" nor "quantitatively lower than" the generally applicable minimum requirements under Basel III. This language clearly empowers the FRB to apply insurance-based standards similar to insurance RBC so long as they are not "less than" nor "quantitatively lower than" the minimum bank risk-based and leverage capital requirements. ACLI urges the FRB to use this authority to develop an appropriate methodology for insurance entities that is modeled on insurer RBC.

ACLI Strongly Supports S. 1369 Authored by Senators Sherrod Brown and Mike Johanns

In the absence of FRB action to use its existing authority to develop insurance-based capital standards for insurance companies, the ACLI supports a legislative solution. ACLI strongly supports S. 1369, legislation authored by Senator Sherrod Brown (D-OH) and Senator Mike Johanns (R-NE), that would clarify the FRB's authority to develop insurance-based capital standards for the insurance companies under its supervision. This common sense legislation would facilitate strong prudential supervision of insurance companies and prevent unnecessary disruptions in the insurance marketplace. ACLI looks forward to working with the Senate in support of this important legislation. ACLI also supports similar efforts in the House led by Representatives Gary Miller (R-CA) and Carolyn McCarthy (D-NY). Finally, ACLI appreciates the leadership of Senator Susan Collins (R-ME), author of Section 171 of the Dodd-Frank Act, who has consistently supported proper implementation of the Collins Amendment and application of appropriate capital standards.

Thank you for convening this important hearing and for your consideration of the views of ACLI and its member companies.

Statement of the American Insurance Association

Before the

Committee on Banking, Housing, and Urban Affairs

Subcommittee on Financial Institutions and Consumer Protection

United States Senate

"Finding the Right Capital Regulations for Insurers"

March 11, 2014

Statement of the American Insurance Association

"Finding the Right Capital Regulations for Insurers"

The American Insurance Association (AIA) appreciates the opportunity to submit comments to the Subcommittee on Financial Institutions and Consumer Protection on the subject of finding the right capital regulations for insurers. AIA represents approximately 300 of the nation's leading insurance companies that provide all lines of property and casualty insurance to consumers and businesses in the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums.

Our members have a strong interest in ensuring that implementation of prudential standards required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) for holding companies and nonbank financial companies supervised by the Federal Reserve Board (Board) are applied to companies engaged in the business of insurance in a manner consistent with the Act's intent of differentiating among the financial sectors and do not reflect a single, monolithic approach.

We are heartened by statements of Chair Yellen during recent testimony and Board actions in establishing enhanced prudential standards for certain bank holding companies and foreign banking organizations. These statements and actions indicate the Board's recognition that insurers are different than banks, and measures and requirements applicable to banking organizations cannot be mechanistically applied to insurers and companies that control insurers.

Insurance regulation emphasizes policyholder protection and the ability to provide capital to meet insurance consumer demand. As a general matter, therefore, capital is maintained at the operating company level so that it can be deployed to cover insured losses. In the U.S., capital is not generally maintained at the holding company level to serve as a source of strength to the operating companies, as that would erode the primary objective of protecting policyholders. U.S. financial regulatory standards and resolution mechanisms for insurers support this objective. Equally important, while some sections of the Dodd-Frank Act grant the Board prudential supervisory authority over certain entities that engage in the business of insurance, nothing in the Act was intended to change the fundamental nature of insurance regulation.

Section 165 of the Dodd-Frank Act

As the Subcommittee knows, Section 165 of the Dodd-Frank Act directs the Board to establish prudential standards for bank holding companies with total consolidated assets of $50 billion or more, and for nonbank financial companies that the Financial Stability Oversight Council (FSOC or Council) has designated for supervision by the Board, in order to prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities of, large, interconnected financial institutions. The Board has stated that it possesses authority under Section 165 to apply the standards it establishes in a manner that differentiates among companies on an individual basis, or by category. Accordingly, the Board applied its final rules relating to enhanced supervision and regulation of covered companies in a manner that takes into account differences and risk characteristics among covered companies based on these factors.

However, the Board determined not to impose its enhanced prudential standards on nonbank financial companies supervised by the Board. Rather, the Board stated its intent to separately issue orders or rules imposing standards on each nonbank financial company subject to its supervision. For those nonbank financial companies that are similar in activities and risk profile to bank holding companies, the Board expects to apply enhanced prudential standards that are similar to those that apply to bank holding companies. For those that differ from bank holding companies in their activities, balance sheet structure, risk profile, and functional regulation, the Board stated that it expects to apply more tailored standards, after providing prior notice to affected companies and opportunity to comment. AIA supports the Board's actions to address the unique nature of nonbank financial companies subject to its supervision, and we look forward to the opportunity to comment on its standards when they are proposed.

Section 171 of the Dodd-Frank Act

At the same time, AIA is concerned that the language of Section 171 of the Dodd-Frank Act, often referred to as the Collins Amendment, may be interpreted to undermine the Board's conclusion that one size cannot fit all. As the Subcommittee is aware, Section 171 requires the Federal banking agencies to establish minimum leverage and risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies (i.e., bank and savings and loan holding companies) and nonbank financial institutions supervised by the Board. The minimum requirements cannot be lower than the requirements in effect for depository institutions as of the date of enactment of the Dodd-Frank Act. The Board has stated that it is constrained by the language of Section 171 and does not have flexibility to take into account differences among financial institutions when it implements the requirements of that section. The inability of the Board under Section 171 to tailor the leverage and risk-based capital requirements will have the effect of negating its recent actions taken under Section 165. Clearly, that was not the intent of Congress. Accordingly, we urge Congress to provide the Board with the authority needed to reflect the objectives Congress established for the Dodd-Frank Act. To that end, we reiterate our support for legislation (S. 1369) introduced by Chairman Brown and Senator Johanns. That legislation would clarify the Board's ability to tailor appropriate insurance-based capital standards for the insurance companies under its supervision. We thank the Chairman and Committee for your efforts on this important issue.

Property-Casualty Insurers Are Not a Source of Systemic Risk

The Dodd-Frank Act addresses potential sources of instability to the financial system or U.S. economy to prevent future financial crises. For reasons flowing from the insurance business model and detailed in numerous submissions to the Board to FSOC during the Dodd-Frank Act rulemaking process, the property-casualty insurance industry has not been and is not a source of instability to the financial system or U.S. economy. Accordingly, we believe that very few nonbank financial companies will be designated as Systemically Important Financial Institutions (SIFIs) because of their property-casualty insurance activities. However, some bank and savings and loan holding companies are, or may become, affiliated with insurers. We believe it is important that the standards developed by the Board and the agencies under Section 171 and other provisions of the Dodd-Frank Act reflect the distinction between insurers and banking organizations.

Finding The Right Capital Requirements

The process for finding the right capital requirements for property-casualty insurers is not an easy task. There are ongoing efforts, both domestically and internationally, to modernize financial regulation of insurers and to fill any perceived or real gaps revealed during the financial crisis.

The National Association of Insurance Commissioners (NAIC) has undertaken a Solvency Modernization Initiative, which seeks to enhance the regulatory review of capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance. One of the tools for accomplishing this is an "Own Risk and Solvency Assessment," whereby an insurer would conduct an internal assessment of the risks associated with its current business plan and the sufficiency of capital resources to support those risks.

The European Union also has taken action and is in the process of implementing Solvency II, which addresses supervisory review/governance and risk management; market discipline through supervisory reporting and public disclosure; and includes group-wide determinations on quantitative capital requirements.

In addition, the International Association of Insurance Supervisors (IAIS) is proceeding to establish a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), which seeks to promote more effective supervision of these insurance groups, and regulation that is more reflective of their business practices. The IAIS has also developed a methodology and policy measures that would be applied to Global Systemically Important Insurers (G-SIIs). Further, at the direction of the Financial Stability Board (FSB), the IAIS is working on multiple quantitative insurance capital workstreams. The IAIS work includes a "basic capital requirement" (BCR) that is intended as a foundation on which to build targeted higher loss absorbency (HLA) for systemic activities of G-SIIs. The IAIS has also indicated that the BCR will inform its development of an insurance capital standard (ICS) for internationally active insurance groups under ComFrame.

Further, the development of suitable capital standards depends upon a financial accounting framework that consistently and fairly reflects the capital resources of an insurance group. The U.S. accounting standard-setter, the Financial Accounting Standards Board, recently completed its comparative review of the existing financial reporting model for short duration contracts with a radically different model that has been proposed by the International Accounting Standards Board, and determined that only targeted disclosure improvements are needed, rather than pursuing a proposal that would have overhauled the U.S. insurance accounting framework. Although unlikely, a convergence by both accounting boards would create a common, global accounting approach for valuing capital resources.

And finally, in December, the Federal Insurance Office released its study of how to modernize and improve the system of insurance regulation in the United States. The FIO's report contains important recommendations regarding capital adequacy and other modernization measures.

These ongoing state, federal and international modernization efforts will result in an enhanced insurance regulatory structure and capital standards in the U.S. and internationally. Of necessity, the results of these endeavors must be taken into account in order to find the right capital regulations for insurers.

Conclusion

At first glance, finding the right capital regulations for insurers may sound like an elusive task. It is clear, however, that the requirements must be fashioned to appropriately reflect that insurers are different than banks. With measured consideration, we are confident that the agencies can achieve the right result. AIA looks forward to working with the Board, other agencies, and Congress to ensure that any rules reinforce the insurance business model and promote market competition while protecting policyholders.

PCI

Property Casualty Insurers
Association of America
Advocacy. Leadership. Results.

Property Casualty Insurers Association of America (PCI)

"Finding the Right Capital Regulations for Insurers"

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

March 11, 2014

Thank you Chairman Brown and Ranking Member Toomey and Members of the Senate Banking Committee for the opportunity to provide testimony on the important issue of "Finding the Right Capital Regulations for Insurers". PCI strongly supports efforts by Congress to ensure that any capital standards for insurance holding companies with depository institution affiliates be appropriately tailored to the business of insurance.

The Property Casualty Insurers Association of America (PCI) is comprised of over 1,000 member insurance companies who write over $195 billion in premium, which represents 39 percent of the home, auto and business insurance protection written in the United States. In addition to providing policyholders protection from property and casualty related risks, a number of our members also own community banks or other relatively small depository institutions which provide basic services.

PCI supports a strong capital regime for insurance companies, which protects policyholders and supports our members' commitment to financial strength. However, as the International Association of Insurance Supervisors (IAIS) concluded in its report on insurance risk,

> *[The] traditional insurance business model is different from banking.... The risk profile of an insurer becomes less risky the more risks are assumed, i.e. the larger it is and the more diversified its business is (the more lines of business it writes).... The insurance business model also has several unique features which are not typically found in banking... [and in] general, insurance underwriting risks are not correlated with the economic business cycle and financial market risks and the magnitude of insurance events is not affected by financial market losses. The nature of insurance liabilities, and the fact that payments to policyholders generally require the occurrence of an insured event, makes it less likely for insurers engaged in traditional activities to suffer sudden cash runs that would drain liquidity.*[1]

Forcing bank capital standards onto an insurance company makes no more sense than imposing standards designed for auto insurers onto banks. They are fundamentally different businesses, with different risks, leveraging, and regulatory focus on insurance legal entities versus banking source of strength. While the Federal Reserve Board needs the ability to protect the soundness of the banking system, this goal is not advanced in any meaningful way by imposing one-size-fits-all bank capital rules on holding companies that are primarily in the business of insurance.

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[1] IAIS report on Global Systemically Important Insurers: Initial Assessment Methodology (18 July 2013)

Unfortunately, as acknowledged by Janet Yellen in recent congressional testimony, an unintended consequence of section 171 of the Dodd Frank Act, the ownership of a bank by an insurance group subjects insurance companies in the group to bank- centric capital requirements. While the Federal Reserve Board has acted prudently in delaying imposition of bank capital standards on insurers until Congress can rectify the situation, the potential burdens under the Dodd-Frank Act are already causing many PCI members to quit the banking industry, with nearly half of our members with depository institution affiliates dropping off that list or considering divesting their affiliations in the near term. Such affiliations can provide important community and customer services and insurers in some cases can be a financial anchor for depository institutions. But the potential regulatory costs and challenges involved are causing many companies to vote with their feet. While Congress chose in the Dodd-Frank Act not to unwind the Gramm-Leach-Bliley Act's repeal of Glass-Steagall, without further legislative relief, the required imposition of bank capital standards on insurers will so unfairly tilt the regulatory playing field against those entities that it will impair their competitiveness and make such affiliations decreasingly tenable.

The Federal Reserve has repeatedly stated in testimony that the language in section 171 of the Dodd Frank Act requires it to impose a Basel III-like, bank-centric capital regime on insurance holding companies that own a bank as well as insurers that are designated as systemically important financial institutions (SIFIs). The statutory language requires that the generally applicable capital requirements shall not be lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions at the date of enactment. However, Senator Collins, the author of this language, has stated in writing to the federal banking regulators that "it was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime."

The business and regulatory model of banking is so significantly different than that of property casualty insurers that it is not conducive to an identical capital regime. For example, a significant difference is that, unlike banking, there can be no "run" on the assets of a property casualty insurer. Other than payments for a covered loss, the only claim a policyholder can make on the assets of an insurer is for the return of unearned premium if an insured cancels a policy or requests a reduction in coverage, both actions that reduce the insurer's risk. Similarly, the occurrence of auto accidents or storms are not correlated with economic downturns for insurers like interest rates or lending are for banks, resulting in very different risk exposures. Traditional insurance is thus not systemically important and lacks the same domino effect and need for a safety net and insurers do not have the same capital pressures or demand.

Insurance companies are currently subject to rigorous, tailored capital requirements at the state level under the state risk-based capital (RBC) system. Risk-based capital was developed by insurance regulators to get away from fixed capital standards in order to tailor requirements based on individual insurer's risk profiles, condition and size. RBC analysis captures risk exposures specific to insurance companies, including asset risk, insurance/underwriting risk, interest rate risk, and business risk. Even within the insurance industry, insurance regulators tailor capital standards very differently for life, property and casualty, and health insurance.

In contrast, the banking capital framework focuses on measuring asset risk and is calibrated by regulators specifically for the asset profile of banks. The risk-weightings for bank assets are often inappropriate for insurance company assets due to the 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. Applying a banking measurement to insurance would fail to capture the primary risks while significantly overstating lesser exposures.

False measurements of risk imposed on insurers who happen to have depository institution affiliates do not benefit consumers or the economy in any way. In fact, consumers are already being harmed by the expected implementation of burdensome anticompetitive standards that are being arbitrarily duplicated from one sector and imposed onto a completely different industry, as compliance costs are increasing, capital is exiting the market, and new entrants are scarce. This is a poor result for a requirement whose sponsoring author agrees is being misapplied and whose regulator agrees is inappropriate.

PCI strongly urges the members of the Senate Banking Committee and Congress to act quickly to protect consumers and the marketplace from this errant misfire and exempt companies engaged in the business of insurance from being subjected to bank capital requirements.

FINANCIAL SERVICES ROUNDTABLE

THE FINANCIAL SERVICES ROUNDTABLE

"Finding the Right Capital Regulations for Insurers"

Subcommittee on Financial Institutions and Consumer Protection

Banking, Housing, and Urban Affairs Committee,
U.S. Senate

Tuesday, March 11, 2014

Thank you, Chairman Brown and Ranking Member Toomey for holding this important Subcommittee hearing entitled "Finding the Right Capital Regulations for Insurers," and for your continued leadership to ensure capital standards are appropriately tailored to each sector. The Financial Services Roundtable (FSR) appreciates the opportunity to submit testimony for the record.

The Financial Services Roundtable

The Financial Services Roundtable is a leading advocacy organization that represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

As referenced above, FSR represents both banking and insurance organizations and is, as a result, uniquely positioned to understand the different business, capital, and risk models in those different sectors. FSR believes the businesses are different and the capital standards applied to each should be tailored appropriately.

Federal Reserve Supervision

The Dodd-Frank Act (DFA) charged the Federal Reserve Board (Federal Reserve) with establishing minimum leverage and risk-based capital standards for insurance companies that own Savings and Loan Holding Companies (SLHC) and non-bank entities designated Systemically Important Financial Institutions (SIFIs) by the Financial Stability Oversight Council (FSOC).

According to Section 171 of the DFA, also known as the Collins Amendment, these capital and leverage requirements "shall not be less than the generally applicable risk-based capital requirements that the agency may require, nor quantitatively lower than the generally applicable risk-based capital requirements that were in effect for insured depository institutions as of date of enactment of this Act." This could potentially lead to the Federal Reserve applying Basel III's bank-centric leverage and capital standards to insurers.

The Differences Between Banking and Insurance

Applying bank-centric leverage and capital requirements, as contemplated in Basel III, to insurance companies ignores fundamental differences between banks and insurers.

Banks are funded largely through short-term borrowing and deposits that can be withdrawn at any time. The ability for depositors to withdraw their funds on-demand leaves the institution vulnerable to a "run," in which large amounts of the institution's deposits are withdrawn quickly. Such a "run on the bank" could, if large enough, undermine capital levels of the bank.

Insurers, however, are funded through long-term liabilities. In the insurance model, assets and liabilities are generally linked and are comparatively longer term and more diversified than those of the banking sector. While insurers must have enough capital available to compensate policyholders in the event of a claim or similar payout trigger, these liabilities are not subject to a "run" in the same manner that banks are through their on-demand redemptions. An insurer's obligation to pay typically depends on the occurrence of a covered event, commonly exogenous in nature. Thus, an insurance policy is not an instrument that permits insurance consumers to have on-demand access to the assets of their insurers. Further, insurers are highly regulated with regard to required reserves to cover claims, both known and anticipated.

In addition to the different funding models, insurers invest in long-term assets to match the duration of their long-term liabilities. These stable, longer term assets, also subject to strict state regulation, can buffer insurers in times of economic and financial distress; this attribute should inform the type of capital and leverage requirements to which insurers are subject.

These two fundamental attributes of insurance require leverage and capital requirements specifically formulated for the insurance business model.

Federal Reserve Authority

Federal Reserve officials, including new Chair Janet Yellen, have noted the differences in the business models of banking and insurance and the need to tailor capital standards:

> We [Federal Reserve] recognize that there are very significant differences between the business models of insurance companies and the banks that we supervise, and we are taking the time that's necessary to understand those differences and to attempt to craft a set of appropriate capital and liquidity requirements that will be appropriate to the business model of insurance companies.

Despite that understanding, the Federal Reserve has noted that the language in the DFA limits its flexibility to tailor capital standards to insurers. Although the Federal Reserve notes that DFA language constrains its ability to tailor standards, FSR believes the existing language allows the Federal Reserve to establish and apply tailored capital and leverage requirements to insurers that own savings and loan holdings companies or which have been or are designated as SIFIs. Many, including FSR, welcomed the Federal Reserve's July 2013 decision to temporarily exempt insurance companies from final Basel III framework until it determined the appropriate framework.

Senator Collins, the author of the Collins Amendment, has also indicated that she did not intend for insurers to be subject to the same capital requirements as banks. In her November 2013 letter to the Federal Reserve, the Federal Deposit Insurance

Corporation, and Office of the Comptroller of the Currency, on the topic, Senator Collins explicitly asserts that "it was not Congress's intent that the federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime." Senator Collins continues, asserting that "consideration should be given to the distinctions between banks and insurance companies."

It is clear that the author of the amendment, uniquely qualified to express Congressional intent on this issue, did not intend for bank-centric capital and leverage requirements to be applied to insurers. FSR supports her assertion and believes the Federal Reserve has the authority under the existing statute to apply separate and tailored standards to insurers that own SLHCs or are designated SIFIs.

Legislation Proposals

Although FSR believes the Federal Reserve has the authority to tailor capital standards, we also support legislative proposals that would provide additional clarity and further signal Congressional intent to the Federal Reserve.

To that end, FSR supports S. 1369, introduced by Senators Brown and Johanns, which would provide additional flexibility to the Federal Reserve to establish capital standards that are properly tailored to the unique characteristics of the business of insurance. This legislation has bipartisan support; we understand that the Federal Reserve also supports the legislation's intent.

Brown-Johanns would enable the Federal Reserve to develop tailored, more appropriate capital standards. It would not, however, dilute the Federal Reserve's authority to apply appropriate standards to the insurer holding company or its depository institutions that the Federal Reserve supervises, including those owned by an insurer. This flexibility ensures that the Federal Reserve develops adequate standards to bolster the safety and soundness of the financial system and that banks and insurers are subject to appropriate standards tailored to their business, risk, and capital profiles.

FSR applauds Senators Brown and Johanns for their leadership to enact this bipartisan legislation.

FSR also greatly appreciates the constructive leadership and continued involvement that Senator Collins has provided throughout this process.

Conclusion

Insurers have a different capital, risk, and business model than banks. This is true whether an insurer owns an SLHC or is designated a SIFI. It is important that the Federal Reserve draft appropriate and tailored capital and leverage standards to reflect those differences. Doing so not only allows for the insurer to function more effectively, but better protects the safety and soundness of the insurance marketplace and the consumers it serves.

FSR believes that the Federal Reserve has the authority to develop and apply separate, tailored standards under existing powers. To help clarify the Federal Reserve's authority and reinforce Congressional intent, FSR supports legislation, specifically, S. 1369, which further clarifies the Federal Reserve's flexibility.

FSR thanks Chairman Brown and Ranking Member Toomey for holding this important hearing and the opportunity to submit comments for the record. We look forward to assisting the Subcommittee in any way we can in its important work on these and other issues.

NAIC National Association of Insurance Commissioners & The CENTER for INSURANCE POLICY and RESEARCH

March 10, 2014

Chairman Tim Johnson
Senate Banking Committee
United States Senate

Ranking Member Michael Crapo
Senate Banking Committee
United States Senate

Chairman Sherrod Brown
Subcommittee on Financial Institutions and Consumer Protection
United States Senate

Ranking Member Patrick Toomey
Subcommittee on Financial Institutions and Consumer Protection
United States Senate

Re: Insurance Capital Regulations Hearing

Dear Senators:

We write today on behalf of the National Association of Insurance Commissioners (NAIC) to thank you for empaneling tomorrow morning's hearing on "Finding the Right Capital Regulations for Insurers." Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

As the regulators of insurance in the U.S., we are keenly aware of the many complicated considerations involved in setting capital standards appropriate for insurers, which necessarily have different risk profiles and liquidity needs than banks. Insurance companies are already subject to very strict state capital and reserving requirements to protect policyholders by ensuring that a company has sufficient funds to pay claims. We applaud your efforts to address potential confusion with respect to the capital and leverage requirements that should apply to insurers subject to supervision by the Federal Reserve as a result of their status as a Thrift Holding Company or systemically important financial institution designated by the Financial Stability Oversight Council.

As you consider legislative reforms, such as those suggested by Senators Brown and Johanns to allow additional flexibility for the Federal Reserve to carefully tailor their holding company capital and leverage standards to the insurance business model, we want to emphasize that it is critical that you preserve the walls around insurance legal entities that have protected policyholders for more than 150 years. Such walls ensure that a company has the ability to pay out claims to insurance consumers who purchased insurance to protect their home, their livelihood, or their retirement.

EXECUTIVE OFFICE [illegible]
CENTRAL OFFICE [illegible]
SECURITIES VALUATION OFFICE [illegible]
[illegible]

Historically, the Federal Reserve has been limited by provisions in the Bank Holding Company Act that required insurance regulator consent (subject to certain conditions) before using the capital or assets of an insurer to prop up a troubled bank. Unfortunately, the Dodd-Frank Act called this requirement into question with respect to insurers organized as thrift holding companies in its Source of Financial Strength provisions (Section 616) that require non-bank companies to have the ability to prop up a troubled bank, even if it means such assistance could be to the detriment to insurance policyholders who have acted responsibly by purchasing insurance. Consent of the appropriate state insurance regulator should remain a requirement for any capital transfer with the potential to affect policyholder protections.

Thank you again for your careful attention to this matter. We look forward to working with you as you consider these important issues affecting the entities we regulate and the policyholders we protect. Should you wish to discuss this letter or any other matter relating to the NAIC's views on insurance capital standards, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980 or Mark Sagat, Counsel and Manager, Financial Policy and Legislation, at (202) 471-3987.

Sincerely,

Adam Hamm NAIC President North Dakota Insurance Commissioner	Monica J. Lindeen NAIC President-Elect Montana Commissioner of Securities and Insurance
Michael F. Consedine NAIC Vice-President Pennsylvania Insurance Commissioner	Sharon P. Clark NAIC Secretary-Treasurer Kentucky Insurance Commissioner

CC: The Hon. Susan Collins, U.S. Senate
The Hon. Mike Johanns, U.S. Senate

NAMIC®

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of the

National Association of Mutual Insurance Companies

to the

U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on

Finding the Right Capital Regulations for Insurers

March 11, 2014

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the U.S. Senate Committee on Banking, Housing, and Urban Affairs on capital standards for insurers.

We are the largest property/casualty insurance trade association in the country, serving regional and local mutual insurance companies on main streets across America as well as many of the country's largest national insurers.

The 1,400 NAMIC member companies serve more than 135 million auto, home and business policyholders and write more than $196 billion in annual premiums, accounting for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market.

Through our advocacy programs we promote public policy solutions that benefit NAMIC companies and the consumers we serve. Our educational programs enable us to become better leaders in our companies and the insurance industry for the benefit of our policyholders.

NAMIC would like to share some concerns with the Committee regarding the imposition of new capital standards on U.S. insurers being driven by both domestic and international pressures. In general, we believe the following:

- The fundamental objective of capital regulation should be to ensure that financial companies are financially sound and can meet their obligations to their customers. Bank-centric standards applied to insurers fail this test and actually undermine an insurer's financial strength.

- Bank-centric capital standards are not consistent with the property/casualty insurance company business model, do not properly measure the capital adequacy of insurers, and impede the ability of insurers to operate optimally in the best interests of their insurance and banking customers.

- Risk-Based Capital standards applicable to insurance companies in the U.S. have proven to be among the most effective standards globally and there is no compelling reason for the imposition of duplicative, global capital standards for companies in well-supervised jurisdictions.

- If inconsistent global capital standards are imposed upon the U.S. insurance industry, they will create a competitive disadvantage for U.S.-based international insurers and could distort the domestic market, especially if different accounting standards and different capital adequacy goals are applied.

Federal Reserve Capital Standards for Insurer SLHCs

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") [1] abolished the Office of Thrift Supervision, which regulated savings associations and savings and loan holding companies ("SLHCs"), and transferred its supervisory authorities over these entities to the Office of the Comptroller of the Currency ("OCC") and the Federal Reserve, respectively. Dodd-Frank also, through the "Collins Amendment,"[2] requires the Federal Reserve to establish minimum leverage and risk-based capital requirements on those depository institution holding companies. Initially, these new regulatory agencies proposed applying a Basel III, bank-oriented framework of quantitative capital requirements to all SLHCs, including those that are predominately engaged in the business of insurance ("insurance SLHCs").

Simply put, the standards are not appropriate for insurance SLHCs. For example, for many SLHCs the banking component of the holding company system represents a relatively small part of the business. Furthermore, insurer capital allocation is based on an entirely different business model than banks. Consequently, attempting to apply a bank-centric capital regime or banking standards upon non-banking businesses is problematic. Just as insurance capital standards would not work well for banks, bank capital standards will not work for insurance companies. Likewise, attempting to force bank-centric standards on groups predominately engaged in insurance will damage and undermine the well-functioning insurance regulatory system without enhancing the transparency or the financial stability of these insurance groups.

Bank-centric capital standards would subject insurance SLHCs to an expensive and onerous new quantitative regulatory regime without fulfilling the intended purpose of assessing the safety and soundness of the SLHC. As NAMIC has consistently pointed out, there are fundamental differences between the capital structures and business models of insurers and banks. These differences develop from the unique regulatory accounting applied to insurers, the variations in the source and predictability of liabilities, and group vs. legal entity structure of capital in the two industries. Property/casualty companies are not highly interconnected, they are not highly leveraged, and they do not generally rely upon short-term funding for their operational activities. In fact, it is quite common for insurance companies to have no long-term debt on their balance sheets. On the other hand, the assets of an insurer are often coupled with claim liabilities that result in a much more modest net worth. Many insurance companies do not engage in securities lending or use derivative instruments in their investment activities, nor are they a source of credit or liquidity in the financial system.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010). ("Dodd-Frank")
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010), Sec. 171.

Another key difference is the legal entity vs. group capital approach between insurers and banks. Each insurance legal entity is responsible to pay the claims filed by its customers, so insurers are required to adequately capitalize each legal entity to assure the payment of those claims. Consequently, the capital is not as fungible in an insurance holding company. Legal entity financial reporting is an important feature of statutory accounting as well. All insurers must complete financial reporting on a statutory basis. While statutory accounting is similar to GAAP many mutual insurers only file on a statutory basis.

The Federal Reserve Basel III capital standard is asset-based and makes no meaningful attempt to accommodate the insurance business model – including accounting. For example, insurance risk-based capital standards take into account various categories of both asset and liability risk and statistically address the interaction of factors that affect the required capital levels.

We believe that the current state-based system of insurance regulation provides effective, appropriate, and transparent regulation of insurance company operations. It is our position that the Collins Amendment does not mandate the imposition of the Basel III standards on insurance SLHCs (which are wholly inappropriate for assessing their capital adequacy needs) and federal regulators have the authority to accept and deem – either strictly or on some modified basis – state-based, risk-based capital requirements as equivalent.

We urge Congress to continue working with the Fed to ensure they exercise the appropriate discretion when it comes to the regulation of insurance SLHCs.

Global Capital Standards

At the international level, the International Association of Insurance Supervisors ("IAIS") has been tasked by the Financial Stability Board with identifying Global Systemically Important Insurers ("G-SIIs"). As in the case of U.S. Systemically Important Financial Institutions ("SIFIs"), G-SIIs are to be subject to enhanced supervision and increased capital standards. Three US-based insurers have been named G-SIIs: AIG, Prudential Financial, and MetLife. The IAIS is also creating another category of insurance groups to be designated as Internationally Active Insurance Groups ("IAIGs"). This designation will incorporate many more U.S. insurers applying supervisory requirements and capital standards as well.

The FSB charged the IAIS in July 2013 with developing capital standards for the G-SIIs and IAIGs. Three levels of global capital for insurers are currently under development. The Basic Capital Requirement (BCR) has been exposed for comment and seems to focus on a backstop or minimum capital level for G-SIIs. The IAIS is also discussing the Higher Loss Absorbency (HLA) and the "Insurance Capital Standard" ("ICS") would potentially apply to all IAIGs and is to be completed by the end of 2016. IAIS member countries are intended to impose these standards beginning in 2019. U.S.-based global insurers that are neither SIFIs, nor G-SIIs, could certainly be considered IAIGs, a designation which is made with no indication that a group poses a systemic risk and which will lead to an additional layer of regulation for U.S. companies engaged in insurance activities in three or more countries.

The concern is that these proposed standards are being based on accounting systems that differ from U.S. statutory accounting and even from U.S. GAAP. In this way these global capital standards will create disproportionate burdens for U.S. insurers over insurers currently using the IFRS accounting system. And the burdens are not insignificant. In fact the FASB worked with the IASB for a number of years to attempt to develop a single accounting system for insurers, and recently delivered the edict that they could not reach convergence and would not continue to try. They cited the largely converged global standards around U.S. GAAP and the unnecessary costs and burdens for insurers as key factors in their decision.

NAMIC supports the thrust of evolving international efforts to support insurance supervisors in their regulation of large, multi-national insurers. For example, the IAIS develops international standards for insurance supervision, provides training to its members, fosters cooperation between insurance regulators, and creates a forum for dialogue between insurance regulators and regulators in other financial and international sectors. The IAIS has supported the use of supervisory colleges as a means for international regulators to convene and discuss the activities of international insurance groups. We support these efforts as supervisory colleges are very similar to the NAIC Financial Analysis Working Groups that convene in the U.S.

In the end, the international coordination of insurance regulation should be focused on understanding each unique insurance group, how they manage their own enterprise risks, how they incorporate the information into a robust risk management culture and how they manage their capital to address the potential risks they face. This information combined with the local regulatory capital assessment will provide supervisors with the best information to identify problems before they result in systemic risks to the global economy. We believe this type of evaluation and interaction is the foundation on which international coordination of insurance regulation should be developed. We support communication and coordination between international regulatory authorities to improve understanding of differing regulatory systems and to share best practices. However, the extension of enhanced capital requirements to IAIGs merely because the group happens to operate across international borders is neither prudent nor necessary.

Conclusion

Insurance – and in particular property/casualty insurance – is unique among the financial services sector. As this is the case, the approach to regulation and developing capital requirements should be carefully tailored to fit the realities of the business. By all objective measures, it is clear that the current state-based system of insurance regulation provides effective, appropriate, and transparent regulation of insurance company operations. There is no compelling evidence that additional risk-based or global insurance capital standards are needed, and no potential benefit to consumers has been shown. Indeed, the current U.S. insurance capital and solvency regulatory system is one of the strongest and most resilient in the world. U.S. regulators at the state or federal level should take the lead from FASB and reject the pressure to impose other regulatory regimes on U.S. insurance companies. In the absence of a failure of the U.S. insurance regulatory system we urge this committee to support efforts to reject the international pressure to converge around bank-centric standards.

NAMIC encourages acceptance of the differences in effective regulatory systems and suggests that consistency around an inappropriate standard does not serve a valuable purpose. We would also urge care be taken to avoid the unintended and tangential impacts of any revised regulatory structure both internationally and in the U.S. More regulation is not necessarily better regulation.