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The Board of Governors
Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Capital and Accounting Standards for Certain Insurers under Dodd-Frank

Ladies and Gentlemen:

The Committee on Insurance Law of the New York City Bar Association (the "Committee") writes[1] to support efforts to preserve existing state-law based risk-based capital ("RBC") and accounting standards for insurers, including those covered by Section 171 (the "Collins Amendment") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[2] We note with approval recent statements by Vice Chair Yellen on this subject[3] and also the current legislation pending in Congress that would clarify the application of the Collins Amendment for insurers.[4] In addition, the proposed bank liquidity rules recently issued by the Board of Governors and other Federal bank regulators would sensibly exclude most insurers[5]; similarly, capital and accounting standards to be enforced by such agencies under Dodd-Frank should

[1] This letter was prepared by a subcommittee of the Committee on Insurance Law chaired by Dan Rabinowitz and also comprising Leah Campbell, Susan Donnellan, Robert Fettman, Drexel Harris, Jill Levy, Richard Liskov, Charlene McHugh, John Pruitt, Francine Semaya and Thomas Workman. Committee members Robert Easton, Executive Deputy Superintendent of Financial Services for the State of New York, and Joana Lucashuk, Senior Attorney with the Department of Financial Services for the State of New York, have recused themselves from all Committee deliberations on the position expressed herein.
[2] P.L. 111-203.
[3] Letter dated Nov. 18, 2013 from Vice Chair Yellen to Sen. Sherrod Brown (the "Yellen Response").
[4] H.R. 2140; S. 1369.
[5] "Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring" (proposed rule of Office of Comptroller of the Currency, Federal Reserve System and Federal Deposit Insurance Corporation), 12 CFR Part 50, 12 CFR Part 249 (Regulation WW), 12 CFR Part 329 (the "Proposed Liquidity Rules").

appropriately exclude insurers. Finally, we would draw your attention to recent statements by Federal insurance policymakers accepting state-based capital standards, albeit with more uniformity.[6] In general, we believe that a consensus is emerging that state-based RBC and accounting standards should be preserved and not supplanted by Federal standards.

The Committee comprises lawyers representing a diverse cross-section of the insurance community, including lawyers in private practice, in-house counsel at insurance carriers and producers across multiple lines of insurance business, trade association officials, regulators, policyholder lawyers, insurance arbitrators and other types of insurance professionals. This letter represents the views of the Committee as a whole and not necessarily those of any particular member thereof.

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As you know, Section 165 of Dodd-Frank directs the Board of Governors to establish prudential standards for non-bank financial companies under its supervision. The Collins Amendment, generally, imposes on a depository institution (such as a savings and loan), a depository institution holding company or a non-bank supervised by the Board, in each case together with all of its affiliates on a consolidated basis (a "<u>Covered Financial Group</u>"), risk-based capital and leverage requirements at least as rigorous as those currently applicable to banks. H.R. 2140, which was introduced in the House of Representatives in May 2013, would amend the Collins Amendment and is designed to preserve, for insurers within Covered Financial Groups, the applicability of state insurance law RBC and accounting requirements. S. 1369, introduced in the Senate in July 2013, would exempt insurers more categorically from the application of the Collins Amendment. We support the objectives of these bills as well as administrative efforts by the Board of Governors that are consistent with these objectives.

In addition, we applaud Vice Chair Yellen on her recent statements recognizing the differences between insurers and banks for these purposes, as well as the efforts taken in the Proposed Liquidity Rules to insulate insurers from bank-based liquidity standards. In her response to Senator Brown, Vice Chair Yellen called for a "workable" and "appropriate" capital framework for insurers within Covered Financial Groups, citing the differences between the "business model and associated risk profile" of insurers and those of banks. She indicated that the Board of Governors "continues to carefully consider how to design capital rules for" such insurers. We respectfully suggest that preserving RBC standards for such companies is the best way to achieve this with the least amount of disruption or ambiguity.

Bank products and insurance products not only differ from one another; they reflect intrinsically different motivations and legal characteristics, warranting distinct regulatory regimes. The vast majority of insurance products are, fundamentally, promises to pay in the event of a future contingency. The resulting liquidity needs differ greatly from banking products such as demand deposit accounts, letters of credit, certificates of

[6] *How to Modernize and Improve the System of Insurance Regulation in the United States*, Federal Insurance Office ("<u>FIO</u>"), U.S. Dept. of Treas. (December 2013) ("<u>Modernization Report</u>")

deposit and revolving credit facilities. In the life insurance industry, liabilities tend to be very long dated, and because they are tied to human mortality, generally follow predictable actuarial patterns and do not create sudden or unexpected liquidity needs. It should also be noted that property-casualty insurers generally do not offer products with non-insurance-like or investment characteristics, making them similarly unsuitable for bank-centric standards.

It has been suggested that a single security, held as an investment asset in two companies, one a bank and the other an insurer, could not be given different capital treatment or risk-weighting. Without expressing a view on the scope of the Board's statutory authority, risk-weighting in the banking context is not exactly analogous to, and cannot be harmonized in all cases with, the comprehensive risk-based capital requirements applicable to U.S. insurers. To a virtually uniform degree, states follow the National Association of Insurance Commissioners' ("NAIC") RBC regime, which consists of the RBC model law in effect in all states[7] and the NAIC's detailed instructions on completing RBC calculations[8] pursuant to which insurers must ascertain their appropriate level of capital. Various multiples of the level are then used as supervisory triggers, prompting sequentially increasing degrees of regulatory intervention if actual capital falls below the thresholds. The RBC standards are oriented specifically for insurance companies, with one set of instructions for life companies and another for property-casualty. These instructions take into account sector-specific factors such as

- investment holdings,
- off-balance sheet exposures,
- insurance underwriting,
- premium rates,
- reserves for losses and
- reinsurance.

For an insurer within a Covered Financial Group, replacing or augmenting these tailored standards with capital guidelines appropriate for a deposit-taking institution would be onerous and difficult to implement, posing an unnecessary regulatory burden with no correlative benefit. State insurance law RBC standards already measure the characteristics of an insurer most likely to create a need for a capital buffer to absorb losses. These standards are applied on a stand-alone basis to each and every individual insurance company without any reliance on a parent as a source of strength. Furthermore, the very structure of bank-based capital requirements makes these standards impracticable, if not impossible, to apply sensibly to an insurer. For example, the Collins Amendment defines "generally applicable leverage capital requirements" in relation to the ratio of "tier 1 capital to average total assets." Tier 1 capital is a concept from bank regulation not easily transposed on insurers because of the differences between banks and insurers in terms of asset mix, investment strategy and capital structure.

[7] *Risk-Based Capital (RBC) for Insurers Model Act* (NAIC).
[8] *2012 RBC Forecasting & Instructions (Life)*; *2012 RBC Forecasting & Instructions (Property & Casualty)* (NAIC).

The view that the "risk-weighting" of a single security should be uniform, whether the holder of the security is a bank or insurer, may have merit but somewhat obscures the larger point. Insurance-law RBC standards do more than make judgments about individual assets in an insurer's portfolio. By considering the mix of various other factors inherent in operating an insurance business (such as the ones enumerated in the bullets above), the NAIC standards effectively take into account the larger context in which the security was purchased and is held. Consequently, insurance RBC essentially measures not only the risk associated with the security itself but other business factors that may have influenced the ownership of the asset in the first place (for example, yield, asset-liability matching, tax attributes or a host of other factors). In other words, it is not particularly meaningful that two hypothetical companies, one a bank and the other an insurer, own the same amount of the same security. What is considerably more important is the entire mix of circumstances within each such company that motivated it to hold that particular position.

The FIO implicitly recognizes this in its Modernization Report, writing not only that RBC should be administered in a more harmonized form[9] but also that states should take the lead in developing proper tools for financial regulation of insurance *groups* and not merely insurance companies.[10] Also underscoring the importance of insurance-centric standards are the recent announcements by the International Association of Insurance Supervisors (the "IAIS") that it plans to develop global capital standards for internationally active insurers[11] as well as for so-called "global systemically important insurers."[12] The IAIS is a global standard-setting body comprising insurance regulators from nearly 140 countries. The FIO's and IAIS's respective views support the principle that insurance company capital standards ought to be specific to the sector, a goal that would be frustrated if RBC were weakened as a regulatory tool for certain categories of insurers (such as those within Covered Financial Groups).

We note further that H.R. 2140 preserves and codifies the use of statutory accounting (rather than GAAP) for insurers, a goal we support. As you know, insurers are subject to NAIC-prescribed statutory accounting principles ("SAP"), a comprehensive body of accounting specifically designed for insurers. SAP is more appropriate for insurance regulatory purposes than GAAP in a number of respects, including

- SAP's emphasis on liquidation value, insofar as it is that value that is most meaningful for determining assets remaining to pay policyholders,
- SAP's focus on entity-level results and condition rather than consolidated groups, again with an emphasis on quantifying resources available to policyholders and

[9] Modernization Report, p. 30-31.
[10] *Id.*, p. 39-41.
[11] *IAIS Commits to Develop by 2016 a Global Insurance Capital Standard* (press release), Int'l. Assoc. of Insurance Supervisors, October 9, 2013. The NAIC has expressed "serious concerns" in connection with a single global capital standard but has indicated it will remain involved in the process. (*See Statement from NAIC CEO Senator Ben Nelson on the Global Insurance Capital Standard* (item on NAIC website), October 9, 2013.)
[12] *Basic Capital Requirements for Global Systemically Important Insurers (G-SIIs): Proposal,* Int'l Assoc. of Insurance Supervisors, December 16, 2013.

- SAP's distinction between admitted and non-admitted assets, which prioritizes policyholder value over "going-concern" value as under GAAP.

Superseding or augmenting SAP by imposing another type of accounting on insurers would dilute the effectiveness of SAP as a measure of insurance company financial condition and performance in the sector by creating competing accounting regimes among entities in the same business.

The objectives expressed above are supported and validated by the Proposed Liquidity Rules, which impose quantitative liquidity requirements on national banks, savings and loans, bank holding companies and other firms. Yet these rules exempt bank holding companies that are insurers as well as any non-bank that either is an insurer or holds 25% or more of its total consolidated assets in insurance company subsidiaries.[13] Without expressing a view on whether these exemptions should be broader, we support the policy underlying this exemption and believe that it exemplifies the logic in preserving insurance-law based capital standards as argued in this letter. The agencies issuing the Proposed Liquidity Rules have recognized that insurance companies cannot be governed by liquidity rules designed for banks. Banks and insurance companies have vastly different needs for cash flow and liquidity, and the challenges that banks and insurance companies face in meeting these needs require regulatory responses tailored for the one or the other. Similarly, it is entirely appropriate, and would serve the needs of policyholders and the insurance-buying public, to prevent bank-based capital standards from being used in insurance regulation. Preserving (and not duplicating) state-based RBC for insurers is the best way to ensure the needed clarity and visibility in insurance regulation.

We note that SAP, RBC requirements and numerous other safeguards are functions of the larger, comprehensive regulatory regime for insurance companies that has existed at the level of state government for over 150 years. Insurance companies have developed institutional habits and compliance cultures oriented around this regulatory framework. Federal requirements that duplicate this framework would tend to create redundancies, legal ambiguities and inefficiencies.

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It may fairly be asked how, specifically, should the Board "tailor the application" of the "more stringent prudential standards" under Dodd-Frank by "differentiating among companies on an individual basis or by category."[14] In other words, the question remains how to accommodate the presence of an insurer in a Covered Financial Group. One way would be simply to exclude insurance companies from all calculations of risk-based capital or leverage ratios performed at the level of a consolidated group, and measure only non-insurance risks, assets, liabilities and activities. Alternatively, insurance businesses within a consolidated group could be required to report a combined RBC by calculating their capital on an aggregate basis, but not aggregating any insurance company with any non-insurer within the group. This would yield two distinct

[13] Propose Liquidity Rules, §__.3.
[14] Dodd-Frank §165(a)(2)(A).

measurements of required capital for the group, one for insurance and one for non-insurance activities. There could be other alternatives as well; we urge the Board to undertake statistical and accounting efforts to assess the best approach. However, we stand with Vice Chair Yellen, the sponsors of H.R. 2140 and S. 1369, the FIO and the IAIS in favor of insurance-specific capital standards. A departure from RBC is very likely to create confusion in implementation and produce less-meaningful results in measuring group risks at the large financial companies that, under Dodd-Frank, will be subject to the Board's jurisdiction.

The Committee would be delighted to answer any questions or respond to any concerns that the Board may have regarding the foregoing matters. Feel free to respond to us by contacting the undersigned.

Very truly yours,

Daniel A. Rabinowitz
Chair, Committee on Insurance Law

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