April 6, 2011

The Honorable Timothy F. Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Financial Stability Oversight Council Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (12 CFR Part 1310; RIN 4030-AA00)

Dear Mr. Geithner,

These comments are submitted in response to the Financial Stability Oversight Council (FSOC) Notice of Proposed Rulemaking (NPR) on the authority to require supervision and regulation of certain nonbank financial companies as provided for under the Dodd-Frank Act (DFA).

Industry trade groups, including the American Council of Life Insurers (ACLI) and the Geneva Association, have provided commentary to regulators concerning the implications of life insurance activities for potential systemic risk. This commentary has generally included insurance-specific considerations and factors which are needed to take into account the unique characteristics of life insurance companies. As opposed to banks and other financial institutions, life insurers are primarily funded with longer-term, illiquid liabilities, have lower interconnectedness with other financial firms, and are subject to a regulatory regime which provides for an orderly wind-down in the case of distress or failure. These differences make the application of simple metrics that may be used for other financial institutions inappropriate for insurers.

We believe that careful analysis will show that the traditional core activities of a life insurance organization do not present significant systemic risk[1]. However, FSOC may require more specific metrics and analytical approaches in evaluating any potential systemic risk presented by life insurers. To assist in this process, we have included in this letter a framework for evaluating life insurers, for use in determining which (if any) should be given a Notice of Consideration for determination. The three-step process outlined below is designed to balance the need for robust analysis with efficient use of available regulatory resources, and includes specific recommendations for metrics aligned with the risk factors identified in the DFA and FSOC's NPR.

Though we provide FSOC with a potential approach, we would like to reiterate the industry's objections to the process outlined by the NPR. We believe it is imperative that FSOC's full complement of three members with insurance expertise are seated and available for discussion before any decisions are made that impact insurers, and that the proposed framework and any metrics by which companies will be selected for consideration be incorporated within the provisions

[1] For more detail and analysis of systemic risk in life insurers, see the Geneva Association presentations on this topic from March 2010 and July 2010.

of the rule itself, with a subsequent opportunity for the industry to respond. These objections are outlined in the ACLI's February 25 response to the NPR as well as in the joint commentary submitted by the ACLI, the American Insurance Association (AIA) and the Reinsurance Association of America (RAA) on February 9.

Overview of approach

We propose that FSOC evaluate life insurers using a three-step approach, designed to first filter the list of all insurers to a practical number, then screen the insurers to identify those that may pose a systemic risk, and finally provide for the in-depth, firm-specific analysis required to accurately assess potential systemic risk. Firms identified as systemically risky in this third step would then be issued Notice of Consideration for determination, as described in the NPR.

Proposed three-step process

Steps	Description
1. Initial filter	▪ Preliminary criteria to reduce the list of insurers to be evaluated to a practical number ▪ Based on appropriate publicly-available size criteria ▪ Threshold set based on regulatory resources and capacity to evaluate insurers in Step 2
2. Screening metrics	▪ Combination of public and non-public metrics to identify the potential extent and size of potentially systemically risky activities ▪ Used to determine which insurers should be subject to in-depth analysis
3. In-depth, firm-specific, analysis	▪ Stress testing used to assess the risk to the U.S. financial system due to distress or failure of an insurer ▪ Review of individual business activities of potential systemic concern ▪ Used to determine which insurers will receive Notice of Consideration for determination

This process is designed to efficiently use FSOC's resources while allowing for analysis at the level of depth and detail that will be necessary to warrant a Notice of Consideration for determination as a systemically important financial institution. This Notice itself has the potential to be a significant event for a life insurer, and may trigger investor disclosures and create uncertainty in the investor community. For this reason, the process for identifying which life insurers will receive a Notice of Consideration must be robust.

We recognize that FSOC and its member organizations require a timely and efficient process to review companies for consideration of determination. FSOC will need a practical method to filter and screen the large number of life insurers to determine which should be subjected to in-depth analysis. We emphasize that while the use of simple metrics is helpful for determining which life insurers should be subject to deeper analysis, these metrics do not provide a sufficient basis for issuing a Notice of Consideration for determination. Systemic risk cannot be accurately assessed using only simple metrics and public data, and static analyses are not appropriate for assessing the extent of the impact of an institution's distress or failure on the U.S. economy. Only the results of a deep analysis and stress testing, incorporating non-public quantitative and qualitative information, will provide robust grounds for consideration.

Step 1: Initial filter

Given the large number of life insurers (and other nonbank financial institutions), FSOC will likely require a way to quickly focus regulatory resources on only those institutions which may pose systemic risk to the U.S. financial system. For purposes of this initial filter, a simple, publicly available size metric would be appropriate. However, we emphasize that size by itself is not a sufficient criterion for determining which institutions should receive Notice of Consideration for determination.

The simplest size metric is total assets, which includes all separate account and other assets equally. However, it is important to note that this simple measure should not be used to compare life insurers to other types of financial institutions, since the differing characteristics of the liabilities associated with these assets mean that size has different systemic implications.

One factor that should be addressed in any insurer size metric is the treatment of separate accounts. The DFA specifies that regulators should consider the extent to which an institution's assets are managed rather than owned by a company. With regard to risk, separate accounts function more like managed assets, rather than assets owned by the insurer. Such assets are ultimately controlled by the policyholder, not the insurer, and can generally be withdrawn at fair value. Some separate accounts contain guarantees that present risk to the insurer, but assets backing these guarantees are held by the insurer, and appear on the insurer's balance sheet, outside the separate account.

Step 2: Screening metrics

Following the initial filter, we propose that FSOC apply screening metrics across key systemic risk factors to identify which institutions are engaging in activities which may pose a systemic risk. The proposed metrics below are based on public data where possible, however some categories of systemic risk factors (e.g. interconnectedness, liquidity risk) cannot be accurately measured using public data. For these factors, we have proposed metrics based on non-public data, which could be collected using a simple data request distributed to institutions meeting the initial filter described in Step 1.

We reiterate that simple metrics such as those included below are by themselves not appropriate for identifying which life insurers should be issued a Notice of Consideration. Rather, they should be used to identify which institutions should be subjected to the in-depth, company-specific analysis described in Step 3.

No single metric can appropriately assess the potential systemic risk posed by a life insurer. Instead, regulators must examine each of the categories of risk factors identified by FSOC in the NPR, as well as how these factors relate and interact with each other. Thus the sections below provide potential considerations and metrics for the six categories identified:

1. Size
2. Lack of substitutes
3. Interconnectedness
4. Leverage
5. Liquidity risk and mismatch
6. Existing regulatory scrutiny

Except where noted, all metrics apply to life insurers at the group level, including the holding company and all subsidiaries.

1. Size

An institution's size is only important if that institution is engaged in activities that may result in systemic risk, and as such is highly interconnected with other financial institutions, provides credit and liquidity for which there are no substitutes, or would undergo a rapid and disorderly liquidation in the event of failure. Therefore size is not by itself a sufficient criterion in determining systemic risk.

In addition to these considerations, size has different meaning for life insurers and banks or other financial institutions. A dollar of assets for a life insurer does not have the same systemic implications as a dollar of assets for a bank or other financial institution, due to the differences in the characteristics of the liabilities associated with those assets. These differences would be more apparent with in-depth analysis and stress testing, but are not apparent in simple size metrics.

For these reasons, we do not propose FSOC use overall size as a screening metric to determine which institutions should be subjected to the in-depth analysis described in Step 3. Rather, FSOC should focus on the size of potentially systemically risky activities, as measured by the other categories identified in FSOC's NPR.

2. Lack of substitutes for the financial services and products the company provides

The lack of substitutes category identified by FSOC pertains to three statutory factors included in the Dodd-Frank Act, which focus on the need to review a company's importance as a source of credit to households, businesses, and state and local governments. Insurers primarily provide credit and liquidity to these groups through the following instruments:

Group	Instrument
Households	▪ Residential mortgage-backed securities (RMBS) ▪ Directly-held residential mortgages
Businesses	▪ Commercial mortgage-backed securities (CMBS) ▪ Commercial real estate whole loans ▪ Corporate bonds ▪ Corporate loans
State and local governments	▪ Municipal bonds

In this context, the insurer's total credit held for each of the three groups above, as a share of the total credit outstanding to that group, would be an appropriate set of metrics for the lack of substitutes.

Share of credit provided to U.S. households
The institution's total U.S. mortgage debt held through RMBS and directly-held residential mortgages as a percentage of total U.S. mortgage debt outstanding.

Share of credit provided to U.S. businesses
The institution's total U.S. commercial debt held through CMBS, commercial real estate whole loans, corporate bonds and corporate loans, as a percentage of the total U.S. corporate debt outstanding through these instruments.

Share of credit provided to State and local governments
The institution's total U.S. municipal bond holdings, as a percentage of total U.S. state and municipal debt outstanding.

For each of these three metrics, we would expect that FSOC would request data for each institution's holdings, and then compare these figures to total outstanding debt itself, to ensure completeness and consistency across institutions. Also note that these metrics would be applied at the group level, and would include all U.S. debt, regardless of the nation in which the institution holds the debt (e.g. bonds issued by a U.S. corporation but held in an Asian operating company would be included).

Life insurers also provide other financial services through life insurance and annuity products. However, as the ACLI discussed in its February 25th letter, these products and services are not critical to the immediate continuation of near-term economic activity, and their disruption would not have systemic impacts on the U.S. financial system.

3. Interconnectedness

We consider interconnectedness to be the most important criteria in assessing systemic risk. This risk includes both the sensitivity to other financial institutions' distress, and the degree to which an institution's distress or failure would have spillover effects on other institutions or the broader economy. This latter effect is the most relevant in evaluating systemic risk, and interconnectedness that may transmit distress to other institutions should be the focus of systemic risk analysis. Life insurers may have systemically-relevant interconnectedness through derivatives liabilities and liabilities held by other financial firms.

Derivatives are largely used by insurers to hedge risks arising from products sold. These derivatives generally expose insurers to the risk of other institutions' distress, but do not serve to transmit their own distress to other institutions. However, some derivative products do represent potential liabilities to other financial institutions, and thus may pose some systemic risk. We feel it is appropriate to focus on these derivative liabilities.

Fair value of current derivative liabilities (netted by counterparty and for collateral)
The fair value of liabilities gives a measure of the total market derivative exposure to an institution during current conditions, and can be useful in assessing the level of derivative activity. It is important that such measures be netted for counterparty relationships and collateral, to measure the true risk to the institution.

Total notional value of CDS protection sold
CDS protection sold was shown to be a potential risk during the recent financial crisis. Due to the potential for rapid changes the value of such guarantees, notional value should be used to examine the maximum potential exposure in a crisis.

Life insurer liabilities held by other financial institutions potentially expose those institutions to distress of the insurer. For screening purposes, FSOC could potentially review the total amount of short term debt issued by the institution that is held by other financial firms.

Total short-term debt held by financial institutions
The total amount of short-term funding provided by institutional sources can provide a view of the total exposure of the financial system to the distress of the institution. However, this measure does not provide any information on the concentration of this exposure, or the significance relative to the overall capital of the holders of these liabilities. To assess short-term debt, the amount of debt maturing within 1 year would be a reasonable metric.

4. Leverage

The most important effects of leverage are the impact on interconnectedness if leverage is provided by other financial firms, and the impact of liquidity risk when it is achieved by short-term or callable financing. Thus, for life insurers, the defining characteristics of leverage are the nature of the leverage and the provider of the leverage, which are addressed by the Liquidity Risk and Interconnectedness categories, respectively. Further, leverage is directly addressed by Risk-based Capital regulations, which limit leverage within insurance operating companies to prudent levels.

In other financial institutions such as hedge funds, leverage is not regulated, and thus is a key criterion in determining overall risk of a firm. Further, with excessive leverage, an otherwise small, lightly-regulated institution can amass a systemically-relevant amount of assets, resulting in a potentially dangerous fire-sale in a distressed scenario. However, due to the nature of their regulation, this is not possible for life insurers.

If FSOC wishes to use a leverage metric for screening purposes, there are a variety of available metrics and ratios to measure financial leverage. To the extent that assets are a factor, consideration should be given to the treatment of separate accounts as discussed earlier. A simpler metric may be appropriate for Step 2 screening purposes, as follows:

Debt/(Debt + Equity)
Insurance operating companies can issue surplus notes. From a regulatory capital perspective, these notes are included in capital, while under GAAP accounting these are included as debt. Regulators should examine leverage under both approaches.

5. Liquidity risk and mismatch

Life insurers' liquidity risk is significantly different from that of banks and other financial institutions, due to the generally illiquid nature of insurance liabilities and the generally more liquid nature of the assets held. Further, insurance regulation provides for an orderly wind-down of failing insurers, preventing the "fire sale" failures that are the main systemically important effect of liquidity shortfalls. Due to the complexity of assessing liquidity exposure, liquidity risk should be measured using comprehensive stress testing as part of company-specific, in-depth analysis described in Step 3. For the purposes of screening, we propose two potential metrics that are relevant and appropriate for life insurers.

Liquid assets to liquid liabilities
Overall liquidity ratios can provide a sense of the company's abilities to meet its short-term obligations without selling long-term assets. Assets and liabilities should be weighted according to their liquidity during market distress. Asset weightings take into account potential difficulties in selling securities at fair value during a crisis. Similarly, liability weightings take into account the extent to which it is possible or likely that they would be called or withdrawn during a crisis. Such an approach would also need to capture the impact of potential collateral calls on activities with liquid liabilities (e.g. securities lending). If required, we would be happy to provide further information on a potential weighting system for assets and liabilities.

Holding company debt coverage
Debt for a publicly-traded insurer is typically held at the holding company level while revenues are generated by the insurance operating companies. During periods of stress, insurance regulators may limit the extent to which insurance operating companies may pay dividends to the holding company (in order to protect policyholders). For this reason, it is important that holding companies keep sufficient assets to service their debt. A typical measure would compare assets held at the holding company to scheduled debt service payments (interest and principal) over a fixed time period.

6. Existing regulatory scrutiny

Careful analysis will show that the traditional core activities of a life insurance organization do not present significant systemic risk, in part due to the thorough and well-tested U.S. insurance regulatory regime, which is collectively managed and administered by state insurance commissioners. These insurance regulators carefully monitor capital levels and provide a structure for the orderly wind-down of impaired or insolvent insurance companies. Most major foreign markets have regulatory frameworks that mandate prudential standards and provide for a resolution process for the foreign insurance businesses of U.S.-based insurers, and foreign-owned insurers which have U.S. operations. Insurers may also own operating companies that are regulated by the Federal Reserve, Securities and Exchange Commission or other U.S. regulatory bodies.

Breakdown of total revenues by regulatory jurisdiction
Examining the revenues occurring by regulatory jurisdiction would allow FSOC to assess the portion of the life insurer's business that occurs in lightly regulated or unregulated areas. Revenues may be more useful than assets, as some activities may not be asset-intensive.

Step 3: Company-specific in-depth analysis

The identification of the life insurers to which FSOC wishes to issue a Notice of Consideration must be based on company-specific, in-depth analysis. This analysis should include stress testing to determine the likelihood of distress or failure and the potential impacts of such a failure on the U.S. financial system, as well as a careful review of any specific non-traditional life insurance businesses or activities that may result in systemic risk.

1. Stress testing

Stress testing should be used to assess two factors: the risk of a life insurer failure, and the impact to the U.S. financial system in the event of a failure. Sensitivity to market-wide stresses by itself does not constitute systemic risk, unless the institution's failure would have spillover effects into the broader financial system. These stress tests should be done at the holding company level.

The risk of failure should be assessed using a stress scenario that includes a significant drop in equity and credit market price levels, as well as a broad disruption in funding markets (limiting access to new funding). This joint capital and liquidity stress scenario will determine a life insurer's ability to survive a significant system-wide market disruption. This stress test may be similar to the tests conducted by federal banking regulators on large U.S. banking organizations in 2009, and to internal stress testing conducted by major insurers today.

If the stress tests identify a risk of failure of the life insurer, the test should then be used to determine the potential impact of such failure with respect to trading counterparties, disruption to customers, and effect on the health of the U.S. financial system. This analysis would need to incorporate the resolution process established by the U.S. state insurance regulatory system, as well as mechanisms implemented by any other relevant regulators. In assessing the impact of such a failure on financial counterparties, the impact must be evaluated in the context of those counterparties' overall size and capital base.

To complete stress tests under a reasonable time frame, they could be conducted in a way similar to that used for the banking stress tests conducted in 2009, with regulators defining the stress scenario parameters, and the insurers performing the bulk of the analysis themselves (with appropriate review of the assumptions and results by regulators).

2. Analysis of non-traditional life insurance businesses and activities

Traditional core activities of a life insurance organization do not present significant systemic risk. However, individual insurance organizations may have other business lines and activities which present more potential systemic risk. Given the heterogeneity and firm-specific nature of such activities, it will be difficult if not impossible to assess the relevant potential systemic risk through any broadly applicable screening metric or criteria.

Regulators may therefore wish to review in more depth activities occurring outside of regulated insurance operating entities, as well as securities lending business conducted within a regulated insurance entity. We believe the most important considerations in assessing such activities for systemic risk to be whether the activity creates the possibility of a rapid and disorderly failure, and whether it creates significant interconnections with the rest of the U.S. financial system.

Conclusion

We hope that the framework proposed is useful in developing FSOC's approach to evaluating life insurers. We believe that this approach strikes an appropriate balance between the need for robust analysis of systemic risk and the efficient use of regulatory resources. If you require any further detail on any of the metrics or frameworks proposed in this letter, we would be happy to assist.

Sincerely,

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