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October 22, 2012

BY ELECTRONIC MAIL

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Re: Regulatory Capital Rules:

- 1. Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Prompt Corrective Action (OCC Docket ID OCC-2012-0008; FRB Docket No. R-1430; RIN No. 7100-AD87; FDIC RIN 3064-AD95).**
- 2. Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009; FRB Docket No. R-1442; RIN No. 7100 AD87; FDIC RIN 3064-AD96).**
- 3. Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010; FRB Docket No. [XX][XX]; FDIC RIN 3064-AD97).**

Ladies and Gentlemen:

The American Insurance Association ("AIA") appreciates the opportunity to provide comments on the above three proposed rules ("Proposed Rules") regarding regulatory capital standards, as announced

jointly by the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“Federal Reserve”), and the Federal Deposit Insurance Corporation (“FDIC”) (collectively, the “Agencies”).¹ AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses, writing more than \$117 billion annually in U.S. premiums and approximately \$225 billion annually in world-wide premiums. Our members are keenly interested in the Proposed Rules because we believe it is critical that the Agencies develop regulatory capital rules that are appropriate for depository institution holding companies that may have affiliates that are property-casualty insurance companies. Moreover, the Proposed Rules are of added importance to us because the standards adopted by the Agencies will likely apply to nonbank financial companies that are determined to present systemic risk and pose a threat to the financial stability of the United States.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”)² is structured and drafted to recognize the critical differences between insurance and banking. These differences must be respected in the regulations promulgated under the Act. This is particularly true where the regulations set forth new standards that apply a monolithic, bank-centric, “safety and soundness” approach to insurance. For example, in February 2011 comments to the Agencies on their joint notice of proposed rulemaking with respect to Basel II capital adequacy standards, AIA urged the Agencies to distinguish property-casualty insurance companies from banks based on the unique insurance business model and accompanying state-based financial regulatory system. We noted that “it is critical” that the Agencies employ insurance risk-based capital standards that are embedded in the financial regulation of insurance and are, therefore, the only suitable way to reflect and manage the risks that are inherent to property-casualty insurers.³ AIA has also urged that regulations implementing Sections 113, 165 and 166 of the Dodd-Frank Act,⁴ as well as supervisory guidance under Title I,⁵ adhere to the Act’s intent to respect the insurance business model and to defer to the existing state-based system of regulation.

¹ 77 Fed. Reg. 52792; 77 Fed. Reg. 52888; 77 Fed. Reg. 52978 (Aug. 30, 2012).

² Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010).

³ Comments of the American Insurance Association in Response to “Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of a Risk-Based Capital Floor (OCC Docket ID OCC-2010-0009; FRB Docket No. R-1402 and RIN No. 7100-AD62; FDIC RIN 3064-AD58 and PIN XXXX-XXXX),” at p. 2 (comments filed Feb. 28, 2011).

⁴ Comments of the American Insurance Association in Response to Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies Pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Docket No. FSOC-2010-0001) (comments filed Nov. 5, 2010) (*available at www.regulations.gov, Doc. ID FSOC-2010-0001-0029 through FSOC-2010-0001-0029.3*) (“AIA ANPR Comments”); Comments of the American Insurance Association in Response to Proposed Regulation YY - Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (RIN 7100-AD-86; Docket No. 1438) (comments filed Apr. 30, 2012).

⁵ Comments of the American Insurance Association in Response to Supervisory Guidance by the Board of Governors of the Federal Reserve System to Savings and Loan Holding Companies as set forth in 76 Fed. Reg. 22662 (comments filed May 23, 2011).

As detailed more fully below, it is more appropriate to apply the risk-based capital system of insurance financial regulation to firms that are engaged in the insurance business than to incur the adverse consequences from trying to shoehorn those companies into capital standards that were developed for the unique features of banking organizations. Therefore, for those companies with property-casualty insurance affiliates that would otherwise be subject to the Proposed Rules, AIA strongly urges that the Agencies ring-fence the insurance companies and allow them to continue to be subject to state risk-based capital standards in lieu of the Proposed Rules. At minimum, the Agencies should adjust the Proposed Rules as needed to reflect the state insurance risk-based capital standards for insurance companies that are part of financial institutions that are otherwise subject to the Proposed Rules.

BACKGROUND

Section 171

Section 171 of the Dodd-Frank Act requires the Agencies 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 Federal Reserve. The section further provides that the minimum ratios may not be less than the generally applicable leverage and risk-based capital requirements, which will serve as a floor for the Agencies' requirements, nor lower than the generally applicable leverage and risk-based capital requirements that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act.⁶ Section 171 was introduced by Senator Collins, who stated the following:

Our amendment is aimed at addressing the too-big-to-fail problem at the root of the current crisis by requiring financial firms to have adequate amounts of cash and other liquid assets to survive financial crises without turning to the taxpayers for a bailout. It is critical to our ability to avoid future crises that this amendment be adopted.⁷

As indicated by Senator Collins, the leading sponsor of the provision, the objective of Section 171 is to require financial firms to maintain an appropriate level of capital to strengthen their financial positions and to prevent the need for a taxpayer bailout. Nothing in Section 171 or its legislative history requires the Agencies to establish a specific regulatory structure beyond the direction that minimum capital ratios may not be less than the generally applicable leverage and risk-based capital requirements, nor lower than the generally applicable leverage and risk-based capital requirements that were in effect for insured depository institutions as of the date of enactment.

⁶ Dodd-Frank Act §171(b)(1), (2).

⁷ 156 Cong. Rec. S3459 (daily ed. May 10, 2010).

The Agencies' Proposed Rules

The first Proposed Rule addresses the Standardized Approach proposal and includes proposed changes to the Agencies' general risk-based capital requirements for determining risk-weighted assets (*i.e.*, the calculation of the denominator of a banking organization's risk-based capital ratios). The proposed changes revise and harmonize the Agencies' rules for calculating risk-weighted assets to enhance risk-sensitivity and incorporate certain international capital standards of the Basel Committee on Banking Supervision ("Basel Committee") presented in the standardized approach of the "International convergence of Capital Measurement and Capital Standards: A Revised Framework" ("Basel II"), as revised.

In the second Proposed Rule, the Agencies propose to revise their risk-based and leverage capital requirements consistent with agreements reached by the Basel Committee in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III"). The proposed changes would implement a new common equity tier 1 minimum capital requirement, a higher minimum tier 1 capital requirement, and, for banking organizations subject to the advanced approaches capital rules, a supplementary leverage ratio that incorporates a broader set of exposures in the denominator measure. Additionally, the Agencies are proposing to apply limits on a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a specified amount of common equity tier 1 capital in addition to the amount necessary to meet its minimum risk-based capital requirements.

In the third Proposed Rule, the Agencies propose to revise the advanced approaches risk-based capital rule to incorporate certain aspects of Basel III that would apply only to advanced approach banking organizations. The proposal also includes additional changes to reflect changes made by the Basel Committee to Basel II, as revised. The Agencies also propose to revise the advanced approaches risk-based capital rule by replacing references to credit ratings with alternative standards of creditworthiness. Additionally, the Federal Reserve stated that the advanced approaches and market risk capital rules will apply to top-tier U.S. savings and loan holding companies ("SLHC") that meet the applicable thresholds.

THE PROPOSED RULES DO NOT REFLECT THE UNIQUE ATTRIBUTES OF INSURANCE COMPANIES

The Proposed Rules apply consolidated capital requirements to savings and loan holding companies, which previously were not subject to consolidated quantitative capital requirements. Because savings and loan holding companies may be affiliated with insurance companies, the Proposed Rules would effectively apply to insurance companies. As we have commented previously, AIA believes that it is not appropriate to apply "bank-centric" consolidated capital standards to depository holding companies to the extent they engage in insurance activities.

Insurance companies are not banking organizations. Applying the Proposed Rules to holding companies that are insurers or maintain insurance affiliates is not consistent with the language or intent of the Dodd-Frank Act. As the Agencies are aware, the Dodd-Frank Act recognizes the unique attributes of insurance companies and treats insurers differently in numerous provisions. For example, in recognition of the unique aspects of the insurance business, the Act established a new office – the Federal Insurance Office – to address matters relating to the business of insurance at the federal level. Further, Section 201(a) of the Dodd-Frank Act provides that the term “financial company” does not include a subsidiary of a bank holding company or a nonbank company supervised by the Federal Reserve if the subsidiary is an insurance company. Moreover, Section 203(e) of the Act provides that the orderly liquidation provisions of the Act do not apply to insurance companies. Rather, insurance companies are to be liquidated or rehabilitated by state insurance authorities in accordance with state law. Further evidence that Congress recognized that insurance differs significantly from other financial activities is demonstrated by Title X of the Dodd-Frank Act, where Congress carved out the business of insurance from the jurisdiction of the Consumer Financial Protection Bureau.

Although the Proposed Rules contain several provisions that relate to certain aspects of the insurance business, we believe that such provisions are clearly inadequate to address the considerable differences between banking organizations and insurers. We believe that Section 171 does not require the Agencies to apply bank-like capital rules to affiliates of banking organizations that are engaged in the business of insurance. Moreover, carving out insurance activities from the application of the Proposed Rules would reflect the fact that property-casualty insurance activities present far lower risk to our financial system than do banking activities. Hence, property-casualty insurers present virtually no risk that a taxpayer bailout will be needed to address such activities.⁸

The Insurance Business Model

The Agencies should employ risk-based capital standards that are suitable and reflective of the risks that are inherent to the insurance business. Insurers, particularly property-casualty insurers, and depository businesses operate according to different business models and their behavior, activities, and regulatory scheme flow from their respective models.

Insurance companies operate under a business model based on an “inverted cycle of production”⁹ where premiums are received up-front. “This means that the product - the contractual promise to pay

⁸ Senate Report No. 111-176 of the Committee on Banking, Housing, and Urban Affairs on the “Restoring American Financial Stability Act of 2010,” p. 64 (Apr 30, 2010). (“It is intended that the risk-based assessments may vary among different types or classes of financial companies in accordance with the risks posed to the financial stability of the United States. For instance, certain types of financial companies such as insurance companies and other financial companies that may present lower risk to U.S. financial stability (as indicated, for example, by higher capital, lower leverage, or similar measures of risk as appropriate depending on the nature of the business of the financial companies) relative to other types of financial companies should be assessed at a lower rate.”)

⁹ “Systemic Risk and the Insurance Sector,” International Association of Insurance Supervisors, p. 2 (IAIS Paper) (Oct. 25, 2009).

an agreed amount only if a particular event occurs in the future - is sold at a price, the insurance premium, which has to be estimated before knowing the actual cost of the product which depends on probabilities of occurrence and severity of future events.”¹⁰ The property-casualty industry business model is premised upon collecting sufficient premium in advance to fund covered claims. Hence, there is less need to borrow and consequently a substantially lower likelihood of becoming highly leveraged. When insurance companies do borrow, they generally do so through issuance of long-term debt or surplus notes in the public and sometimes private placement markets, for the purpose of long-term strategic positioning. They do not continuously tap short-term funding vehicles such as commercial paper issuance for their day-to-day funding requirements.

The primary risks for insurance firms are underwriting and market risks; liquidity and credit default risks are low. With regard to market risks, insurance assets and liabilities are generally linked, and risks are comparatively longer term and more diversified than in sectors such as banking. Relevant types of risks pooled are typically “real events” such as theft, fire, sickness, death and natural hazards. These are exogenous events and mostly independent in nature, as opposed to other types of financial risk.

The insurance business model also helps shield property-casualty insurers from the so-called “run on the bank” scenario frequently used to describe the contagion effect of systemic risk. Unlike customer deposits held by banks, payment of claims under an insurance policy depends on the occurrence of a covered event. Therefore, as a practical matter, insurance consumers do not have “on-demand” access to insurance assets as they would with other financial institutions that do not operate according to an inverted cycle of production.

Insurance vs. Bank Balance Sheets

One important consequence of the fundamentally different business models is that banks and insurers feature quite different balance sheets. A bank turns a profit by earning more money in loans than it pays out in interest to depositors. An insurer, on the other hand, must earn more from premiums and investment returns than it pays out in claims. This differing feature of return on assets represents the crucial distinction between bank and insurance models; for banks, loans are the primary source of income whereas for insurers, underwriting profitability is primary and investment income is secondary. Banks must attempt to maximize their returns on loans, whereas insurers must manage the liquidity and duration of their investments in order to meet claim payment obligations.

This core difference between the models results in material differences in bank and insurance industry balance sheets. With more modest demands on asset return, insurers maintain a far higher proportion of assets in cash and investments than banks, which keep over two-thirds of assets tied up in loans to maximize income. Bank borrowers can always default on loans, but insurers invest primarily in high-grade debt and equity securities. On the liability side of the balance sheet, insurers maintain extensive capital pools and loss reserves to honor claims. Most bank liabilities are relatively short-term deposits, which are used to fund longer term loans. This maturity mismatch does not exist for property-casualty

¹⁰ *Id.*

insurers. Finally, for insurers, claims are “prefunded” because customers must pay premiums “up front.” Bank depositors, however, can withdraw a significant portion of their deposits on demand. Bank reliance on short-term funding is why banks are far more likely than insurers to be exposed to suffering a liquidity crisis. The attachment presents further details on the differences between the balance sheets of banks and insurance companies.

Insurance RBC System in the U.S.

Insurance regulators have designed a risk-based capital framework that takes into account the “inverted cycle of production” business model and the specific risks applicable to property-casualty insurers. We believe that framework more accurately reflects the risk characteristics of a property-casualty insurer than the Proposed Rules. The existing insurance risk-based capital system has established regulatory standards for assessing capital adequacy based upon the particular risks applicable to the insurer. It is a uniform standard that has been adopted by all of the states and provides for a ladder of regulatory intervention if risk-based capital falls to certain levels.

In response to insurer insolvencies in the late 1980s and early 1990s, the National Association of Insurance Commissioners (“NAIC”) developed a risk-based capital (“RBC”) regulatory system for insurance. It was first introduced in the U.S. in 1994. That system created a formulaic approach that weights key risk elements in determining required levels of risk-based capital. The material components of the RBC formula address risks for both the underwriting side of the insurer’s business (*i.e.*, underwriting risk relating to insurance reserves and net written premiums) and the investment side (*i.e.*, risks related to investments in subsidiaries, equity securities, debt securities and related default risk). By focusing on the specific risk elements of the insurer, U.S. insurance regulators have developed an RBC system that has been effective in identifying weak companies and has provided them with the ability to intervene as necessary.

The insurance RBC system was established with two primary objectives in mind:

1. *Focusing Regulatory Attention:* The risk-based capital requirement should help regulators to meaningfully discriminate between those companies needing regulatory attention due to potential capital inadequacy and those that do not require such attention.
2. *Changing Company Behavior:* The requirement should lead company management to modify its behavior so as to carry sufficient capital to avoid such regulatory attention.¹¹

According to a recent study by the NAIC, the RBC system has been effective in meeting those objectives. Out of more than 2600 insurer filings in each of the past five years, only about 3% on average have

¹¹ “Property-Casualty Risk-Based Capital Requirement – A Conceptual Framework,” Actuarial Advisory Committee to the NAIC Property & Casualty Risk-Based Capital Working Group (February 1992), *available at* www.casact.org/pubs/forum/92spforum/92sp211.pdf

required *any* action by regulators.¹² That same report shows that the property-casualty industry has maintained three times as much capital as is required by the RBC system. Moreover, unlike the banking industry, there have been relatively few property-casualty insurance insolvencies. Equally important, as Congress recognized in exempting insurance companies from the FDIC's liquidation authority under Title II of the Dodd-Frank Act, those insolvencies have been handled in an orderly manner under the state-based resolution system.

A SLHC that is predominantly engaged in property-casualty insurance activities operates under a capital structure and regulatory capital requirements that do not correlate with the regulatory environment under which depository institutions have long operated. Without a more focused examination of the statutory or regulatory restrictions upon, or the capital requirements that apply to, the insurance activities of an SLHC, the Proposed Rules will likely lead to an inappropriate determination of the capital adequacy of an SLHC that is primarily engaged in insurance activities. Equally important, requiring additional capital at the holding company level in those circumstances would undermine the ability of the insurance company to deploy capital to support existing policyholders or to provide additional insurance capacity, thwarting both the insurance regulatory goal of policyholder protection and the market goal of insurance availability.

Proposed Risk Weights Should Reflect Benefits of Insurance

AIA believes that the risk weights assigned to various asset classes should take into account the benefits of insurance coverage as a vehicle for reducing exposure to credit risk. For example, comments submitted by insurers that offer private mortgage insurance point out the important role such insurance can play in mitigating credit risk, and in reducing the risk weights assigned to specific categories of mortgage loans and mortgage backed securities. The fact that the Proposed Rules do not provide credit for mortgage insurance in risk weighting mortgage loans will likely have adverse capital implications for lending institutions and result in a reduction in the availability of mortgage credit available to otherwise qualified borrowers, especially those who must rely on low down payment loans. AIA supports recommendations advanced by the private mortgage insurers, including (1) allowing banking institutions to continue to recognize private mortgage insurance and other credit enhancements for purposes of calculating capital charges for residential mortgage exposure; (2) permitting full recognition of private mortgage insurance or other credit enhancement if determined to be financially sound by the terms of a proposed new model for claims paying ability; and (3) deeming financially sound any private mortgage insurer that is licensed by its domiciliary state department of insurance and able to demonstrate ability to pay all claims under a severe stress scenario.

RECOMMENDATION

Because property-casualty insurance companies operate under a fundamentally different business model that requires different financial regulatory standards than those envisioned by the Proposed

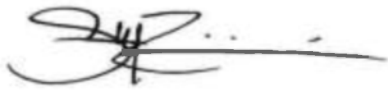
¹² "Property & Casualty Industry RBC Results for 2011," National Association of Insurance Commissioners, p.3 (Sept. 2012), available at http://www.naic.org/documents/research_stats_rbc_results_pc.pdf.

Rules, AIA respectfully urges the Agencies to except property-casualty insurance companies from the Proposed Rules. Instead, AIA recommends that the Agencies “ring fence” property-casualty insurance companies that are part of a BHC or SLHC and defer to the existing state RBC standards applicable to such companies. At minimum, the Agencies should adapt the Proposed Rules to reflect the considerable differences between insurance companies and depository institutions.

CONCLUSION

AIA appreciates the opportunity to provide our perspective and recommendations on the Agencies’ Proposed Rules. It is important that the Proposed Rules reflect the statutory intent of the Dodd-Frank Act to recognize the distinction between insurance companies and depository institutions, and to defer to the existing system of insurance regulation, where necessary, to enable the industry to continue to effectively meet the needs of insurance consumers in the United States.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "J. Zieleski", with a long horizontal flourish extending to the right.

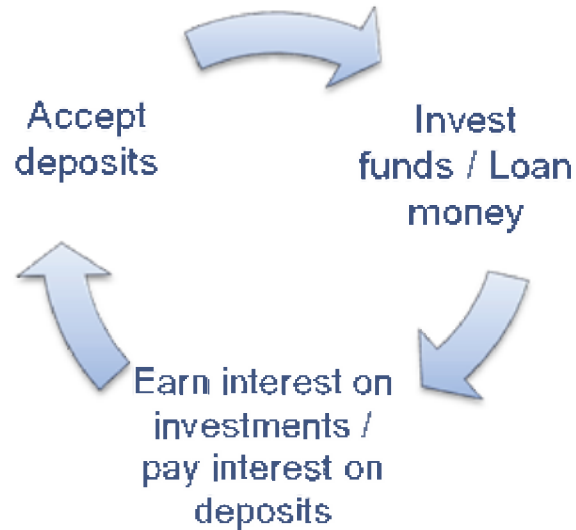
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Bank and P&C Balance Sheets:

Comparing industry risks through examination of assets, liabilities and capital

Banking & Insurance: Basic Difference Between Business Models

The banking model depends on the interest rate spread between deposits and loans:¹



- **Banks are financial intermediaries -**
 - Accept deposits or assume other debt (deposits), then
 - Loan money to borrowers or make other investments (earning assets)
- Banking profitability results from the difference between interest the bank earns on loans (as well as fees from banking services) and the interest the bank pays on deposits

The property and casualty insurance model depends on the frequency and severity of insured loss events:²



- **P&C insurers spread risks -**
 - Collect premiums in exchange for protection from an insured risk;
 - Invest funds collected (invested assets);
 - Establish reserves for claim liabilities (insurance reserves) ; and
 - Pays claims as they come due
- P&C profitability results from difference between the premiums the insurer collect and the claims and expenses the insurer pays ("underwriting profitability"), as well as investment income earned between the time of premium collection and claim payment.

Source: ¹ – Adapted from the AICPA Audit guide: *Depository and Lending Institution, Chapter 1*

² – Adapted from the AICPA Audit guide: *Property and Liability Insurance Companies , Chapter 1*

Overview Comparison of the Bank and P&C Industry Balance Sheets

	Banking Industry Profile ¹	P&C Insurance Industry Profile ²
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Assets

Cash & Investments	25%	84%
Loans	65%	
Total Earning / Invested Assets	90%	84%
Premium / Reinsurance Receivables		12%
Other Assets and Receivables	10%	4%
Total Assets	100%	100%

Where are the most assets?

Banks: Loans

P&C: Investment securities

Liabilities & Capital

Loss reserves		38%
Unearned premium reserves		14%
Deposits	73%	
Other borrowings - short term	14%	1%
Total operating liabilities	87%	53%
Accounts payable and other liabilities	2%	15%
Capital & surplus	11%	32%
Total Liabilities & Capital	100%	100%

Where are the most liabilities?

Banks: Demand and time deposits

P&C: Incurred loss reserves

What is the leverage?

Banks are typically significantly more leveraged than P&C companies

¹ - Source: Federal Financial Institutions Examination Council - Uniform Bank Performance Report for all commercial banks over \$3B total assets (as of 12/31/09)

² - Source: SNL Interactive - P&C Industry Profile - P&C Industry Balance Sheet (on a statutory accounting basis) - (as of 9/30/09)

Closer Examination of Earning / Invested Assets

Banks



- As financial intermediary, banks invest a portion of depositors funds in loans and investment securities
- Banking profitability is based on the investment spread between earnings on its loans and investments and the interest paid to depositors
- Typically, the loan portfolio is the most significant asset on a bank's balance sheet
- Banks may originate loans, purchase loans or participating interests in loans, sell loans or portions of loans, and securitize loans

P&C Insurance

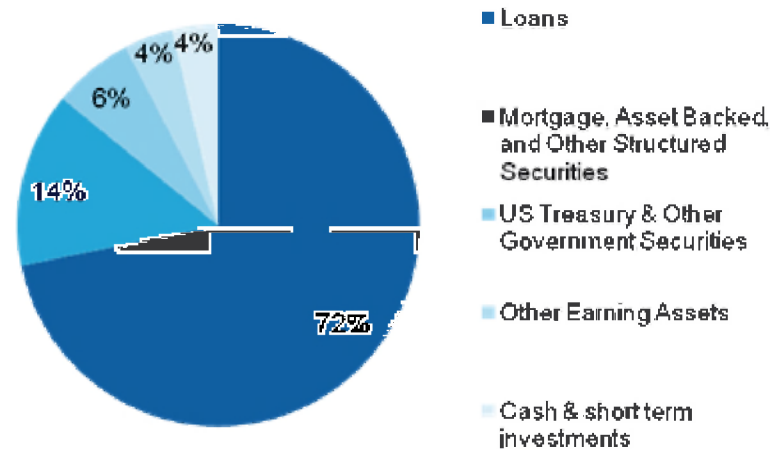


- As a part of the risk-spreading process, P&C insurers invest the funds representing premium payments
- Investment returns represent a secondary income source to P&C insurers, with the primary focus on underwriting profitability
- The P&C industry's portfolio is primarily concentrated in debt and equity securities

Earning / Invested Assets – Looking into the Portfolios

Banking Earning Assets (90% of Total Assets) ¹

Comprised of:

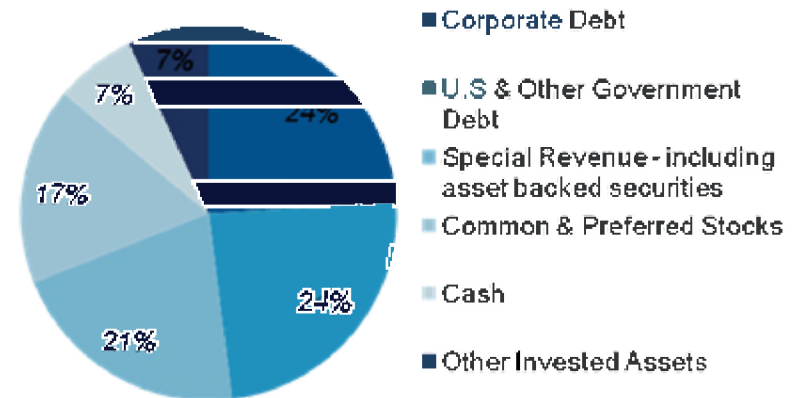


Loans are typically the most significant asset balance for banking institutions (72% of total earning assets for the example peer group):

- **Valuation:** Typically, loans are carried at amortized cost
- **Credit Risk:** Loan quality & related credit risk may be assessed through internal or external ratings or analytically (default rates, nonaccrual rates, etc.).
- **Impairment:** An allowance for loan losses reduces the recorded amount of the loan portfolio to reflect its collectability as of the balance sheet date.

Insurance Invested Assets (84% of Total Assets) ²

Comprised of:



Debt securities are the most significant earning asset of a P&C insurance company (69% of total invested assets):

- **Valuation:** Under Statutory accounting, debt securities are carried at amortized cost. Under GAAP accounting, they are generally carried at fair market value.
- **Credit Risk:** NAIC rates the asset quality for all invested assets based on publicly available credit ratings (securities below investment grade are reported at fair market value)
- **Impairment:** Impairment charges are recorded against debt securities with potential credit losses, reducing the recorded value of the investment

¹ - Source: Federal Financial Institutions Examination Council - Uniform Bank Performance Report for all commercial banks over \$3B total assets (as of 12/31/09)

² - Source: SNL Interactive - P&C Industry Profile - P&C Industry Balance Sheet (on a statutory accounting basis) - (as of 9/30/09)

Closer Examination of Operating Liabilities

Banks



- In its role as financial intermediary, banks accept funds from depositors and in turn invest those funds in loans and securities
- Deposits are the primary source of funding for banks
- A bank is obligated to repay a depositor's funds on demand, after a specific period of time or after expiration of some required notice period

P&C Insurance



- In exchange for premium received on the policy, the insurer agrees to reimburse the insured for covered losses incurred
- Claims are pre-funded in the sense that premiums are collected prior to claim payments
- Loss reserves represent claim liabilities to be paid in the future for insured loss events that have occurred as of a specified date

Operating Liabilities – Looking into the Portfolios

Banking Deposits & Borrowings 87% of total liabilities & capital ¹

Deposits (73% of total liabilities & capital): Deposits (time and demand) are typically a major source of funding for many banks.

- **Timing:** A bank is obligated to repay a depositor's funds on demand, after a specific period of time or after expiration of some required notice period, presenting liquidity risk

- **Fixed Liability:** The settlement value of a deposit account is fixed by the amount deposited and related interest and terms

- **Liquidity Resources:** Deposit insurance, access to the Federal Reserve's discount window and payment system guarantees are part of the federal safety net that provides liquidity when necessary

Other borrowings (14% of total liabilities & capital): Other long and short-term borrowings supplement deposits and enable banks to carry out their overall asset/liability management strategy.

Insurance Reserves 53% of total liabilities & capital ²

Loss and loss adjustment expense reserves (38% of total liabilities & capital: Claim costs and expenses are incurred only if an insured event occurs during the contract period

- **Timing:** Payment on the insurance liability depends on if and when an insured event occurs and the liability comes due, presenting asset / liability matching risk

- **Estimated Liability:** Claims reserves are estimated based on projected settlement costs when claim payment is expected to come due

- **Resources to Spread Risk:** In addition to the spread of risk achieved through the insurer's own portfolio of liabilities, the insurer may further spread risk by ceding a portion of its loss obligations to a reinsurer. On a statutory basis (as presented on page 3), loss reserves are presented net of reinsurance recoveries.

Unearned premium reserves (14% total liabilities & capital): Represents the unearned revenue for the unexpired portion of an insurance contract

Other borrowings (1% total liabilities & capital)

¹ - Source: Federal Financial Institutions Examination Council - Uniform Bank Performance Report for all commercial banks over \$3B total assets (as of 12/31/09)

² - Source: SNL Interactive - P&C Industry Profile - P&C Industry Balance Sheet (on a statutory accounting basis) - (as of 9/30/09)

Capital Framework – Banking

A risk-based capital adequacy model

- Aligns capital to the risk profile of the institution by making capital measures sensitive to changes in (primarily credit) risk
- Categorizes assets by broad segment and applies standardized risk weights to compute the basis for risk-based capital levels
- Factors in off-balance sheet exposures by applying a credit conversion factor to translate the exposure into an asset equivalent

Capital adequacy standards for commercial banks under current Basel I

Capital Measure	Minimum	“Well Capitalized”*
Total capital/risk-weighted assets	8%	10%
Tier 1 capital/risk-weighted assets	4%	6%
Tier 1 capital/total assets (“leverage ratio”)	4%	5%
Tier 1 (“core”) capital = common shareholder equity; qualifying perpetual preferred stock; minority interest in consolidated subs (less, <i>generally</i> , goodwill, intangibles, unrealized gains (losses) on AFS securities, deferred tax assets)		

An advanced approach under Basel II

- Incentivizes institutions to enhance techniques for measuring and managing risks
- Recognizes an institution’s internal risk rating, segmentation and risk parameter quantification systems, and operational risk management processes
- Provides for levels of customization from standardized to fully institution-specific

* As defined under the Prompt Corrective Action Framework

Capital Framework – Banking (Simplified Capital Calculation)

Item	Amount	Conversion Factor	Risk Weighting	Total
Balance Sheet Assets				
Cash	\$ 5,000		0%	\$ -
U.S. Treasury securities	20,000		0%	-
Balances at domestic banks	5,000		20%	1,000
Loan (first lien, 1–4 family residential)	5,000		50%	2,500
Loans (commercial)	65,000		100%	65,000
Total Balance Sheet Assets	\$ 100,000			\$ 68,500
Off-Balance Sheet Items				
Standby letters of credit (backing general obligation municipal bonds)	\$ 10,000	1.00	20%	\$ 2,000
Commitments (binding, greater than 1 year)	20,000	0.50	100%	10,000
Total Off-Balance Sheet Items	\$ 30,000			\$ 12,000

Total Risk-based assets	\$ 80,500
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Tier 1 Capital	\$ 5,000	Total capital/risk-based assets	7.45%
Tier 2 Capital	1,000	Tier 1/risk-based assets	6.21%
Total Capital	\$ 6,000	Tier 1/Total assets (leverage)	5.00%

Capital Framework – P&C Insurance

A risk-based capital adequacy model ¹

- RBC requirements establish a framework for linking various levels of regulatory corrective action based on a comparison between total adjusted capital (TAC) and the authorized control level (ACL) based on the entity's risk based capital
- Risk factors used in the RBC calculation are prescribed by the National Association of Insurance Commissioners (NAIC)

Capital adequacy standards for insurance companies under NAIC Risk Based Capital (RBC) ¹

- TAC is equal to the sum of statutory capital (common and preferred stock), surplus notes, and unassigned surplus (surplus is the difference between statutory admitted assets and liabilities)
- ACL represents an accumulated RBC calculated based on the following risk rating factors prescribed by the NAIC:
 - **Asset Risk:** Measures the credit quality of invested assets, receivables, reinsurance recoveries, as well as asset concentration risk;
 - **Underwriting Risk – Loss Reserves:** Different risk rated factors applied to reserves for industry average loss sensitivities for each line of business; and
 - **Underwriting risk – Written Premiums:** RBC is calculated for annual net written premiums based on industry average loss ratios for each line of business
- Regulatory action levels are defined for any insurance entities with TAC less than or equal to 2 x ACL

An advanced approach under Solvency II

- Emerging Solvency II proposals promote internally modeled risk management measurements to assess risk based a market view of cash flows
- Despite the fact that Solvency II is a European initiative, and implementation remains three or more years away, US insurers are expressing interest in its potential effects

¹ – Source: AICPA Audit and Accounting Guide: Property and Liability Insurance Entities – Chapter 2

Other Assets & Liabilities

Generally, other assets and liabilities are not material components of banking or insurance company balance sheets. The following describes the general nature of these items:

Common Balance Sheet Items:	
<p>Other assets & receivables (Banking – 10% of total assets / P&C Insurance – 4% of total assets): For example,</p> <ul style="list-style-type: none"> • Real estate and properties owned and occupied by the entity; • Capitalized software • Furniture and equipment <p>General accounts payable (Banking – 2% of total assets / P&C Insurance – 15% of total assets): For example,</p> <ul style="list-style-type: none"> • Accounts payable and other accrued expenses for operational costs • Taxes or other charges • Compensation and benefit-related accruals, such as bonuses, pension liabilities, supplemental executive retirement plans, and postretirement health care benefits 	
Banking Industry ¹	P&C Insurance Industry ²
<ul style="list-style-type: none"> - General receivables: Typically miscellaneous fees or penalty amounts due from customers - Bank acceptances receivables / payables: Short term drafts from a bank to finance a customer's purchase from a vendor. The bank recognizes a receivable from the customer and a liability for the acceptance it has issued to the vendor. 	<ul style="list-style-type: none"> - Insurance premiums receivable: Uncollected premiums for insureds or amounts due from agents or brokers on insurance policies. - Reinsurance recoverables / payables: uncollected recoveries from reinsurers on paid losses or unremitted premiums to be paid under a reinsurance transaction.

¹ - Source: Federal Financial Institutions Examination Council - Uniform Bank Performance Report for all commercial banks over \$3B total assets (as of 12/31/09)

² - Source: SNL Interactive - P&C Industry Profile - P&C Industry Balance Sheet (on a statutory accounting basis) - (as of 9/30/09)