

April 20, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. 1438, RIN 7100-AD86: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

Dear Ms. Johnson:

We write on behalf of the National Association of Insurance Commissioners (NAIC) regarding the Federal Reserve's notice and proposed rulemaking on "Enhanced Prudential Standards and Early Remediation Requirements for covered Companies." 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. The NAIC respectfully submits the following comment to the Notice of Proposed Rulemaking and Request for Comment published in the January 5, 2012 issue of the Federal Register.¹

As noted in the proposed rule, the market perception associated with "too big to fail" can pose a significant threat to the financial system.² It reduces market discipline, encourages competitive distortions through funding advantages, and artificially encourages further consolidation and concentration in the financial system. We, therefore, think it is appropriate for the Federal Reserve to implement strong prudential standards to offset the advantages that may accrue to firms perceived as "too big to fail" as well as mitigate the other negative externalities associated with Financial Stability Oversight Council (Council) designation.

The measures selected should seek to ensure critical protections to the financial system, while at the same time minimizing the harmful consequences that can result from such a designation. As it relates to any non-bank financial company the Council determines poses a grave threat to financial stability³ and is designated for oversight by the Federal Reserve, we believe that the enhanced prudential standards

¹ Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (proposed January 5, 2012) (to be codified at 12 C.F.R. pt. 252).

² *Id.* at 595.

³ *Id.*

applied should be tailored to the specific business model and structure of the financial institution, the characteristics of the markets in which the firm operates, and the activities that make the institution systemically risky. With respect to insurance companies, systemically risky activities are antithetical to the interests of policyholders. Insurance consumers should not be materially exposed to such activities and we are actively working to ensure that is the case.

Standards should minimize negative market implications

Our interest in the proposed rule is the impact of federal policy on insurance markets and companies, and ultimately insurance consumers. Consumers value the financial strength of their insurer.⁴ They are often purchasing promises extending decades into the future, for payment upon the occurrence of an insured event. Although state insurance guaranty funds serve as a backstop for some coverages up to specified limits, an insurer's obligations to a consumer may exceed those limits. Thus, the value of those promises depends fundamentally on the ability of the insurer to survive into the future.

Given the value placed on financial strength by insurance consumers, state insurance regulators are concerned that the creation of a two-tiered system of supervision, where some insurance companies are perceived as safer than others, could create competitive distortions, artificially advantage some companies, and encourage undesirable consolidation and concentration in the insurance sector. Our priority is to avoid such unintended and undesirable consequences in our sector.

To prevent these consequences, we encourage the Federal Reserve to impose policies that will strongly discourage non-bank systemically important financial institution (SIFI's) from engaging in activities that resulted in their designation as a SIFI. In particular, enhanced prudential standards applied to insurance groups that have been identified as SIFIs should be aimed at returning them to non-SIFI status, thus avoiding a market perception that some insurance companies are safer than others.

Recommendations

As supervisors of the insurance sector, we are keenly aware of the need to have a strong and competitive market to serve our policyholders. The inherent nature of most traditional insurance activities is such that government support is not essential. Traditional insurance activities typically do not add systemic risk to the financial system—they generally do not involve the transformation of short term liabilities into long term assets and do not lend themselves to run risk.

To the extent that any insurance company is designated a SIFI, the rules for implementing enhanced prudential standards will have critically important, and potentially detrimental implications for the industry that we regulate and ultimately for the policyholders we serve to protect. Even the perception of implicit support could interfere with competitive insurance markets. We do not believe insurance companies should engage in systemically risky activities that would lead to designation by the Council, nor be materially exposed to companies that are engaging in such activities.

⁴ It is not surprising that scholars have found evidence that consumers place considerable value on the solvency of their insurer. Among other evidence, researchers have found an inverse relationship between insurance premium and firm risk, an inverse relationship between default risk and policyholder willingness to purchase insurance, and a direct relationship between rating downgrades and an increase in life insurer lapses and a decrease in premium revenue. These findings are consistent with consumer preference for insurers that are perceived to have a stronger financial condition. See, e.g. Sommer, D.W., *The Impact of Firm Risk on Property-Liability Insurance Prices*, Journal of Risk and Insurance 63(3): 501-514 (1996).

To that end, state insurance regulators have already taken measures to improve their ability to identify systemically risky activity within an insurance group. We have recently enhanced the solvency framework to provide more “windows” into group activities and developed assessment tools to better identify, quantify, and account for risk in various stress scenarios. In addition, holding companies will be required to identify activities of affiliates that could pose contagion or reputational risks to the insurer. These tools will allow state insurance regulators to work with insurers in a timely manner to limit the impact of systemically risky activities. We intend to continue to develop these tools and work with our fellow regulators toward the goals of protecting policyholders and the financial system from systemically risky activity by insurers.

It is with these efforts in mind that we recommend the standards adopted by the Federal Reserve reflect these important features:

- To the extent that the systemically risky activities reside at an affiliate of an insurance company (as was the case with AIG), the affiliate should be walled-off from the insurance legal entities. That is, the affiliated company should not be able to leverage off the assets of the insurance company to support its risk taking activities. Among other measures, the affiliate should be required to hold sufficient capital to provide a strong disincentive for excessive risk taking. Cross subsidies, loans and guarantees of the affiliate’s balance sheet by the insurance legal entities should be prohibited. Dividends provided by the insurance company to the holding company should be limited to those provided in the normal course of business. Any diversification benefits recognized in the capital framework should be eliminated. The measures to wall-off the systemic activities should be made fully transparent to the market so that financial strength ratings do not reflect implicit support from affiliate insurance companies. These measures will ensure that the risky activities of the affiliate are constrained and policyholder interests are not threatened by such activities.
- To the extent that an insurer engages in activities that result in its designation by the Council, state regulators have committed to curtailing such activities that could result in designation in the first place. State regulators have improved mechanisms to identify and address potential threats. In this regard, we strongly encourage the Federal Reserve to work closely and collaboratively with us. Any measures applied should be mindful of the interests of policyholders in addition to being consistent with desired outcomes from a macro perspective.

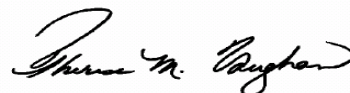
Conclusion

We appreciate the opportunity to comment. Should you wish to discuss this comment or any other matter relating to the NAIC’s views on this proposed rule, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980 or Mark Sagat, Counsel and Manager of Government Relations, at (202) 471-3987.

Sincerely,



Kevin M. McCarty
Florida Commissioner of Insurance and
NAIC President



Therese M. Vaughan, Ph.D.
NAIC Chief Executive Officer