State Insurance Regulator Comments Regarding FSOC Proposed Rule and Guidance

Provided to Director John Huff, State Insurance Commissioner Representative to the Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC) issued a second notice of proposed rulemaking and proposed interpretative guidance relating to its authority to require supervision and regulation of certain non-bank financial companies. The comment period ends on December 19, 2011. Upon issuance of the proposed rule and guidance, Director Huff solicited comments from his fellow state insurance regulators. The review of the guidance culminated in a discussion call held on November 9, 2011 that was open to all regulators. Several members of the Government Relations Leadership Council, several chief financial regulators, and other interested insurance regulators joined the call.

Comments from regulators regarding the guidance are summarized below:

1. *Overall Process*

   There was a general consensus among the state insurance regulators providing comments that, as a general matter, the proposed process appeared reasonable. In their view, the proposed process provided reasonable opportunity for insurance regulator participation and consultation in the non-bank consultation process and for companies to provide information and present arguments to FSOC concerning potential designations. They did ask Director Huff to seek clarity that the references to consultation with primary financial regulatory agencies in the proposed guidance and preamble include the primary financial regulatory agencies of subsidiaries as required by statute and set forth in the rule text.

   Of concern to the insurance regulators was the lack of clarity as to how decisions to advance specific companies through different stages will be formalized and documented by FSOC. Regulators wanted a better understanding as to whether the FSOC will vote at the end of each designation stage to determine whether a company moves to the next stage and how views of various council members will be reflected in the public record. Votes and individual member views would be critical to ensure a transparent process by providing information to the public and industry stakeholders at key points in the designation process. Regulators also took note that that the FSOC reserved the right to consider companies even if they did not satisfy the stage 1 initial screens. There was consensus among the regulators that FSOC should vote any time such circumstances arise.

2. *Stage 1 Screens*

   Regulators thought most of the screens were appropriate for identifying companies for additional review. They did raise concerns that the leverage screen, 15 to 1 assets to equity, may generate some “false positives” as some life insurers can operate safely at higher leverage ratios due to the nature of the their business model, the extent of the reserves such insurers already hold as liabilities and the extent of the assets required to support such liabilities. Regulators also wanted to know whether repurchase agreements are captured in the initial screens, perhaps in the short term debt screen. If such transactions are not captured, regulators believe FSOC should give some consideration to including these transactions in the first stage because insurers and other financial market participants engage in significant amount of such transactions. If not considered in the first stage, such transactions should be considered in the second and third stages.

3. *Consultation*

The regulators agreed that it was imperative that memoranda of understanding or other confidentiality agreements would need to be executed between the states and the FSOC before any information sharing or consultation took place. They committed to working with Director Huff and the FSOC members to complete such agreements as soon as possible. Regulators asked Director Huff to request that regulators be consulted prior to any vote to advance a company, because the regulators will have valuable insights into the company's operations that could potentially impact FSOC's analysis. It is also important for the regulators to be aware of any actions taken with respect to their regulated entities. Regulators also acknowledged that FSOC may want to coordinate through "lead states" to gather information, though all states that are primary financial regulatory agencies should be consulted. As a technical comment, they noted that the rule references primary financial regulatory agencies of both the company under consideration and its subsidiaries, but the guidance is not clear. While they believe that the guidance's references to primary financial regulatory agencies implicitly refer to both regulators of the company and its subsidiaries, they requested that the language be clarified.

Regulators indicated they already have quite a bit of information to contribute to the process including examination and analysis reports, asset/liability modeling results, asset adequacy analyses, group holding company information, and a world-leading database of information about each insurance company. They believe other types of information collected in the future will be useful to FSOC as well including group holding company reports detailing the enterprise-wide risks posed by non-insurance affiliates and own risk solvency assessments (ORSA) provided by companies to the regulators. As noted previously, consideration must be given to ensuring the appropriate confidentiality protections and information sharing agreements are in place.

4. *Other Criteria Considered by the Council*

The regulators noted that the stage 2 and 3 metrics were merely representative and did not represent all the criteria that FSOC will consider. They thought more information regarding the criteria to be considered would be useful, though they recognize that stages 2 and 3 would involve both quantitative and qualitative information. They noted that some of the listed metrics may not be appropriate for all types of insurance. For example, direct written premiums are not a good measure for certain lines of reinsurance such as catastrophe reinsurance and, when confronted with such lines, FSOC should consider other approaches that better reflect the risk being transferred.

In considering analysis of systemic risk posed by an insurer, the regulators should give consideration to other criteria as well. For example, while recognizing that it made sense to exclude separate account assets for purposes of determining a firm's size for the initial screens, they noted that analysis of such products might be appropriate for purposes of the second and third stages. In certain circumstances, the insurer may be providing certain minimum guarantees on the performance of the separate account and such guarantees may pose risks that should be examined. Regulators also thought some attention should be given to the customer base of an insurance company. Insurers who have corporate clients may pose greater risks to the financial system than insurers who just sell policies to individuals. For example, corporations are more likely to purchase complex types of insurance rather than just standard life or P&C policies.

There was also broad consensus that risk mitigation techniques should be examined as part of the analysis and taken into account beginning in stage 2 of the process. The regulators discussed how insurers' use of derivatives is primarily for hedging purposes and such hedges should be reflected in the analysis as a mechanism for managing or reducing risk. Some thought a different distinction should be made as between derivatives that are bought and those that are sold regardless of their use. Under this approach, derivatives sold would be of concern because the failure of the company selling the derivatives would be unable to meet its obligations it sold to others as protection, and therefore, have a greater impact on financial markets.

Regulators also believe that an insurer's resolvability should be taken into account. They noted that an insurer's liabilities do not mature quickly and, therefore, while resolutions are not quick, they are typically orderly.