American Council of Life Insurers (ACLI) Statement for the Record
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
"The Impact of the Dodd-Frank Act: Understanding Heightened Regulatory Capital Requirements"

May 18, 2012

Thank you Chairman Capito and Ranking Member Maloney for convening today's hearing on heightened capital standards required under section 171 of the Dodd-Frank Act (DFA). The American Council of Life Insurers (ACLI) is pleased to submit this statement for the hearing record expressing the concerns of the life insurance industry about implementation of section 171.

The ACLI is a national trade association with over 300 member companies representing more than 90 percent of the assets and premiums of the life insurance and annuity industry in the U.S. ACLI member companies provide the products that protect against life's uncertainties, helping individuals and families manage the financial risks of premature death, disability, long-term care, and retirement. More than 75 million American families, nearly 70% of households, rely on life insurers' products for their financial and retirement security. In 2010 alone, American families received $58 billion in life insurance death benefits, $70 billion in annuity payments, $16 billion in disability income insurance benefits, and $7 billion in long-term care insurance benefits.

Unlike nearly all other financial institutions, life insurers are predominantly focused on the long term. Life insurers must manage the policy premiums and investments entrusted to them by their customers to meet obligations to those customers over multiple decades. The fundamental business model of a life insurance company does not involve high risk or short term profit seeking.

Capital Standards Appropriate for Banks are Not Appropriate for Life Insurers

Life insurance companies, including those that are or are held by depository institution holding companies, are vastly different than banks. We believe that any capital standards established under section 171 must recognize the fundamental differences between life insurance companies and banking organizations. As noted in a 2002 joint report of the staff of the Federal Reserve Board and the National Association of Insurance Commissioners (NAIC) on risk-based capital, the different capital approaches for insurance companies and banks reflect the "inherent differences between the insurance and banking industries." As was further noted in that report, the "two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors." "The effective capital charges cannot be harmonized simply by changing the nominal capital charges on an individual basis," the report states. Rather, the different capital approaches "arise from fundamental differences between the two industries, including the types of risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."

By way of example, it is worth noting that current Federal Reserve Board capital rules do not account for the fundamental differences between life insurers and banks. Bank Holding Company (BHC) rules do not sufficiently account for insurance-related assets and liabilities, nor do they sufficiently account for instances where a company engages in other nondepository activities. BHC rules do not appropriately account for the unique nature of various life insurer products, such as variable annuities supported by separate account assets. Similarly, the bank risk-based capital formulas provide no weightings for insurance risks, such as exposure to mortality losses or fluctuations in claims reserves.

<u>The fundamental differences between the insurance industry and the banking industry must be taken into account in the design of capital standards under section 171</u>.

Federal prudential regulators acknowledged basic differences between insurance and banking companies in their Joint Notice of Proposed Rulemaking (JNPR) last year. Supplementary Information section I.E. of the JNPR, entitled "Effect of Section 171 of the Act on Certain Institutions and Their Assets," discusses the fact that certain depository institution holding companies and nonbank financial companies designated for supervision by the Federal Reserve Board under section 113 of the DFA that are subject to section 171 have not previously been subject to these bank capital requirements, and may hold assets that do not have a specific risk-weight assigned to them under generally applicable bank risk-based capital requirements. Section I.E. notes that under existing bank risk-based capital requirements, assets that do not have a lower risk-weight (i.e. 0 percent, 20 percent or 50 percent) assigned to them will by default be assigned a 100 percent risk-weight. It states further that, going forward, there may be situations where exposures of a depository institution holding company or a nonbank financial company, or affiliates of such companies, do not fit within the terms of the existing bank risk-weighting categories but also impose risks that are not commensurate with the risk-weight otherwise specified.

Specifically, section I.E. states:

For example, there are some material exposures of insurance companies that, while not riskless, would be assigned to a 100 percent risk weight category because they are not explicitly assigned to a lower risk weight category. An automatic assignment to the 100 percent risk weight category without consideration of an exposure's economic substance could overstate the risk of the exposure and produce uneconomic capital requirements for a covered institution.

This is a very important observation and one that should guide any rulemaking under section 171. As was indicated in the 2002 joint report of the Federal Reserve Board and the National Association of Insurance Commissioners on risk-based capital, the differences between bank capital rules and the insurance industry's risk-based capital rules cannot be harmonized simply by changing the nominal capital charges on individual assets. Simply put, the existing components of capital in the bank risk-based capital rules do not align with the elements of capital in the risk-based capital regime applicable to insurance companies.

The application of bank rules to insurers ultimately leads to poor outcomes, both for regulators and private industry. Forcing an insurer to unnaturally contort itself to fit within bank standards would provide a completely inaccurate and misleading picture of the company to regulators. Insurance companies are not banks. The liabilities and obligations of the two types of entities are very different, and so their capitalization and reserving requirements must be very different as well.

Existing Insurance Capital Standards Should be Considered Equivalent

ACLI believes that any capital rules applied to insurance companies as a result of section 171 must take account of the different asset and liability categories in an insurance operation. We believe the best way to accomplish this is to recognize and accept to the greatest extent possible insurer risk-based capital standards as equivalent for this purpose. As noted above, doing so would be in keeping with the past findings of the Federal Reserve Board and NAIC on this very issue.

In addition, ACLI believes that regulators should identify asset classes that are held by insurers that have no banking-industry equivalent and therefore do not fit within the terms of the existing bank capital risk weightings. Doing so will illustrate that such asset classes should not be automatically assigned a 100 percent risk weight category, but instead should be given special consideration because they are, in fact, necessary and appropriate classes of assets to be held by life insurers. Separate account assets are one example of an insurer asset class with no comparable match in the banking world. As such, they must be given special consideration when applying section 171.

Finally, a number of our member companies are concerned that banking regulators implementing section 171 may require the use of Generally Accepted Accounting Principles (GAAP). Presently, many insurers prepare financial statements using Statutory Accounting Principles (SAP) and we believe that they should be allowed to continue to do so under section 171 rules.

Thank you for convening this important hearing and highlighting the potential impacts of the section 171 rulemaking process. We appreciate your consideration of the views of ACLI and its member companies.