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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

February 25, 2011

The Honorable Timothy Geithner,
Secretary, Department of the Treasury
Chairman, Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW.
Washington, DC 20220

RE: Docket ID: FSOC-2011-0001
Authority to Require Supervision and Regulation of
Certain Nonbank Financial Companies

Dear Secretary Geithner:

The National Association of Mutual Insurance Companies ("NAMIC") is pleased to offer comments on the proposed rulemaking regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies.

NAMIC is the largest and most diverse national property/casualty insurance trade and political advocacy association in the United States. Its 1,400 member companies write all lines of property/casualty insurance business and include small, single-state, regional, and national carriers accounting for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market. NAMIC has been advocating for a strong and vibrant insurance industry since its inception in 1895.

Introduction and Background

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") on July 15, 2010.[1] Section 111 of the DFA established the Financial Stability Oversight Council ("Council") and subsequent sections tasked the Council with identifying risks to the financial stability of the United States that could arise from the material financial distress of large, interconnected bank holding companies or nonbank financial companies. Section 113 established a number of criteria for the Council to consider in making a determination of whether a company should be subject to supervision by the Board of Governors. On October 6, 2010, the Council issued an Advance Notice of Proposed Rulemaking ("ANPR") regarding the designation criteria in section 113.

NAMIC submitted comments on the ANPR making several key points: 1) the legislative history of the DFA makes clear that lawmakers did not believe that insurers generally pose a systemic risk; 2) evidence shows that the property/casualty insurance industry is highly competitive and well capitalized; 3) the nature of property/casualty insurance products, the industry's low leverage ratios, its relatively liquid assets, and the lack of concentrations in the marketplace make the industry truly unique within the financial services sector; and 4) the very nature of mutual insurance company activities should be distinguished from activities of stock companies relating to business strategies, incentives, and risk-taking. As such, and consistent with academic research on risk-taking by mutual insurance companies compared with stockholder-owned insurers, mutual insurance companies are conservative, and they do not engage in the types of activities that are the hallmarks of systemic risk.[2]

The last point on mutuality cannot be overstated. Main Street-focused financial firms such as mutual insurance companies, which provide everyday citizens and business with products such as automobile or home insurance and commercial insurance, have an entirely different mission and business model than Wall Street capital intermediaries. Mutual insurance companies, as opposed to other financial stock companies, serve a

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, 124 Stat. 1376-2223), July 21,2010

[2] See, e.g., Joan Lamm-Tennant, Laura T. Starks, Stock versus mutual ownership structures: The risk implications. Journal of Business; Jan. 93, Vol. 66 Issue 1, p. 29, p. 18 (charts and graphs); Scott E. Harrington and Greg Niehaus, Capital Structure Decisions in the Insurance Industry: Stocks versus Mutuals, Journal of Financial Services Research, Feb-Apr 2002, Vol. 21 Issue 1/2 p. 145, p. 17 (charts and graphs).

different customer and are subject to an entirely different and more rigorous regulatory regime. The very nature of the mutual insurance industry and its approach to risk meant that mutual companies, even large ones, did not seek or need any government assistance during the 2008 financial crisis. Indeed, mutual insurance companies placed no additional stress on the U.S. financial system and paid all claims and obligations when due without the least disruption.

There are other significant distinctions between mutual and stock companies. A mutual company is operated for the benefit of its policyholders and issues no stock. Therefore, incentives and decisions are not driven by earnings pressure from shareholders, nor are its executives compensated based on the value of a company's stock. Rather, a long–term, conservative approach designed to build and maintain policyholder surplus to ensure adequate capital to pay claims is inherent in the mutual structure. In other words, mutuality impacts a nonbank financial company's entire approach to risk.

A review of the recent financial crisis is telling in this regard. Only a small handful of companies with significant insurance operations experienced material financial distress. As the Council considers evaluative criteria that could impact the property/casualty industry, it is imperative to keep in mind first and foremost the track record and the financial and structural underpinning of the industry that serve as a source of stability. History reflects the property/casualty industry's solid track record on solvency [3] and a recent study of the Geneva Association-- a leading Risk & Insurance Economics think tank—found that insurers possess specific features making them a source of stability in the financial system.[4]

Moreover, the Geneva Association also found that those few insurers who experienced serious difficulties were affected, not by their insurance business, but by their quasi-banking activities.[5] In addition, state rehabilitation and liquidation regimes are also supported in all states by longstanding state guaranty and assessment mechanisms, which have historically provided sufficient capacity to handle the insolvency of even the largest property/casualty insurer, adding yet another element of protection to policyholders and the public. In sum, none of the companies that encountered difficulties in the recent crisis did so because of their core insurance operations. Further, none of the small handful of nonbank financial companies that encountered distress was a mutual insurer.

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[3] See e.g., Weiss, Mary, 2010. Systemic Risk and the U.S. Insurance Sector,
[4] Geneva Association Information Newsletter, February 26, 2010, Press Release – No Systemic Risk from Insurance Core Activities – Findings of the Geneva Association Special Report on Systemic Risk in Insurance, p.1.
[5] Id.

Given these characteristics, the risk that property/casualty insurance companies in general, and mutual insurance companies in particular, pose to the overall financial system is negligible. Nor are property/casualty insurers as susceptible to the adverse systemic consequences of activities engaged in by banks and other financial institutions that are the principal generators of systemic risk. The Council's failure to make these critical distinctions could result in substantial anti-competitive consequences and added costs in the market for important consumer financial products, which ultimately hurts consumers without providing any commensurate benefit in protecting U.S. financial stability.

Proposed Analytical Categories

The preamble to the proposed rule recognizes that leverage, liquidity risk, interconnectedness, degree of primary regulation, and substitutability should be given significant weight in determining whether a nonbank financial company could pose a threat to the financial stability of the United States. As an analytic framework, the Council proposes six categories of factors (i.e., size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny), which in turn can be divided into two groups. The first group (size, lack of substitutes, and interconnectedness) recognizes that larger interconnected firms providing critical financial services for which there are few substitutes are more likely to create "spillovers" when experiencing financial distress and pose a greater systemic threat to U.S. financial stability. The second group (leverage, liquidity and maturity mismatch, and existing regulatory scrutiny) assess a firm's vulnerability to financial distress.

In its November 5 response to the ANPR, NAMIC observed that six primary factors affect the probability that a financial institution will create or facilitate systemic risk: leverage, liquidity, correlation, concentration, sensitivities, and connectedness. NAMIC also called for a similar two-part approach relating to a firm's possible risk of failure and the impacts it could have on other financial companies due to interconnectedness. Consequently, NAMIC believes the six categories and two groupings identified by the Council provide a solid foundation for assessing the potential for a financial company to pose a systemic threat.

Bearing in mind that property/casualty insurers in general, and mutual insurers in particular, do not pose systemic risk to the nation's economy and the recognizing the stringent regulatory oversight of the industry, NAMIC offers comments on each of the six proposed analytical categories.

1. Size

NAMIC has long noted that size alone must not be the criterion for designating nonbank financial companies as posing a threat to the financial stability of the United States. Size is only relevant to the designation inquiry to the extent that a nonbank financial institution is involved in activities that are sufficiently interconnected and pose a sufficient risk to other financial players that they could threaten the U.S. financial system. The evidence will demonstrate to the Council that, as a general proposition, no individual property/casualty insurer is involved in a sufficiently sizeable amount of interconnected, high risk activities to pose such a threat.

Although Congress did not choose to completely excuse any broad category of financial services firms from potential scrutiny, as the bill's official title indicates, a major focus of the DFA is Wall Street, not Main Street. In other words, the center of congressional and regulatory concern embodied in the DFA is with key players and intermediaries in U.S. capital markets. In particular, Congress and the Council in the proposed rule recognize that these players are often highly leveraged and more vulnerable to liquidity pressures when the availability of credit tightens. Moreover, these firms are often involved in very complex financial transactions and instruments where a lack of transparency and the potential for high-level risk can not only escape the attention and understanding of a company's own leaders, but also may fall outside the jurisdiction of any effective financial supervision and regulation. Previously, there was no comprehensive way to monitor these activities, even though they had the potential for systemically disastrous consequences for the financial system as a whole. The activities of Lehman Brothers, Bear Stearns, and AIG Financial Products are notable examples of where Congress sought additional and more effective supervision and regulation.

It is critical that any evaluation of a nonbank financial company take a holistic view of the enterprise and consider how it is managing risks. Rather than considering size alone, that analysis should consider the characteristics of the firm, its culture, risk tolerance and its risk management to help determine the probability of its material distress. This entails assessing whether the company's culture or customer base creates incentives for excessive risk taking, whether it has a strong system of risk management, and whether it has financial strength.

In addition, some firms' business models also relied on excessive leverage, which, combined with doubts about the realizable value of the firm's assets, heightened solvency and business-model concerns among the firms' creditors and counterparties.

For example, the Geneva Association found that certain firms "permitted excessive leverage and reliance on short-term financing to develop over time because of a combination of risk governance weaknesses and misaligned incentives …, incomplete risk capture in management reports, limitations or unintended consequences of regulatory requirements, and ineffective market discipline." [6]

The Council must thoroughly review all these considerations. As such, size should not be utilized as an arbitrary threshold for evaluation or designation as a threat to the financial stability of the United States. A nonbank financial company's size, in the absence of extensive interconnection does not pose a threat to the U.S. financial stability. Only if the degree of interconnectedness presents a high probability that material financial distress at a nonbank financial company could threaten U.S. financial stability should the Council should be concerned with that institution's activities.

2. Lack of Substitutes

The Council has identified the lack of substitute products and services as a leading indicator of the degree of concentration and likelihood of spillover effects from financial distress in an institution. As noted in earlier comments, property/casualty insurance is highly competitive. There are more than 5,000 insurers operating in the United States, the majority of which are relatively small. No single insurer or group of insurers dominates either the personal or commercial marketplace. Property/casualty insurers actively compete for business in all markets. A number of studies over the years, including those done by the U.S. Department of Justice, state insurance departments and respected economists and academics, have consistently concluded that the property/casualty insurance industry is very competitive under classic economic tests. The competitiveness and diversity in the insurance market is evidenced by NAMIC's membership in terms of size, geographic dispersion, lines of business and corporate structure.

The proposed rule links the inquiry on substitutability with the issue of a nonbank financial company's importance as a source of credit. The nation's property/casualty insurance companies serve the insurance needs of households and businesses. Although some insurers meet additional consumer needs by offering other financial products and services, such as credit services, no individual property/casualty insurer is a major source of credit in the U.S. financial system. Likewise, while property/casualty insurers may offer other non-traditional insurance products, for the great majority of companies, these services constitute only a very small portion of the total business

[6] Id. at 2.

volume of these companies. Lastly, these products and services represent only a small fraction of the total market for such services.

As a threshold question of the significance of any insurer, it should be acknowledged that no insurer dominates any market and there are numerous viable, competitive alternatives. As such it is highly unlikely that any insurer would be so interconnected that it would pose a systemic risk to the national economy. Further, any inquiry directed at property/casualty insurers must focus on non-traditional insurance activities.

3. Interconnectedness with other financial firms

NAMIC believes the analytical framework for Section 113 designation determinations should involve a two-part analysis. Congress established several considerations to be evaluated in conducting a systemic risk analysis and the Council has proposed six categories for evaluation. Although Section 113 and the proposed rule place no particular emphasis on any specific criteria, NAMIC believes that interconnectedness should be weighted more heavily than others and should serve as a threshold inquiry. In particular, the Council must consider the degree to which a nonbank financial company is interconnected with other major financial companies.[7]

Interconnectedness represents the interaction and interdependency between financial institutions and/or specific market segments. This interconnection can only be assessed by looking to the specific activities of an individual institution. The activities of the institution determine the degree to which financial distress in one company can be transferred to another company or market segment (i.e., contagion). Only if the specific activities of a particular company are capable of transferring or spreading such risk can the institution pose a systemic risk to the nation's financial system. As the Council assesses the interconnectedness of nonbank financial institutions, NAMIC urges members to focus on types of activities that could pose risk, rather than the type or size of the company.

When evaluating the risk posed by certain activities, the Council should carefully weigh the presence of offsetting risk mitigation activities. Property/casualty insurers collect premiums in advance and claims payments are triggered only by the occurrence of specified events and the risk is limited to the "insurable interest" (i.e., the item or liability for which insurance is obtained against the risk of loss), making the industry inherently less vulnerable to disintermediation risk. Reinsurance also serves as an important

[7] The importance of the relationship between interconnections and financial stability is well documented (e.g."Interconnectedness, Fragility and the Financial Crisis" a paper presented to the Financial Crisis Commission by Randall Kroszner, University of Chicago, February 26-27, 2010).

mechanism to transfer and disaggregate risk within the property/casualty industry. Reinsurance spreads risks from the ceding insurance company and specific risk can be spread among several reinsurers and/or through multiple layers of reinsurance. Although insurers utilize reinsurance to mitigate risk, insurers retain a portion of the risk, reducing moral hazard and encourage primary insurers to effectively underwrite risks and mitigate loss. In addition to the reinsurance mechanism, very large risks are often syndicated among direct insurers to spread the risk and avoid concentration within one company or groups of companies.

The lack of concentration coupled with underwriting and investment standards make property/casualty insurers less sensitive to the actions and conditions of other sectors of the financial services industry or other economic shocks. Even where a property/casualty insurer is held by a holding company that also holds other types of financial services companies, regulatory restrictions designed to protect policyholders operate to “ring-fence” the property/casualty insurer’s capital and protect it from incursions caused by any problems of the other subsidiaries. The regulatory system also serves to limit the interconnectedness of insurers with other financial firms.

In contrast with some other types of financial institutions such as investment banks and hedge funds, most of the obligations of property/casualty insurers are also protected by the insurance guaranty fund system. This nationwide system, which is financed by the property/casualty insurers of each state, reduces the systemic impact of any failing property/casualty insurer by providing an orderly system for dissolution and payment of claims, subject to specific limitations, on a timely basis. These factors negate, if not eliminate, the likelihood that a property/casualty company could pose a systemic risk to the nation’s economy and NAMIC urges the Council to make this distinction as it develops a rubric for designating companies for federal supervision and enhanced prudential standards.

NAMIC believes these criteria are central to any methodology and evaluation standards. Oversight and regulation of systemic risk should focus on the impact of products or transactions used by financial intermediaries viewed in light of the company’s leverage, liquidity, correlation, concentration, sensitivities, and connectedness.

4. Leverage

With respect to leverage, property/casualty insurance companies in general and mutual insurance companies in particular hold far more capital in relation to their liabilities than banking entities. Moreover, it is important to note that very few property/casualty insurers use commercial paper, short-term debt or other leverage instruments in their

capital structures. [8] As a result, they are much less vulnerable than highly leveraged institutions when financial markets experience distress. At the time that the financial crisis began to unfold, many large commercial and investment banks were operating at very high leverage ratios, often borrowing $15 to $25 for every $1 in capital they held. By contrast, property/casualty insurers neither borrow to make investments, nor borrow to pay claims.

When assessing the degree of leverage and risk of insurers it is also important to note the difference between asset-backed securities and other derivative products, and property/casualty insurance. In the former, the underlying risk is a financial or market factor (such as credit, price, interest rate, or exchange rate), whereas in property/casualty insurance, the underlying risk is a more tangible event, such as an automobile accident, fire, or theft. While the financial risks are likely to be correlated, in that they will be affected by similar cyclical economic or financial factors, the latter are largely individual, non-cyclical, idiosyncratic risks. Banking risks are often highly correlated, particularly in economic downturns. Traditional property/casualty insurance, in contrast, pools uncorrelated, idiosyncratic risks, and is not subject to systemic crises in the same way as banks. Insurers use underwriting tools specifically designed to identify and control various types of correlation, including market concentration, in order to control underwriting exposures. Although these tools allow insurers to accurately price and underwrite risk, the side benefit of rigorous underwriting is a reduction in systemic risk exposure. The importance of the distinction of the varying risk portfolios and the diversification evidenced by the property/casualty business must be a cornerstone in the Council's evaluation of the risk posed by these entities.

As the Council evaluates criteria, NAMIC urges members to recognize the strong capitalization of the property/casualty insurance industry and the nature of risks undertaken by the industry.

5. Liquidity risk and maturity mismatch

As property/casualty insurers are less leveraged than other financial services companies, they are likewise more liquid. For both business and regulatory reasons property/casualty insurers carry a liquid investment portfolio. Unlike most other types of financial institutions, the nature of the products that property/casualty insurers provide also makes them inherently less vulnerable to disintermediation risk.

[8] Surplus notes are utilized by mutual insurance companies; however, unlike commercial paper and other short term debt obligations state insurance regulators must approve the issuance of the note and retain the authority to deny payments of principal and interest, effectively limiting the degree of leverage.

Insurance companies build up reserves and investments are calibrated to match the statistically anticipated claims payments in order to eliminate liquidity risk and the possibility of a "run on the bank" scenario. As the Council evaluates and weighs criteria, NAMIC urges members to acknowledge property/casualty insurers' high liquidity position and low disintermediation risk.

Concentration, sensitivities, and connectedness also play vital roles in determining the risk imposed by a particular institution. Property/casualty insurers manage concentrations of investments and have regulatory limitations on both the type and concentrations of the assets in which they invest. These limitations have the effect of reducing the property/casualty insurance industry's connectedness. As previously noted, the industry itself is diverse and competitive with no particular company or group of companies dominating a market or geographic segment.

6. Existing regulatory scrutiny

As noted in comments on the ANPR, property/casualty insurers are subject to a high degree of supervision and regulation by state insurance regulators. Because consumer protection by state insurance regulators is paramount, each state's statutes gives authority to regulate insurers licensed to do business in the state and insurance companies are subject to comprehensive financial reporting standards; rigorous financial analysis; thorough examination of all aspects of insurance operations; and prompt corrective action. Although a separate banking/financial services system has in recent years developed and grown largely outside the direct supervision and oversight of primary regulators, insurance products and services remain closely regulated. Insurance supervision adheres to the highest standards of oversight and as a result the industry remains strong and vibrant.

The goal of state insurance regulators to encourage the availability and affordability of insurance products for consumers dictates that state regulators closely monitor insurer solvency. To that end, comprehensive state regulatory systems have been developed including detailed investment laws and conservative accounting standards and procedures. State regulations place limits on the amounts of each type of asset that an insurer may hold, as well as the level of concentration in any single investment. State regulations also require insurers to properly value their assets. Securities must be valued according to the rules of the National Association of Insurance Commissioners' ("NAIC") Securities Valuation Office, and that other invested assets be valued according to the rules of the NAIC's Financial Condition (E) Committee. In addition, statutory accounting principles ("SAP") include the concept of admitted assets -- assets readily convertible into cash. To the extent that a company's investments exceed specified

amount limits or fall below specified quality limits, the assets are considered "nonadmitted" and the company is prohibited from taking credit for them on the Annual Statement's balance sheet.

Finally, to the extent the Council wishes to determine how best to apply the analytical framework to all nonbank financial companies; NAMIC suggests looking to existing regulatory criteria and benchmarks. There are examples of such tools that are currently utilized by insurance regulators. For instance, the NAIC's risk-based capital regulation establishes a uniform standard for capital adequacy and further provides specified levels of regulatory actions for weakly capitalized insurers. Another example is the Insurance Regulatory Information System ("IRIS") utilized by state regulators, which consists of a series of 12 financial ratios for which ranges of normal results have been calculated. The ratios focus on critical financial and business conditions, including capital adequacy, changes in business patterns, underwriting results, reserve inadequacy and asset liquidity. In addition, the NAIC's Financial Solvency Tools ("FAST") system includes other ratios focusing on profitability, asset quality, investment yield, affiliate investments, reserves, reinsurance, liquidity, cash flows and leverage. These ratios have been developed with careful consideration to the business of insurance and are based on well understood definitions and reflect the more conservative approach to accounting utilized by insurers pursuant to SAP. These tools provide a clear and accurate picture of an insurer's size, degree of leverage, and liquidity risk.

NAMIC believes the Council must avoid measures that would weaken or impair those regulatory systems that have functioned well throughout the crisis, including the state-based system of property/casualty insurance regulation. Imposition of another set of solvency requirements, which are potentially inconsistent with existing requirements, on a subset of property/casualty insurers would be counterproductive. Such a move would create major competitive distortions in the property/casualty insurance market.

Explicit and Transparent Regulatory Standards

NAMIC has a number of procedural concerns with the proposed rule. Most significantly, it is essential that any regulatory standards developed by the Council be explicit, transparent, subject to meaningful public review, and provide safeguards to protect business confidentiality. Nonbank financial companies must be clear about the specific standards and metrics against which they will be measured in the designation process. Inherent in this process must be the explicit inclusion of any factors or metrics proposed to be used for designation within the language of any rule itself to ensure full force and effect.

More specifically, NAMIC believes the development of clear, specific regulatory criteria is required by the spirit and letter of the recent Presidential Executive Order 13563 - Improving Regulation and Regulatory Review. [9] The Executive Order requires agencies to use “the best, most innovative and least burdensome tools for achieving regulatory ends." Other parts of the Executive Order help to reinforce the principle that a fair and effective regulatory system establishes clear rules for those businesses it governs. For example, Section 1.General Principles of Regulation, part (a) states: "Our regulatory system must... promote predictability and reduce uncertainty... [and] ensure that regulations are accessible, consistent, written in plain language, and easy to understand." Moreover, Section 1(b) (4) states that agencies who are administering our regulatory system must "to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt." Failure to establish clear, specific and transparent standards undermines the credibility of the oversight process and leaves nonbank financial institutions unsure of the rules of the road.

The Executive Order on regulations is also very explicit about the need for public input in the rulemaking process. Section 2 specifically outlines the process for public participation. The Executive Order states:

(a) Regulations shall be adopted through a process that involves public participation. To that end, regulations shall be based, to the extent feasible and consistent with law, on the open exchange of information and perspectives among State, local, and tribal officials, experts in relevant disciplines, affected stakeholders in the private sector, and the public as a whole.
(b) To promote that open exchange, each agency... shall endeavor to provide the public with an opportunity to participate in the regulatory process. To the extent feasible and permitted by law, each agency shall afford the public a meaningful opportunity to comment through the Internet on any proposed regulation, with a comment period that should generally be at least 60 days.

Consistent with this principle all Council rulemaking should include extensive public input and the rules must be clear. NAMIC urges the Council to propose the specific standards and metrics it intends to utilize and provide at least 60 days for public input on these standards. Furthermore, no standards and/or metrics should be adopted prior

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[9] Exec. Order No. 13563, 76 FR 3821-3823 (January 21, 2011)

to the completion of this comment period and the Council providing an explanation on how these comments are treated in a final rule. As such, the Council should avoid temporary and interim final rules.

Finally, NAMIC would like to echo the sentiments expressed to the Council by several Members of Congress that any actions regarding insurance should be based on the input and full participation of all the insurance-related members of the Council, including the Federal Insurance Office and presidentially-appointed insurance expert. NAMIC believes that the appointment and participation of these members is necessary for a more full and well informed discussion in the rulemaking and evaluation processes.

Conclusion

The property/casualty industry poses virtually no systemic risk to the U.S. economy. This is especially true for mutual insurance companies, which are run for the benefit of policyholders and lack the types of incentives found in many stock companies that can lead to excessive risk-taking by managers and executives. In addition, the industry is highly competitive, well capitalized, and subject to stringent financial and operational regulation.

As the Council evaluates nonbank financial institutions, NAMIC urges the Council to recognize the level and quality of existing regulatory oversight and existing regulatory tools. Further, NAMIC urges the Council to respect the letter and spirit of Executive Order 13563 by allowing for full public participation in the rulemaking process and to ensure that evaluative criteria are clear, specific, transparent, and protect business confidentiality.

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