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before the

Committee on Banking, Housing and Urban Affairs
United States Senate

Subcommittee on Financial Institutions and Consumer Protection

March 11, 2014

I. Introduction

Chairman Brown and Ranking Member Toomey, and distinguished members of the Subcommittee, I am honored to be with you today to discuss the application of the capital standards in Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1] to a subset of insurance companies.[2] Let me begin by commending you for the leadership you have shown and for your efforts and attention to this important issue.

Section 171, which is commonly known as the "Collins Amendment", after its primary sponsor, Senator Collins, establishes certain capital standards for designated financial institutions. It is a part of Title I, Subtitle C of Dodd-Frank, which includes enhanced prudential standards and differentiation mandates in its principal provision, Section 165. The insurance companies subject to Section 171, which I will refer to as "Covered Insurance Companies", are either savings and loan holding companies ("SLHCs") or have been designated by the Financial

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[1] Pub. L. No. 111-203 (2010).

[2] Section 171 is codified at 12 U.S.C. § 5371.

Stability Oversight Council ("FSOC") for supervision by the Board of Governors of the Federal Reserve System ("Federal Reserve") pursuant to Section 113 of Dodd-Frank.[3]

Stated simply, the core question raised by the application of Section 171 to Covered Insurance Companies is whether they should be subject to the same capital framework as that which applies to banks (which I will refer as the "Bank Capital Framework").

What is most striking about this question is that I do not know of a single legislator or regulator, including the Federal Reserve, who believes that, as a matter of policy, the Bank Capital Framework should be automatically imposed on insurance companies. Nor do I know of a single Member of Congress who maintains that Congress actually intended to impose the identical capital regime on these two very different businesses. As twenty-four Senators from both parties wrote to the heads of the three federal banking agencies on October 17, 2012: "Congress did not intend for the federal regulators to discard the state risk-based capital system in favor of a banking capital regime".[4]

Senator Collins herself has made clear that it was not the intent of Congress to "supplant prudential state-based insurance regulation with a bank-centric capital regime".[5] Instead, Senator Collins explained, "consideration should be given to the distinctions between

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[3] Sullivan & Cromwell represents Covered Insurance Companies and other insurance companies.

[4] Letter to Ben. S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from Twenty-Four U.S. Senators (Oct. 17, 2012) (the "October 17, 2012 Letter"). See also, a December 11, 2012 letter (the "December 11, 2012 Letter") from Thirty-Three Members of Congress of both parties to former Chairman Bernanke which explained (in the context of the federal banking agencies' proposed rule to apply the Bank Capital Framework to insurance companies) that "[t]he bank-centric approach of the proposed rules is inconsistent with the unique nature of insurance and contradicts the intent of Congress."

[5] Letter to Ben S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from Senator Susan Collins (Nov. 26, 2012).

banks and insurance companies. I believe it is consistent with my amendment that these distinctions be recognized in the final rule."[6]

Accordingly, we are not debating what the result should be. Both as a matter of policy and in terms of carrying out Congressional intent, there should be tailored and differentiated capital requirements for insurance companies. Instead, the question is how best to achieve that result under Section 171.

My testimony today is divided into four parts. First, I will summarize the terms of Section 171. Second, I will outline the relevant policy issues. Third, I will attempt to explain why I believe that, as a legal matter, the Federal Reserve already has sufficient authority to deal appropriately with these issues. Fourth, in the event that the Federal Reserve elects not to exercise that discretion, I will explain briefly why Congressional action to deal with this matter is both necessary and appropriate.

II. Section 171

Section 171 of Dodd-Frank does not prescribe specific capital requirements, but provides two general mandates for both risk-based and leverage capital requirements. First, the capital requirements applied to companies subject to Section 171 may not be "less than" the capital requirements applied to banks now or in the future. Second, those requirements may not be "quantitatively lower" than the bank capital requirements in place as of the date of the enactment of Dodd-Frank. Presumably, the first mandate incorporates the so-called Basel III capital framework, as implemented by the federal banking agencies, and the second mandate incorporates the Basel I capital framework, as previously implemented by the agencies.

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[6] Id.

Section 171 is a part of Subtitle C of Title I of Dodd-Frank, entitled "Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies". The key operative provision of Subtitle C is Section 165, which establishes "enhanced prudential standards" for "systemically important financial institutions", i.e., bank holding companies with total consolidated assets of $50 billion or more ("BHC SIFIs") and non-bank financial companies designated by FSOC under Section 113 of Dodd-Frank for supervision by the Federal Reserve ("Nonbank SIFIs").[7]

III. Policy Issues

At the outset, it is seemingly inconceivable that Congress, or any regulator, could conclude that the same capital requirements should logically or appropriately apply to all financial services companies that are deemed systemically important. Various types of financial services companies have different business purposes and asset and liability structures, and they are exposed to different types of risk. As explained in the December 11, 2012 Letter from thirty-three Members of Congress, "[s]trong capital standards need to be consistent with the business models of the industry to which they are applicable". Nonetheless, some have read Section 171, in isolation, to require the Federal Reserve to apply automatically the same capital framework applicable to banking organizations to all the Covered Insurance Companies, as well as all other Nonbank SIFIs.

It is important to stress that the policy issue is not about the need for robust capital requirements for Covered Insurance Companies. The conclusion that such requirements are essential should be beyond disagreement. Indeed, the insurers themselves, in comment letters to

[7] Section 165 does not expressly apply to SLHCs. As discussed in note 16 infra, however, the Federal Reserve has, in effect, made the enhanced prudential standards applicable to SLHCs with total consolidated assets of $50 billion or more and a significant depository subsidiary, as well as to other SLHCs as determined by the Federal Reserve.

the Federal Reserve and other banking agencies, have supported strong capital requirements for the industry.[8]

The real policy question is how best to implement robust capital requirements for Covered Insurance Companies. Is it preferable to import the Bank Capital Framework into the regulatory regime for Covered Insurance Companies or instead to rely principally upon substantive regulation under state insurance law, including, most pertinently, the risk-based capital requirements developed pursuant to the National Association of Insurance Commissioners' Risk-Based Capital ("RBC") framework?

The application of the Bank Capital Framework to Covered Insurance Companies would be inappropriate, redundant and punitive, not only because it is a second capital regime (in addition to the RBC framework), but because the Bank Capital Framework was not designed to, and does not, take into account the critically significant differences between the business of banking and the business of insurance. This essential point is reflected in comment letters to the Federal Reserve by many Members of Congress, including Senator Collins and members of the Senate Banking Committee.[9]

Let me summarize the fundamental difference between the balance sheets and business models of banks and insurance companies and why that difference compels the conclusion that the Bank Capital Framework is not the appropriate framework to govern insurance company capital.

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[8] See, e.g., Letter to Jennifer J. Johnson from MetLife, Inc. (April 30, 2012); Letter to Ben S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from MetLife, Inc. (Oct. 22, 2012); Letter to the Office of the Comptroller of the Currency, Jennifer J. Johnson and Robert E. Feldman from Prudential Financial, Inc. (Oct. 22, 2013); and Letter to Jennifer J. Johnson, Thomas J. Curry and Robert E. Feldman from State Farm Insurance Companies (Oct. 19, 2012).

[9] See, e.g., Letter to Ben S. Bernanke, Martin J. Gruenberg and Thomas J. Curry from Senator Susan Collins (Nov. 26, 2012) and the December 11, 2012 Letter.

Banks perform the crucial role in our economy of maturity transformation, in which deposits and other short-term liabilities are invested in longer-term loans and other assets. This essential role, however, creates the potential for a loss of liquidity at banks in the event of a loss of this short-term funding. Consequently, in addition to enhanced liquidity requirements, the current regulatory framework for banks includes a substantially enhanced set of capital requirements (and related stress tests) that are designed to create a high level of loss-absorbing capital to help ensure that banks can withstand losses on assets and resultant strains on liquidity.

In contrast, insurance companies do not engage in maturity transformation and, generally, have long-term liabilities. Moreover, historical experience, and the nature, structure and design of insurance products, indicate that there is no meaningful risk of "policyholder runs". Among other factors, even if an insurance policy can contractually be surrendered, the policyholder may find that a comparable policy is not readily available (for example, because of age, health, etc.), and the switch could be time-consuming and will involve "breakage" costs – all in contrast to the ease of switching a bank deposit. As a result, capital requirements tailored for banks that are funded, in large part, through short-term liabilities do not constitute an appropriate framework for the businesses of insurers, which are liability-driven and have longer-term assets and liabilities.

This fundamental difference between the business models and liability mixes of banks and insurers, and the consequences for capital requirements, was thoughtfully articulated by Federal Reserve Governor Daniel Tarullo in testimony before the Senate Banking Committee:

> The problem here, Mr. Chairman, comes I think on the liability side of the balance sheet. Bank centered capital requirements are developed with an eye to the business model of banks and the challenge that the FDIC would have in resolving a bank, or now a systemically important banking organization that would be in deep trouble.

> The more or less rapid liquidation of a lot of those claims and the runs on a lot of the funding of that institution, lie behind the setting of the capital ratio. But the liability side of an insurance compan[y's] balance sheet, a true insurance company [like] somebody selling life insurance for example, is very different. There's not a way to accelerate the runs of those, of that funding.[10]

Likewise, Federal Reserve Chair Janet Yellen testified before the House Committee on Financial Services that "[w]e understand that the risk profiles of insurance companies really are materially different. . .".[11]

It is highly relevant that Congress explicitly recognized that the evaluation of the risk of assets could not be separated from consideration of the method by which those assets are funded. Section 165(b)(3)(A) of Dodd-Frank expressly requires the Federal Reserve to consider differences between Nonbank SIFIs and BHC SIFIs and, in particular (through incorporation of Section 113(a)), the nature of the institution's assets and liabilities, including its reliance on short-term funding. Likewise, former Federal Reserve Chairman Bernanke testified that "insurance companies have both a different composition of assets and a different set of liabilities, and appropriate regulation needs to take that into account".[12]

In Appendix A to this testimony, I have described three specific examples of issues that would arise from trying to force Covered Insurance Companies into a bank-centric capital regime. These examples are intended to be illustrative of the fundamental problem I have just described, but should not be taken to suggest there is a finite list of issues that if "fixed"

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[10] Mitigating Systemic Financial Risk: Hearing Before the S. Banking, Housing and Urban Affairs Comm., 113th Cong. (July 11, 2013) (testimony of Daniel K. Tarullo).

[11] Monetary Policy and State of the Economy: Hearing Before the H. Financial Services Comm., 113th Cong. (Feb. 11, 2014) (testimony of Janet L. Yellen).

[12] Monetary Policy and the State of the Economy: Hearing Before the H. Fin. Services Comm., 112th Cong. (July 18, 2012) (testimony of Ben S. Bernanke).

would eliminate all the negative consequences that would result from applying the Bank Capital Framework, even on a "retro-fitted" basis. These are merely symptomatic of the larger issue of applying the Bank Capital Framework to insurance companies for which it was never intended or designed.

The examples do illustrate how the application of the Bank Capital Framework would require Covered Insurance Companies to hold capital that is not correlated to the risk profile of their underlying liabilities and assets. The result would be to impose upon Covered Insurance Companies lower returns on equity, both in absolute terms and in relation to their peer firms (both domestic and international), as well as unnecessary regulatory costs. Because lower returns do not constitute a viable strategy for Covered Insurance Companies (or their investors), their only option to retain marketplace vitality would be to increase the costs for their insurance products and services and cease offering some products altogether because of the uneconomic capital charge. Not only is such an approach obviously antithetical to the best interests of consumers and other customers, but it would also create a substantial competitive disadvantage for Covered Insurance Companies. As set forth in the October 17, 2012 Letter from twenty-four Senators, "applying a bank-focused regime to insurance companies could undermine potential supervision and unintentionally harm insurance policyholders, savers and retirees".

Let me deal briefly with three arguments made against differentiation. The first is that we need simplicity in our capital rules, and, once we start distinguishing among financial institutions, it will not be possible to stop. Simplicity is a legitimate goal, but it should not degenerate into simplemindedness if it produces illogic, inequity and redundancy. And we are not talking about fine distinctions, but an obvious and palpable dichotomy. As the December 11, 2012 Letter argues persuasively, "it is not workable to have one uniform capital standards

regulation to apply across the whole spectrum of financial services companies. . . . [I]nsurers have a completely different business model and capital requirements than banks, which must be appropriate recognized in the [capital rules applied to Covered Insurance Companies]".

The second argument is that an asset should receive the same capital charge irrespective of the type of financial services company that holds the asset. Although this argument may have an appealing simplicity, it results in a divorce of capital from risk because it fails to take into account both sides of the balance sheet. It fails to consider either the purpose for which the asset is held or the institution's ability, due to its liability structure, to hold the asset in times of stress. As I just discussed, the risk weighting developed for bank assets was not designed to reflect that purpose or capability in the context of insurance companies.

Third, some may argue that any concern about the application of the Bank Capital Framework to Covered Insurance Companies is misplaced because "more capital is always better". That argument can only be valid, however, if a company's appeal to investors is, contrary to all evidence, divorced from return on equity and its pricing of a product is likewise divorced from the capital assigned to it. To the contrary, capital requirements that are higher because they are not correlated to risk, produce marketplace and competitive distortions. Such uncorrelated capital requirements can increase the cost of financial products and services and even reduce the availability of lower-margin products and services. Once again, the debate is not about whether we should have robust capital requirements for all participants in the financial services industry – 2008 should have resolved that debate once and for all. Instead, the only legitimate debate is whether the same capital framework should be artificially imposed without regard to the nature of the financial services company.

IV. The Federal Reserve's Authority to Tailor the Application of Section 171

As discussed, there has been an extraordinary "meeting of the minds" among Members of Congress, regulators and the insurance industry that, as a policy matter, the Bank Capital Framework should not be applied to Covered Insurance Companies. To date, however, the Federal Reserve has expressed a concern that the language of Section 171 significantly constrains its interpretative ability.[13]

The Federal Reserve may be reluctant to be seen as usurping a Congressional prerogative and intervening in an area where Congress has legislated. It is also understandable that an administrative agency would take the position that, if there is an ambiguity or error in what Congress has drafted, the agency should not act until Congress has had the opportunity to resolve the issue. Nonetheless, as I have previously written in a letter available on the Federal Reserve's website, I believe that there is sufficient flexibility in the statutory language of Dodd-Frank for the Federal Reserve to determine that Covered Insurance Companies should not be bound by the same capital regime that applies to banking organizations.

I will now explain why the Federal Reserve has this interpretative authority, and can exercise that authority while at the same time maintaining fidelity to the plain language of Dodd-Frank and to Congressional intent. The analysis of the issue can be best understood by dividing it into three parts: the specific language of Section 171; the broader context of the Dodd-Frank Act as a whole, in particular, Section 165; and what I believe to be the most direct approach the Federal Reserve could take to resolve this issue.

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[13] For example, although in recent testimony before the Senate Banking Committee, Federal Reserve Chair Janet Yellen recognized the "very significant differences between the business models of insurance companies and banks," she continued that "the Collins Amendment does restrict what is possible for the Federal Reserve". (Semiannual Monetary Policy Report to the Congress: Hearing Before the S. Banking, Housing and Urban Affairs Comm., 113th Cong. (Feb. 27, 2013) (testimony of Janet L. Yellen)).

A. Section 171 Language

As noted earlier, Section 171 does not prescribe specific capital requirements, but provides that the capital requirements applied to companies subject to Section 171 be (i) not "less than" the capital requirements applied to banks now or in the future nor (ii) "quantitatively lower" than the bank capital requirements in place as of the date of the enactment of Dodd-Frank.

What is striking about the language of Section 171 is the *absence* of a precise and simple statement that Nonbank SIFIs should be subject to the Bank Capital Framework. If that were what Congress intended, it would have been a simple matter for Congress to have said so. Rather, the language of Section 171 calls for a comparability analysis between the capital regime imposed by the Federal Reserve on Covered Insurance Companies and the Bank Capital Framework, and provides only broad guidance as to how the Federal Reserve is to conduct this analysis.

Because Section 171 is not prescriptive as to how the Federal Reserve is to conduct the comparability analysis, the Federal Reserve is authorized to adopt a reasonable interpretation of Section 171 to fill in these gaps. As the Supreme Court has made clear, in circumstances where "the subject matter . . . is technical, complex, and dynamic . . . as a general rule, agencies have authority to fill gaps where statutes are silent."[14] This fundamental principle of regulatory authority applies with full force here. It is presumably beyond debate that Section 171 is "technical" and "complex". It is likewise "dynamic" because the bank capital rules will continue to evolve, as will the assessment of "comparability". In dealing with subject matter of this nature, it was not error, but logical, for Congress to grant significant discretion to the Federal Reserve in implementing Section 171.

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[14] Nat'l Cable & Telecommunications Ass'n, Inc. v. Gulf Power Co., 534 U.S. 327, 339 (2002).

Indeed, in a demonstration of this discretionary latitude, the Federal Reserve and the other federal banking agencies have appropriately exercised this discretion in at least one case. In the agencies' rules implementing Basel III, the agencies provided that the assets in separate accounts that are not guaranteed would generally receive a risk weight of 0%.

Accordingly, even reading Section 171 in isolation, the Federal Reserve has flexibility to apply capital requirements to Covered Insurance Companies that are appropriately tailored for the business and risk profile of these institutions.

B. Section 171 in the Broader Context of Subtitle C of Title I of Dodd-Frank

This conclusion is even more compelling when Section 171 is read in context with the overall statutory scheme of which it is a part. It is a fundamental canon of statutory construction, mandated by the Supreme Court, that individual provisions of a statute must be read in the context of the overall statutory scheme.[15] Accordingly, Section 171 must be read as part of the entirety of Subtitle C of Title I of Dodd-Frank, which establishes a new, comprehensive framework for the federal supervision of BHC SIFIs and Nonbank SIFIs in order to address the risks posed by such institutions to financial stability.

A central tenet of Subtitle C is that there must be both robust regulation and differentiated regulation. Not only are these two objectives not inconsistent, but they are mutually reinforcing because regulation that is directed to the actual risk involved is inherently more robust than regulation divorced from risk. Therefore, when Section 171 is read in the

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[15] FDA v. Brown & Williamson Tobacco Corp, 529 U.S. 120, 133 (2000) (citations omitted) ("It is a 'fundamental canon of statutory construction that words of a statute must be read in their context and with a view to their place in the overall statutory scheme.' . . . A court must therefore interpret the statute 'as a symmetrical and coherent regulatory scheme'. . . and 'fit, if possible, all parts into an harmonious whole . . . .'"). See also Conroy v. Aniskoff, 507 U.S. 511, 515 (1993) (Looking to the "text and structure of the [statute] as a whole" and following "the cardinal rule that a statute is to be read as a whole . . . since the meaning of statutory language, plain or not, depends on context." (internal quotations omitted)).

context of the other provisions of Subtitle C, it must be interpreted consistently with Congress's intent that the capital and other requirements for Covered Insurance Companies, and other Nonbank SIFIs, be applied in a tailored and flexible manner.

The cornerstone of Subtitle C's regulatory framework is the "enhanced prudential standards" in Section 165. Section 165 gives the Federal Reserve broad authority to apply these standards to Nonbank SIFIs, including Covered Insurance Companies,[16] in a tailored manner. Indeed, differentiated application is not merely acceptable but required.

In requiring the Federal Reserve to develop enhanced prudential standards for Nonbank SIFIs, Section 165 is replete with instructions that the Federal Reserve apply these standards through a differentiated approach that takes into account the nature of the institutions and the risks they present. Section 165(a)(2)(A) is titled "Tailored Application", and it expressly authorizes the Federal Reserve to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity . . . and any other risk-related factors that the [Federal Reserve] deems appropriate".

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[16] Section 165 applies, by its terms, only to BHC SIFIs and Nonbank SIFIs. It does not expressly apply to SLHCs. As a result, one could argue that, as a technical matter, Section 165 is inapposite to the application of Section 171 to SLHCs. In its recent rulemaking implementing the enhanced prudential requirements of Section 165, however, the Federal Reserve, relying on its general authority under the Home Owners' Loan Act to regulate SLHCs, indicated that it would expect to apply enhanced prudential requirements to any SLHC that has both $50 billion or more in total consolidated assets and a significant depository subsidiary. The Federal Reserve indicated that it would also apply enhanced prudential requirements to any other SLHC as the Federal Reserve considers appropriate. As a result of this Federal Reserve position, any argument based on the statutory language that Section 165 cannot be read to inform Section 171 with respect to insurance-based SLHC is not viable.

Three other provisions of Section 165 reinforce this differentiation approach.

- First, Subsection 165(b)(3)(A) requires the Federal Reserve, in applying enhanced prudential standards, to take into account differences between Nonbank SIFIs and BHC SIFIs, including the following factors:
    - whether the institution is already regulated by a primary financial regulator;
    - the nature and mix of the institution's activities;
    - the amount and nature of the institution's liabilities, including the degree of reliance on short-term funding; and
    - other appropriate risk-related factors, as determined by the Federal Reserve.[17]
- Second, Section 165(b)(3)(D) explicitly requires the Federal Reserve to "adapt the required standards as appropriate in light of any predominant line of business".
- Third, Section 165(b)(4), as applicable to Covered Insurance Companies, requires the Federal Reserve to consult with the insurance commissioner representative on the FSOC prior to implementing enhanced prudential requirements under Section 165 to the extent those requirements are likely to have a significant impact on Covered Insurance Companies.

These multiple provisions of Section 165 make clear that Congress expected the Federal Reserve to tailor its enhanced prudential standards to the particular circumstances of insurance companies (and other Nonbank SIFIs), including with respect to capital requirements.

In addition to Section 165, Section 169, which applies independently to modify both Section 165 and Section 171, requires the Federal Reserve to "take any action" that it "deems appropriate" to avoid imposing requirements that are duplicative of requirements already

[17] Section 165(b)(3)(A), as applicable to Covered Insurance Companies, incorporates Section 113(a), which lists the considerations FSOC must take into account when determining whether to designate an institution as a Nonbank SIFI.

imposed on institutions by other provisions of law. It is difficult to imagine a clearer instruction, a broader grant of discretion to a federal banking regulator or a provision that more directly applies to the treatment of Covered Insurance Companies under Section 171. Given that Covered Insurance Companies are already subject to the comprehensive RBC framework under state insurance law, imposing the Bank Capital Framework on Covered Insurance Companies would be not merely duplicative of, but would be at odds with, the state law capital requirements. Accordingly, even if Section 171 could otherwise be read to require the application of the Bank Capital Framework to Covered Insurance Companies (which, as noted, I believe it should not), Section 169 is such a clear and broad grant of authority that it would override any such requirement and would require the Federal Reserve to take action to avoid imposing the Bank Capital Framework on Covered Insurance Companies.

Another fundamental canon of statutory construction that is directly relevant to this analysis is that different statutory provisions must be read consistently rather than in conflict.[18] Indeed, the Federal Reserve and the other banking agencies have acknowledged that "the relationship between the requirements of section 171 and other aspects of [Dodd-Frank], including section 165, must be considered carefully and . . . all aspects of [Dodd-Frank] should be implemented so as to avoid imposing conflicting or inconsistent regulatory capital requirements".[19] It is seemingly incontrovertible that reading Section 171 to preclude differentiation would conflict with the basic mandate in Section 165 to require differentiation.

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[18] See note 15 supra. See also Watt v. Alaska, 451 U.S. 259, 266-67 (1981) ("[W]e decline to read the statutes as being in irreconcilable conflict without seeking to ascertain the actual intent of Congress. . . . We must read the statutes to give effect to each if we can do so while preserving their sense and purpose.") (citations omitted).

[19] 76 Fed. Reg. 37,620, 37,626 (June 28, 2011).

Likewise, such a reading of Section 171 would conflict with the Section 169 requirement to avoid duplication.

Moreover, there is no indication in Section 171 itself, or elsewhere in Subtitle C, that Section 171 was intended to "override" Congress's basic instructions in Sections 165 and 169 for the development and application of capital and other prudential standards for Covered Insurance Companies in a tailored, flexible and non-duplicative manner. Sections 165, 169 and 171 can only be reconciled if Section 171 is interpreted to require a *comparable* capital regime as opposed to an *identical* capital regime. This approach would fulfill the objectives of all three provisions, whereas any more prescriptive reading of Section 171 would undermine the Section 165 requirements of tailoring and differentiation and the Section 169 restrictions on duplication. Any more prescriptive reading is also illogical. It would imply that Section 171 imposed more stringent capital requirements on Covered Insurance Companies than Section 165, even though Section 165 is the key provision that is supposed to impose enhanced (i.e., more stringent) capital and other requirements than those generally applied under Section 171.

There is one other issue of statutory consistency. Both Section 5(c)(3) of the Bank Holding Company Act[20] and the McCarran-Ferguson Act of 1945[21] codify the long-standing federal policy that state laws are to regulate the business of insurance. A reading of Section 171 that overrides this policy would create a conflict that is not necessary.

Thus, upon analyzing Section 171 in context of Subtitle C as a whole, in particular, Sections 165 and 169, and other statutory schemes, the Federal Reserve is clearly authorized to apply the requirements of Section 171 to Covered Insurance Companies in a

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[20] 12 U.S.C. § 1844(c)(3)(A).

[21] 12 U.S.C. § 1012(b).

tailored, flexible and non-duplicative manner that recognizes and accounts for the differences between Covered Insurance Companies and banks.

C. A Solution Consistent with the Plain Language of Section 171 and Subtitle C

The Federal Reserve may have several options to interpret Section 171 in a way that is both consistent with its terms and maintains fidelity to Subtitle C as a whole. The solution, however, that I will now describe may be the most direct and consistent approach. There are two steps.

First, the Federal Reserve would make a determination that the RBC framework that already applies to the insurance operations of Covered Insurance Companies is comparable to the Bank Capital Framework. If, however, the Federal Reserve were to conclude, after consultation with insurance regulators, that the existing minimum capital levels required under the RBC framework are not sufficiently stringent for "enhanced prudential standards", the answer is not to substitute an entirely different capital framework. Rather, the Federal Reserve can simply require that Covered Insurance Companies maintain some percentage greater than 100% of the RBC framework's required capital levels to achieve a level of stringency deemed appropriate to support such operations.

Second, the Federal Reserve would apply the Bank Capital Framework on a consolidated basis to the top-tier holding company of a Covered Insurance Company, but with what is in effect an adjustment for the insurance operations. Any assets of the top-tier holding company held in an insurance company that complies with the RBC framework (as it may be modified by the Federal Reserve) would receive a risk weight of 0% and the RBC capital attributable to those insurance company assets would be deducted from total capital. Under this approach, the holding company's non-insurance assets and activities (including parent company only assets), i.e., those not regulated under the RBC framework, would continue to be subject to

the existing Bank Capital Framework and would require separate and appropriate levels of capital to support such activities. A similar approach could be applied to the leverage requirements.

This approach would not only assure robust and differentiated capital requirements and reconcile the various relevant provisions of Subtitle C, but also would have several other advantages. First, it would apply the Bank Capital Framework to the parent company entity on a consolidated basis, which conforms with Section 171. This result also addresses directly the concern that Senator Collins and former FDIC Chairman Bair identified as an impetus for Section 171 – that, in the financial crisis, holding companies were a source of weakness, rather than strength, to their operating subsidiaries.[22] Second, it would be grounded in the Federal Reserve's existing authority, which the Federal Reserve has exercised previously,[23] to modify risk weights in the existing Bank Capital Framework in order to tailor those requirements for insurance company assets. Third, it would satisfy the not "less than" and not "quantitatively lower than" requirements in Section 171 by leaving in place the numerical ratios underlying the Bank Capital Framework (that is, the numerical ratio requirements under Basel I and Basel III). Fourth, it would build on the existing RBC framework tailored to Covered Insurance Companies, and thereby satisfy the mandate in Section 169 for the Federal Reserve to take action to avoid imposing duplicative requirements on Covered Insurance Companies.

This suggested approach would also give effect to Congressional intent, as evidenced both in the comments of Senator Collins and in the December 11, 2012 Letter in

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[22] 156 Cong. Rec. S3459, 3460 (daily ed. May 10, 2010).

[23] As the federal banking agencies have recognized, Congress did not forbid the agencies from modifying, over time or in response to changes in circumstances, the calculation of the components of the numerical ratios in the bank capital requirements. See 77 Fed. Reg. 52,888, 52,892 (Aug. 30, 2012).

which thirty-three Members of Congress asked the federal banking agencies to ensure that the capital requirements for Covered Insurance Companies "consistently reflect congressional intent by incorporating the state risk-based capital system and applying capital standards that accommodate the existing framework for companies engaged in the business of insurance".

Finally, this approach could be implemented by relying solely on the flexibility inherent in the language of Section 171. That is, by applying the numerical ratios in the Bank Capital Framework, the Federal Reserve would be quite literally imposing capital requirements that are not "less than" nor "quantitatively lower than" the bank capital requirements referred to in Section 171. This approach becomes even more compelling when considered in the context of the broader statutory scheme in Subtitle C, where tailoring and avoiding duplication are the repeated and unambiguous instructions from Congress.

V. Congressional Action

Even though, as just discussed, I believe the Federal Reserve has the authority to resolve this issue, and there are solutions available to the Federal Reserve in the exercise of that authority, there is obviously a distinction between having the authority to take an action and having a statutory requirement to do so. Moreover, in the Federal Reserve's recent promulgation of its rules under Section 165, it postponed a decision on the capital requirements applicable to Covered Insurance Companies to further study the issue. I hope that during this additional period of study, and in view of the firm Congressional support for resolution of the issue, the Federal Reserve will move expeditiously to find an interpretative solution to the problem, whether in the way I have suggested or in some other way.

If, however, the Federal Reserve is not prepared to act promptly, I would strongly urge Congress to act to prevent a result that is so clearly unwarranted and potentially so damaging. The legislation previously proposed by Senators Brown and Johanns, and today by

Senator Collins, represents a sound basis for moving forward. In asking for Congress to act in this matter, I realize that it may seem a "heavy lift", not because of the substance, but because of a reluctance to permit any amendment to the Dodd-Frank Act. The concern is apparently that any amendment would open the door to further amendments that are much more controversial and divisive.

But certainly Dodd-Frank is not such a perfect piece of legislation that any and all amendments should be resisted for all time. When the absence of an amendment would result in perpetuating an adverse result that Congress has clearly stated, on a bipartisan basis, it did not intend, Congress should not be irrevocably barred. Indeed, Congress would be departing from its own fundamental principles if it sought to bind future Congresses from absolutely any reconsideration of what was legislated by its predecessors.

I do recognize the concern about "opening up" Dodd-Frank when there has not been sufficient time to evaluate its impact. But, if there were ever to be any change, this is the time and place to do so. An amendment to clarify Section 171 would be both surgical and non-controversial; of most importance, it is the right result.

VI. Conclusion

In summary, given the virtually unanimous support for finding a solution to the policy issue raised by Section 171, and the flexibility the Federal Reserve has under the terms of Section 171 and Subtitle C, the Federal Reserve can, and should, act to avoid the negative consequences of applying the Bank Capital Framework to Covered Insurance Companies. In the absence of prompt Federal Reserve action, I urge Congress to act.

Appendix A

1. Policy Loans:

As a service to its customers, an insurance company may loan a life insurance policyholder up to the existing cash surrender value of his or her policy, secured by the cash surrender value of the policy. The cash surrender value of the policy is a liability on the insurance company's balance sheet. In this way, the loan is fully collateralized, but unlike a collateralized bank loan, the insurance company is not subject to the risk that the collateral will not cover its exposure under the loan. If the policyholder defaults, the insurance company will reduce the benefits it pays to the policyholder, which will result in the insurer reducing the liability it records for the policy. An insurance company can always recoup a $100 policy loan default by reducing its liability to the customer under the policy by $100.

Despite the fact that the policy loan never exposes the insurance company to credit or market risk, under the Bank Capital Framework – with the mindset of a traditional collateralized bank loan – would require an insurance company to hold Tier 1 capital against the loan at a risk weight of 20%.

2. Guaranteed Separate Accounts:

Many insurance companies offer an insurance product that allows a customer to place funds with an insurance company to be invested and managed by the insurance company, separately from its general assets, with the goal of providing the customer with the income stream from the investments, often upon retirement. These so-called "separate accounts" may be in guaranteed or non-guaranteed form and have varying features and conditions. The basic concept is that, with a guaranteed account, the insurance company guarantees the customer a fixed income stream, with the insurance company exposed if the value of assets in the account

drops below a guaranteed amount at the end of the investment period. Annuities are frequently in the form of a guaranteed separate account.

In the banking context, a guarantee is viewed as a contingent liability that may become fully due at any time. In the insurance context, the separate account products such as annuities are typically structured in such a way that the full liability is not all due at once; the period over which the guaranty payment is made is both long (often 15-20 years) and requires a long waiting period (often 10 years) before any payment is made. This contractual protection substantially eliminates the liquidity concern that the insurance company would need to draw on its own assets to make up for the full amount of the shortfall all at once.

The Bank Capital Framework includes no tailoring for insurance company guaranteed accounts with these protective features. Moreover, because U.S. generally accepted accounting principles require a provision to be made on the insurance company's books to reflect the amount of the insurance company's exposure for the guarantee, requiring additional capital be held against not just the exposure but the entire account results in double-counting.

3. Corporate Bonds:

The Bank Capital Framework is, in a number of respects, tailored for the types of assets held by banks in relatively large amounts. For example, there are different, tailored risk weights for mortgage loans (based on the quality of the loan), sovereign debt (based on categories for various countries), exposures to other U.S. depository institutions and credit unions and exposures to U.S. public sector obligations (based on whether the obligation is general or revenue).

Insurance companies generally hold a significant portion of their assets in corporate bonds – and a greater portion than do banks because bond maturities better fit the

insurance company's asset-liability matching and investment needs. Yet, the Bank Capital Framework is not tailored for corporate debt, so, unlike the RBC framework, there is no distinction between higher and lower quality bonds (as there is for mortgage loans and sovereign debt under both the Bank Capital Framework and the RBC framework), subjecting all corporate bonds to a 100% risk weight. This relatively crude approach is understandable when corporate bonds represent only a small portion of the assets that banks hold, but not when they represent a much larger portion at insurance companies. This exemplifies how the Bank Capital Framework simply was not designed to be applied to insurance companies.