ACLI
Financial Security...for Life.

DIRK KEMPTHORNE
President & Chief Executive Officer

May 24, 2017

The Honorable Steven T. Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Dear Secretary Mnuchin:

The American Council of Life Insurers (ACLI) appreciates the opportunity to share with you our comments on the April 21, 2017 Presidential Memorandum on the Financial Stability Council's (FSOC) systemically significant determination and designation processes for non-bank financial companies.[1] We welcome the President's action and support the Memorandum's directive for you to conduct a thorough review of these FSOC processes and provide the President with a written report of your findings. As you undertake this review, we respectfully request that you take into consideration the issues and comments outlined in this letter.

As we noted in our March 31st letter to you on the President's Executive Order on the Administration's Core Principles for Regulating the U.S. Financial System, we believe strongly that FSOC's authority to designate insurers as systemically significant should be eliminated. In keeping with the spirit of the Presidential Memorandum, this letter expands on the points raised in our March submission. We believe thoughtful consideration of these points during your review will result in Treasury's final report to the President recommending that that authority be repealed, and that all existing designations be rescinded.

I. The FSOC Nonbank Designation Process is Fatally Flawed and Does Not Meet Basic Standards of Accountability, Transparency, and Good Governance.

Since its inception, the FSOC designation process has not met basic standards of accountability, transparency, and good governance. As a result, we believe the process is fatally flawed.

First, the FSOC process has been extremely inconsistent as applied to different sectors of the financial services industry. This broad discrepancy in application of FSOC's authority is illustrated by the very different approaches taken towards different industries, without explanation. The insurance industry has seen individual companies subject to scrutiny and designation, while for other industries FSOC has focused on reviewing and identifying specific practices that may pose significant risk or taken no action at all rather than singling out and designating specific firms.

[1] The ACLI is a Washington, D.C.-based trade association with approximately 290 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 94 percent of industry assets, 93 percent of life insurance premiums, and 97 percent of annuity considerations in the United States

American Council of Life Insurers
101 Constitution Avenue, NW, Washington, DC 20001-2133
(202) 624-2300 t (866) 953-4074 f DIRKKempthorne@acli.com
www.acli.com

Second, even in the insurance sector itself, there is no evidence of a uniform, consistent or transparent methodology being applied to each individual company under review. Life insurance companies that have gone through the designation process have not received adequate information or explanation of FSOC analyses and decisions. Documents provided by FSOC to insurance companies provide little insight into the basis for designation decisions. These documents typically offer only conclusory statements, predictions, and speculations that are unsupported by factual and economic analysis or historical precedent. FSOC has not provided companies with enough information that would allow them to take positive steps to avoid designation, or be de-designated through appropriate action.

An additional illustration of the lack of due process in FSOC designation of individual insurers is its failure to appropriately consider the role of existing primary financial regulators, leading to a lack of understanding and recognition of the strong insurance regulatory framework in place through the state-based system. The state-based insurance regime has a long and successful track record of insurance regulation and has protected insurers and policyholders even through our most difficult times, including from the worst aspects of the financial crisis. One of the explicit statutory requirements FSOC must consider is the "degree to which the company is already regulated by one or more primary financial regulatory agencies." Contrary to this statutory requirement, FSOC has not appropriately considered in its designation of insurers the authority and tools available under the state-based insurance regime, including numerous and substantial reforms policymakers have implemented since the financial crisis.

Insurance companies have experienced prudential regulators that have greatly increased the tools available to oversee and effectively regulate the industry. In the last decade, state insurance holding company laws and group supervision practices have been strengthened and expanded to enable state regulators to be vigilant in identifying and aggressive in addressing issues of concern that might jeopardize the corporation as a whole. For example, insurance companies or groups are now required to submit their own risk and solvency assessments to state insurance regulators, who routinely review them with the group's management in cooperation with other regulators. Prudential oversight of insurance companies through the state-based system continues to be demonstrably strong and effective as it evolves to meet ongoing challenges.

The lack of consideration given to primary financial regulators of insurance has been exacerbated by the lack of insurance expertise and representation on the panel. Of the 10 FSOC voting members, at least seven are primarily banking industry regulators. To this point, when FSOC has considered the status of insurers that were ultimately designated, the dissenting views of both the FSOC Independent Member with Insurance Expertise and the nonvoting state insurance regulator were overruled and appear to have been disregarded. FSOC has also dismissed concerns registered by the primary insurance regulators of the companies under consideration for designation.[2] This resulted in the designations of insurers being largely based on the opinions of regulators with banking or other expertise but no insurance industry knowledge or expertise. By putting designated insurers under the supervision of the Federal Reserve, a banking regulator, FSOC has not leveraged existing regulatory constructs (industry knowledge, staff expertise, established supervisory relationships) that are better positioned to implement a group supervisory construct for insurance. Instead, FSOC has needlessly imposed burdensome, duplicative regulation on a few companies, without any showing of concomitant benefit to the US market.

[2] Letter to the Honorable Jacob Lew, Secretary of the Treasury, from Benjamin M. Lawsky, Superintendent, New York State Department of Financial Services, July 30, 2014.

The fact that FSOC's decisions affecting insurers were bank-centric and not grounded in an accurate understanding of the business of insurance illustrates fundamental flaws in the designation process. Life insurers are fundamentally different from banks. FSOC's reliance on an inappropriate and unrealistic bank-like "run" scenario on insurance products as the trigger of an insurer's financial distress or cause of systemic risk illustrates its bank-centric mindset for considering insurance firm designations. Crucially, life insurers are not subject to bank-like runs. Moreover, state insurance regulators have the power to quickly address any run-like scenarios – authority the FSOC inexplicably speculated the regulators would not exercise and therefore dismissed.

In addition, FSOC's narrow focus on a few individual entities in certain sectors has diverted attention and resources away from its more important role as a broad-sighted macroprudential overseer of the economy that can identify potential systemic risk in a timely fashion. The enormous resources and time devoted by FSOC to burdensome and ill-tailored regulatory oversight of a few individual insurance companies has diverted attention that should be focused on insufficiently regulated or unregulated activities or sectors of the financial industry, where the next crisis is much more likely to arise. FSOC should act as an early warning system and ensure that primary regulators are addressing in a comprehensive and timely manner any activities that it determines may pose a threat to the financial stability of the United States.

FSOC's primary responsibility should be assessing macroprudential risks to U.S. financial stability. It should be made clear that its principal role is making advisory recommendations to primary financial regulatory agencies, which for insurance are the state commissioners, on applying new or heightened safeguards where FSOC identifies financial activities that could increase risks to the stability of U.S. financial markets. There is no evidence that the current structure and approach of FSOC has facilitated the reduction of systemic risk, nor has it effectively demonstrated that life insurance activities present a systemic risk. For that reason alone, the current FSOC SIFI designations should be rescinded and Treasury should support legislative reforms to eliminate the designations.

II. FSOC's Application of the Material Financial Distress Standard Fails Basic Precepts of Accountability, Transparency and Consistency.

The Dodd-Frank Act authorizes FSOC to designate a nonbank financial company for supervision by the Federal Reserve Board if either (1) material financial distress at the company, or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company, could threaten the financial stability of the United States. Each of the designations made by FSOC has been based on the material financial distress standard alone. In each case, FSOC simply assumed the existence of material financial distress had or could occur at the company, and then concluded that such distress could be transmitted to the broader financial system. FSOC affirmatively refused to consider the likelihood of distress.

We believe that FSOC has used a flawed application of the material financial distress standard for designation. This distorts the purpose of designations by failing to account for the vulnerability of prospective designees, and departs from the requirements of the Dodd-Frank Act and FSOC's own regulatory guidance.

The Dodd-Frank Act expressly directs FSOC, when considering a company for designation, to consider eleven factors, a number of which implicate the company's vulnerability to material financial distress. And FSOC's own interpretive guidance recognizes that a company's vulnerability to financial distress is a critical part of the designation inquiry.[3] The statute, FSOC's guidance, and well-established principles of reasoned regulation make clear that FSOC should not evaluate a company's systemic effects by assuming a designated company is failing, but instead should separately assess the company's vulnerability to material financial distress. This analysis is particularly important where primary regulators are actively working to ensure companies' solvency – there is no benefit from imposing federal regulation when existing state regulation is more than sufficient. Making this a part of the designation process also provides guidance and the right incentives for companies that may be considered for designation in the future, because it incentivizes them to consider reducing or eliminating aspects of their business that FSOC regards as vulnerabilities.

Roy Woodall, FSOC's Independent Member with Insurance Expertise, addressed this flawed application of the material financial distress standard in his dissents in both the Prudential and MetLife cases. In the Prudential case, he noted that:

> …the Notice's analysis under the [material financial distress standard] is dependent upon its misplaced assumption of the simultaneous failure of all of Prudential's insurance subsidiaries and a massive and unprecedented, lightning, bank-style run by a significant number of its cash value policyholders and separate account holders, which apparently is the only circumstance in which the Basis concludes that Prudential could pose a threat to financial stability. I believe that, absent a catastrophic mortality event (which would affect the entire sector and also the whole economy), such a corporate cataclysm could not and would not occur.

Similarly, in his dissent in the MetLife case, Mr. Woodall highlighted the lack of evidence to support one of the FSOC's principal bases for assuming "material financial distress" at MetLife:

> I do not, however, agree with the analysis under the Asset Liquidation Transmission Channel of the Notice of Final Determination, which is one of the principal bases for the finding under the [material financial distress standard]. I do not believe that the analysis' conclusions are supported by substantial evidence in the record, or by logical inferences from the record. The analysis relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act.

One consequence of FSOC's interpretation of the material financial distress standard is that FSOC focuses too narrowly on a company's size. In contrast to the SIFI designation for banks, in the Dodd-Frank Act, Congress never intended FSOC to focus on size when designating nonbank companies. Rather, size is just one of eleven factors that Congress directed FSOC to consider when it designates a company.

Another consequence of FSOC's reliance on the material financial distress standard is that it is difficult for a company, or the public, to understand the basis for a designation. The documents accompanying designations address how the company's failure might impact financial stability, but do not address what hypothetically caused the company to fail in the first place or the likelihood of that failure.

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[3] See *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21,637 (Apr. 11, 2012).

Under a material financial distress standard that meets the statutory requirements of the Dodd-Frank Act, FSOC would need to give due weight to *all* eleven statutory factors to first determine whether the company is vulnerable to material financial distress based upon its company-specific risk profile and, if it is, then determine whether the company's failure could threaten the financial stability of the United States. In other words, FSOC should not be able to designate a company on an assumption that it is failing, but instead should designate a company only when a company's specific risk profile – including its leverage, liquidity, risk and maturity alignment, and existing regulatory scrutiny – reasonably support the expectation that the company is vulnerable to financial distress, and then that its distress could threaten the financial stability of the United States. The purpose of designations should be to regulate nonbanking firms that are engaged in risky activities that "could" cause the failure of the firm with systemic impact, not to regulate firms that are not likely to fail.

The statute, FSOC's own regulatory guidance, and common sense dictate that a company should not be designated systemic without an evaluation of whether the company, as currently structured, operated, and regulated, is indeed vulnerable to material financial distress.

III. FSOC has Failed to Consider the Consequences of its Nonbank Designations.

In our opinion, FSOC has failed to consider all of the consequences of a systemic designation. FSOC has an obligation to consider the effects of its final determinations, as administrative law requires that an agency consider the consequences of its actions and failure to do so can cause a court to void the action. To date, however, there is no evidence that FSOC has ever considered the consequences of its designations on the company, the industry, the general public, or even government itself.

This failure is particularly relevant to designations involving insurance companies. The insurance industry is highly competitive, and the additional regulation imposed upon a designated company can place that company at a significant competitive disadvantage relative to its non-designated competitors. Requiring additional capital standards is the most obvious example of just such a result. But ongoing Federal Reserve supervision is burdensome and the annual Resolution and Recovery Plans require ongoing significant expenditure of resources, not to mention operational changes they may compel.

Additionally, FSOC's failure to consider the consequences of designations on insurance companies is at odds with FSOC's duty under the Dodd-Frank Act to monitor regulatory developments, including "insurance issues," and to make recommendations that would enhance the "integrity, efficiency, competitiveness, and stability" of U.S. financial markets.[4]

IV. Entities Subject to FSOC Designations Are Not Provided Meaningful Opportunities to Have Determinations Reevaluated in a Timely and Transparent Manner, Nor with Information on How to Reduce Perceived Risk or Avoid Designation.

For the reasons discussed above, the ACLI believes strongly that FSOC's ability to designate insurers as systemically significant should be eliminated, and any existing designations rescinded. The current designation and de-designation processes lack sufficient procedural safeguards and the explanations provided to the designated companies, as well as the abbreviated explanations that are made publicly available, provide little insight into why particular companies have been designated. Significant reforms are needed to ensure companies understand from the record why they are designated and, as importantly, what actions can be taken to reverse that decision.

[4] §112(a)(2)(D) of the Dodd-Frank Act.

Thank you for consideration of these comments. We welcome the opportunity to meet with you and your staff in the near future to discuss these items in greater detail. Please feel free to contact me directly if you have questions or would like any additional information.

Sincerely,

GOVERNOR DIRK KEMPTHORNE

CC: Craig Phillips, Senior Counselor to the Secretary
Steven Seitz, Acting Director, Federal Insurance Office