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before the

Subcommittee on Insurance, Housing and Community Opportunity
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Joint hearing on

Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards

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Introduction/Summary

Chairwomen Biggert and Capito, Ranking members Gutierrez and Maloney, and members of the subcommittees, thank you for providing State Farm Mutual Automobile Insurance Company ("State Farm Mutual") the opportunity to testify this morning on the Federal Reserve Board's (the "Board") proposals (the "Proposals") to regulate savings and loan holding companies (SLHCs) engaged in the business of insurance in the same manner as bank holding companies (BHCs) under the Basel Framework.

At the outset, I would like to emphasize that State Farm fully supports the fundamental goals of capital adequacy that underlie the proposals. However, utilizing the Basel banking–oriented framework for SLHCs engaged predominantly in the business of insurance (hereinafter, "insurance-based SLHCs"), does not satisfy these goals.

In approaching this issue, we recognize the extraordinary responsibilities, complex issues, and unprecedented number of rulemakings the Board is responsible for addressing under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). We also understand that, within the universe of entities the Board supervises, SLHCs such as State Farm Mutual comprise just a small part. Nonetheless, it does not appear that the Board gave any meaningful consideration to insurance-based SLHCs or to the most appropriate and effective alternatives to implement congressional directives. To the extent the unique needs of insurance companies were addressed, it was in the context of how the Board should treat an insurance subsidiary within a much larger banking organization.

By failing to adequately consider issues unique to insurance-based SLHCs, the proposed bank-oriented Basel framework would impose an ill-fitting and structurally flawed regulatory structure upon insurers, which have starkly different business models, risk exposures, and capital needs than banks and traditional BHCs. In addition, the regulatory mismatch creates tremendous and costly difficulties in the recordkeeping, accounting and reporting requirements for a number of insurance-based SLHCs, while offering little, if any, commensurate benefit to regulators in understanding the capital needs and financial state of the companies impacted.

Indeed, far from promoting safety and soundness for insurance-based SLHCs, these bank-oriented rules and requirements are counterproductive and may promote capital structures and practices that undermine prudential management of an insurance company.

We submit that this is not what Congress intended or mandated in the Dodd-Frank Act. Instead Congress preserved state-based functional regulation of insurance and clearly indicated that nothing in the Act was intended to replace existing and well-functioning capital and accounting regimes for insurers. Unfortunately, this reality is not reflected in the proposed rules. Consequently, unless the Board is willing to modify the Proposals to accept existing state-based capital requirements for insurers in the current rule, we believe the only responsible recourse is for the Board to issue a new proposal for insurance-based SLHCs so these issues can be addressed. We further believe that if the Board ignores existing state regulation and pushes ahead with entirely new standards for insurers, a strong case can be made that the Proposals run afoul of the McCarran-Ferguson Act, which places authority on insurance matters with the states.

Background on State Farm and its Thrift

State Farm Mutual is a state-regulated mutual insurance company established in 1922 and is the parent of the State Farm group of companies. Headquartered in Bloomington, Illinois, State Farm Mutual and its subsidiaries provide personal lines of insurance. We are the largest insurer of automobiles and homes in the United States, and although we have a substantial life insurance business, more than 85% of our revenues are provided through property and casualty insurance activities.

Our thrift was established in 1999 to meet our customers' needs for an efficient and convenient "one-stop shopping" source of products and services for the broad range of their financial services needs. Through ownership of the thrift, State Farm Mutual is a "grandfathered" unitary SLHC, as defined in Section 10(c)(9)(C) of the Home Owners' Loan Act ("HOLA").

Notwithstanding the benefits we and our customers derive from the thrift, it remains a small part of our business. More than 91% of the consolidated assets of the State Farm group are related to our insurance operations, which also generate 98% of the group's total revenues. There should be no confusion that State Farm Mutual is predominantly engaged in the business of insurance.

State Farm Mutual, is both an SLHC and an Operating Insurance Company that is Functionally Regulated on a Consolidated Basis

In addition to being overwhelmingly engaged in the business of insurance, it must be emphasized that State Farm Mutual, the holding company for the State Farm group of companies and the regulated SLHC, is also a regulated insurance company in its own right. It is not a shell holding company. It is directly regulated by the Illinois Department of Insurance (the "Illinois Department"). As such, all parts of the State Farm group are comprehensively regulated. For example, all of State Farm Mutual's subsidiaries, as assets of State Farm Mutual, are subject to holding company system examination by the Illinois Department. There is simply no material aspect of our business that is not currently subject to comprehensive prudential regulation.

Insurance regulation entails strong rules and regulations governing solvency, operations, and investments. Solvency regulations are designed to ensure that all insurance companies, including State Farm Mutual, have the financial ability and liquidity to pay claims. Regulation and laws include strict risk-based capital (RBC) requirements and statutory investment limitations and solvency requirements. Insurers also prepare financial statements on the basis of Statutory Accounting Principles (SAP) that are generally more conservative than Generally Accepted Accounting Principles (GAAP) in the valuation of assets and liabilities. Further, while State Farm Mutual has little in the way of off-balance sheet exposures, statutory accounting rules require insurers like State Farm Mutual to disclose any off-balance sheet exposures that represent a material contingency. Again, these rules are specifically designed to address the particular risks facing insurers, which are starkly different from those facing banking institutions.

This comprehensive supervisory framework for insurers is similar in approach to the supervisory system developed by bank regulators for BHCs and SLHCs that are not insurance companies; however, the insurance system has been designed to specifically address the business of insurance and the risks insurance companies face and has been highly successful.

<u>Insurance Risk-Based Capital Requirements are Superior to the Basel Framework for Insurance-Based SLHCs</u>

A critical component of solvency regulation is the maintenance of adequate capital and reserves. The insurance RBC calculation is intended to assess the capital adequacy of insurers and to identify and assess various risks, including asset, business, and insurance risks. As with bank capital and leverage ratios, breaches of prescribed RBC levels trigger regulatory intervention. Separate RBC formulae exist for each type of insurer (i.e., life, property and casualty, and health). Unlike some other areas of insurance law, RBC standards exhibit a high degree of uniformity across state insurance regulatory systems. RBC model laws have been adopted in their standard form in virtually every state.

Insurance RBC captures the risks associated with insurance operations, assets, and investments in a manner that is tailored to the business models and asset utilization strategies of insurers. For example, the RBC system recognizes that high-quality, long-term, investment-grade corporate bonds are a necessary component of an insurer's investment portfolio because the insurer must match longer-term, relatively stable insurance policy liabilities with long-term assets. Consequently, although the value of long-term bonds fluctuates as interest rates rise and fall, such volatility has limited impact on the financial condition of an insurer that holds the bonds to maturity because redemption of the bonds at par and other cash flows are timed to coincide with the insurer's payment obligations under the insurance policies. Importantly, the Proposals' bank-oriented focus on asset risk and inadequate recognition of insurance and other non-asset risk is troubling. The Proposals do not appropriately recognize that insurance risk is necessarily different than banking risk and that these differences impact the capital required to prudently manage each type of business.

In fact, because the calculation of capital needs for insurers and banks is so different, there are scenarios where an insurance-based SLHC could be subject to potential seizure levels under RBC guidelines, but would look well-capitalized under the Basel "consolidated" framework. Thus, if the goal of the Proposals is to ensure the capital adequacy and financial safety of regulated holding companies, the Basel framework contains gaping holes that fail the test for insurance-based SLHCs.

<u>Mandating GAAP Accounting is Costly and Counterproductive to Prudential Regulation</u>

For State Farm Mutual, the most significant, costly and obvious example of a regulatory mismatch in the proposed rules is the apparent requirement that all insurance-based SLHCs utilize GAAP in preparing financial statements and in the reporting of data to the Board. As a mutual insurance company, State Farm Mutual is not required to and does not prepare GAAP financial statements. Instead, it prepares its financial statements using SAP, the state-mandated accounting system utilized by all insurance companies in the United States. Mandating GAAP would take several years to implement and be extremely costly–both in terms of financial resources and the burden of taking management time away from business operations. Moreover, our use of GAAP accounting would not provide the Board meaningful new information about the financial condition and capital strength of State Farm Mutual.

To the extent GAAP reporting provides any limited new information to the Board, the benefits of this information would be vastly outweighed by the costs of instituting GAAP and producing

duplicative financial statements. A recent study performed on behalf of State Farm Mutual and its subsidiaries indicated it would require a multi-year effort – exceeding four years – to implement a consolidated GAAP and regulatory reporting process. The estimated costs could approach $150 million initially with millions of dollars to maintain it annually. Moreover, the effort just to implement an automated regulatory reporting process – even without converting to GAAP – was estimated to take at least 12 months. Such time, effort and cost cannot be overlooked – or justified – especially when a time-tested and proven regulatory solvency framework is already in place for functionally regulated insurers like State Farm Mutual and no cogent analysis has been presented as to why such a framework falls short of congressional goals and directives. The bottom line is that SAP and the insurance RBC regime provide a much clearer and more insightful picture of the capital adequacy and financial condition of an enterprise where the overwhelming portion of its assets is held by an insurer(s).

As the National Association of Mutual Insurance Companies has explained: "The use of SAP is codified in all states because its more conservative approach in assessing an insurance company's solvency and ability to pay claims, and meet its obligations is the very foundation of financial entity regulation." SAP has a long history of highly effective use in the insurance sector and is well recognized within the accounting profession as an Other Comprehensive Basis of Accounting and, like GAAP, allows for audited financial statements.

Finally, the Board should not ignore that the sufficiency of SAP was clearly recognized by Congress as an acceptable accounting measure for insurance-based SLHCs in its consideration of the Dodd-Frank Act, as well as the Board's similar acceptance of reporting from foreign entities utilizing different accounting systems.

The Board Should Accept its Own Staff's Determination that Bank Rules are Inappropriate for Insurance

In 2002, in connection with the creation of financial holding companies under the Gramm-Leach-Bliley Act, members of the Board staff coauthored a report with the National Association of Insurance Commissioners (the "NAIC") in which they found that significant difficulties exist in reconciling the capital approaches used by bank regulators and those used by insurance regulators, particularly given that "the two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors." The report stated:

> Banking and insurance industry supervisors use very different approaches for identifying and addressing exposure to risks and losses, and to setting regulatory capital charges. The divergent approaches arise from fundamental differences between the two industries, including the types of primary risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities.

The report concluded, "the effective regulatory capital requirements for assets, liabilities and various business risks for insurers are not the same as those for banks. . . . [T]he effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets." Thus, the staff of the Board recognized at least as early as 2002 that bank-oriented capital rules are not appropriate for insurance companies. Not only has nothing changed since

2002 that would alter this conclusion, but the Board specifically stated in its early Dodd-Frank Act capital rule releases concerning SLHCs that it would "to the extent reasonable and feasible tak[e] into consideration the unique characteristics of SLHCs and the requirements of HOLA."

AIG Does Not Justify Establishing Inappropriate and Counterproductive Standards for Insurance-Based SLHCs

On numerous occasions the Board's senior leadership and staff have indicated to the insurance industry and Congress that the Basel framework is required for insurance companies in order to avoid another AIG and the need for a taxpayer bailout. As a substantive regulatory matter, however, this is truly a non-sequitur. Top-tier insurance-based holding companies like State Farm Mutual are subject to state holding company statutes that impose strict oversight of affiliate transactions, which substantially restrict a company's ability to engage in regulatory arbitrage. In contrast, AIG's holding company was not a functionally regulated insurance company and the lack of effective supervisory oversight of holding company activities and risk management practices across that enterprise was central to the company's overall liquidity crisis in 2008. Moreover, nothing that occurred at AIG, including the difficulties experienced in its securities lending program, warrants or justifies imposing a regulatory regime that does not match the business model and economic reality of the SLHC being regulated and that could actually weaken the SLHC.

The Collins Amendment Does Not Mandate Using the Basel Framework for Insurance Companies

Under Section 171 of the Dodd-Frank Act, commonly known as the Collins Amendment, the Board is required to establish minimum leverage capital requirements and minimum risk-based capital requirements, each to be met on a consolidated basis by depository institutions and their holding companies, including SLHCs. As stated in the statute, these requirements "shall not be less than the generally applicable leverage [and risk-based] capital requirements" that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act (i.e., July 21, 2010).

Although Section 171 requires the Board to set minimum capital requirements for depository institution holding companies, it does not preclude the Board from taking into account the existing and comprehensive RBC structure of insurance-based SLHCs in establishing these minimum capital requirements. Nor does anything in the Dodd-Frank Act as a whole suggest any such limitation. The statute does not, for example, require the Board to impose capital requirements based on GAAP rather than SAP (see further discussion below). Nor does Section 171 or any other part of the Dodd-Frank Act otherwise preclude the Board from designing capital standards that otherwise reflect appropriately fundamental differences between insurance SLHCs and other types of institutions so long as those requirements meet the statutory floor.

To the contrary, Congress recognized and preserved in the Dodd-Frank Act, in numerous ways, the "functional" regulation of "grandfathered" SLHCs that was an important aspect of the Gramm-Leach-Bliley Act. In so doing, Congress made clear that the implementation of Section 171 should be accomplished in a manner that accords appropriate treatment to the distinct nature of particular types of SLHCs, the distinct types of products and services they offer, and the comprehensive regulatory environment in which they operate. Indeed, in a letter sent this past

Monday to federal banking regulators, Senator Collins of Maine expressed her view that "it was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime." She added that recognizing the distinctions between banking and insurance was consistent with her amendment.

Any Basel type regulation is not only inconsistent with evaluating insurance risks, but may, and likely will, produce dramatically wrong results. Inflexible adherence to a Basel I benchmark that is in direct conflict with economic reality should not be considered consistent with congressional intent in setting a floor for capital and leverage requirements. Therefore, in cases where the SLHC is engaged predominantly in the business of insurance and the holding company is a functionally regulated, operating insurer, we submit that the incorporating insurance RBC methodology is in fact the most reasonable interpretation of this floor and should be used for such purpose. Again, the issue is not about whether strong capital standards should be required—everyone shares that objective. The issue is about using the most appropriate and effective standards.

The Collins Amendment and the McCarran-Ferguson Act

Congress's intent regarding the application of the Collins Amendment to insurance company SLHCs whose subsidiaries are also engaged primarily in the business of insurance also must be construed against the background of the McCarran-Ferguson Act of 1945, in which Congress explicitly codified the primacy of the states in regulating the business of insurance. Specifically, the McCarran-Ferguson Act provides that no act of Congress, unless it "specifically relates to the business of insurance," shall be construed in a manner that would effectively "invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance."

Under the Supreme Court's decisions interpreting the McCarran-Ferguson Act, it does not appear that the Collins Amendment specifically relates to the business of insurance. The business of insurance is not expressly mentioned in the provision and nothing in its legislative history suggests that Congress specifically contemplated insurance companies in the Amendment. Furthermore, state insurance laws, including state insurance RBC requirements, clearly were enacted for the purpose of regulating the business of insurance. Consequently, any federal rules that fail to take into account state insurance RBC requirements threaten to impair the solvency laws enacted by the States for the purposes of regulating the business of insurance. They do this by adversely impacting the effective functioning of the business according to the well-established principles and practices that insurance companies would otherwise undertake in accordance with State insurance law requirements. Without a clearly expressed Congressional directive, the proposed rules run the risk of legal challenges under the McCarran-Ferguson Act.

The Proposals' Implications for Insurance-Based SLHCs, their Customers, and the Markets they Serve

If the Board persists in insisting upon bank-oriented rules that are inappropriate for insurance-based SLHCs, it is hard to avoid the conclusion some have offered that the proposed rules are the latest step toward the back door elimination of the thrift charter and grandfathered unitary SLHCs. For many such SLHCs, the Proposals would make operating a diversified SLHC, particularly one in which the savings bank subsidiary is a small part of the organization,

prohibitively expensive and subjected to managing to two different capital regulatory regimes, including one that is fundamentally inappropriate. Indeed, even the prospect of the adoption of the proposed rules has contributed to the decision of several insurance-based SLHCs to divest or convert their savings banks to non-depository trusts in order to avoid the expense and regulatory burdens potentially associated with SLHC status.

Congress, however, specifically preserved the thrift charter, SLHCs – and in particular grandfathered SLHCs – and functional regulation in the Dodd-Frank Act. The proposed rules effectively defy that Congressional determination, purportedly to achieve Congress's goals for capital adequacy, but apparently without consideration for how those goals can be met through measures wholly consistent with functional regulation. This regulation, as we have emphasized, relies on a comprehensive, long-standing RBC system that has served the insurance industry and consumers extremely well. The current proposed rules do not improve supervision over the financial strength of the insurance industry or the thrift industry; they detract from it.

A New Proposed Rule is Needed for Insurance-Based SLHCs

The simplest approach to addressing these issues and remaining faithful to Congress's objective to maintaining state functional regulation of insurance companies would be to incorporate state-based, capital, accounting, and reporting rules in the Proposals. However, given the lack of meaningful consideration for insurance-based SLHCs in the Proposals, we believe the Board should go back to the drawing board with respect to insurance-based SLHCs such as State Farm Mutual and develop a new proposed rule for public comment.

In developing a new proposed rule, we urge the Board to consult with the Secretary of the Treasury in obtaining the advice and assistance of the Federal Insurance Office (the "FIO"). We also request the Board to work with the insurance experts on the Financial Stability Oversight Council (the "FSOC), the NAIC, and industry members such as State Farm Mutual. We are confident that, in working in a collaborative manner with these insurance experts, the Board can develop a set of regulations that recognize and build upon the existing RBC structure in which insurance-based SLHCs operate. This will result in the development of a set of guidelines that will provide the Board with a more complete and insightful window into the capital adequacy and financial condition of the insurance-dominated SLHCs.

Conclusion

The Board's emphasis on applying bank-centric regulations to insurance companies creates a regulatory anomaly whereby rules intended to make holding companies financially stronger may compel behavior that weakens the capital strength of insurance-based SLHCs. In essence, the rules designed to fix problems in one industry (i.e., banking) wreak harm if applied to another industry. Such misplaced application is not what Congress had in mind in the Dodd-Frank Act. Furthermore, the Proposals appear inconsistent with the McCarran-Ferguson Act's approach to regulating the business of insurance.

There are a number of alternatives the Board could apply to correct this problem, including modifying the Proposals to accept state-based capital requirements for insurers. Consequently, we strongly urge the Board to withdraw the proposed rules as applied to insurance-based SLHCs and to work together with the insurance experts within the FIO, FSOC, and other entities in the

federal government, as well as the state insurance regulators and the insurance industry to develop a new set of proposed rules designed specifically to achieve Congress's intent for a strong and competitive financial system that effectively delivers high-quality services to consumers within the context of functional regulation of financial institutions.

Again, we are not seeking weak capital rules or special exemptions—just rules that make sense.

Thank you.