Testimony

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Finding the Right Capital Regulation for Insurers

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Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for the opportunity to appear before you to discuss the critical issue of the appropriate capital framework for insurers supervised by the Federal Reserve. My name is Michael Mahaffey and I am the Chief Risk Officer for Nationwide Mutual Insurance Company (Nationwide). I am testifying on behalf of Nationwide but will also represent the perspective of a diverse group of insurers that fall under Federal Reserve supervision. Those insurers include both insurance savings and loan holding companies (SLHCs) and insurance companies that have been or may be designated by the Financial Stability Oversight Council (FSOC) as systemically important financial institutions (SIFIs).

As Nationwide's Chief Risk Officer, I am responsible for overseeing the company's approach to managing its risk profile, including the key functions of Stress Testing and Enterprise Risk and Capital Modeling, Measurement and Management. A critical part of my role is to ensure that Nationwide meets its internal and external capital requirements so the company is always well positioned to honor its promises to our policyholders. In my capacity as Nationwide's Chief Risk Officer, I believe I can offer a helpful perspective on appropriate capital regimes for insurers and the consequences of imposing bank-centric capital rules on companies like Nationwide.

About Nationwide

Nationwide is a Fortune 100 mutual insurance company based in Columbus, Ohio. For almost 100 years Nationwide has been helping our policyholder members protect what is most important to them through our property and casualty and life insurance businesses.

Roughly half of Nationwide's revenue is derived from our property and casualty businesses, and half is derived from our life insurance and related businesses. As a result, Nationwide is representative of both the property and casualty and the life insurance industries. Nationwide Mutual and its property and casualty insurance subsidiaries primarily provide personal auto, homeowners, and commercial insurance products to households and businesses all across the country. In addition, Nationwide Life Insurance Company, a subsidiary of Nationwide Mutual, primarily provides life insurance, individual annuities, and private and public-sector retirement plans. Nationwide also provides banking products and services through Nationwide Bank, a federal savings bank insured by the FDIC.

As of December 31, 2013, Nationwide had approximately $183 billion in combined assets, while Nationwide Bank had approximately $6 billion in assets. While Nationwide Bank is critical to our customers and our business strategy, it is important to note that it represents less than 3 % of the total assets of the combined organization.

Notwithstanding the bank's de minimis relative size, by virtue of its ownership of Nationwide Bank, Nationwide is registered as an SLHC. As an SLHC, Nationwide is now subject to Federal Reserve supervision and regulation pursuant to the Dodd-Frank Act, including new prudential requirements designed to enhance the safety and soundness of banking organizations. These include the Collins Amendment's consolidated capital requirements, capital stress-testing requirements, and the Volcker Rule.

The Applicability of the Collins Amendment to Insurers

Pursuant to the Dodd-Frank Act, two categories of insurance companies came under Federal Reserve supervision – insurers that own depository institutions (and are thus SLHCs) and insurers that are designated by the FSOC as nonbank SIFIs. The Dodd-Frank Act conferred authority on the Federal Reserve to establish group capital requirements for both categories of companies. Section 616 of Dodd-Frank granted the Federal Reserve the authority under the Home Owners' Loan Act (HOLA) to establish group capital requirements for insurance SLHCs. Likewise, Section 165 of the Dodd-Frank Act provided the Federal Reserve authority to establish group capital requirements for insurance SIFIs.

Insurance SLHCs and insurance SIFIs are also subject to the minimum group capital requirements as set forth in the Collins Amendment. The Collins Amendment establishes a "generally applicable" minimum capital floor that is no lower than that which was in effect for banks at the time Dodd-Frank was enacted.

As an SLHC, Nationwide is subject to the Collins Amendment. In addition, our depository institution, Nationwide Bank, is also independently subject to the minimum capital standards in the Collins Amendment. We support the application of the Basel banking capital standards to Nationwide Bank and we are not seeking to exempt Nationwide Bank from the Collins Amendment or in any way alter the capital requirements as applied to Nationwide Bank.

Furthermore, we do not oppose utilization of a group-wide capital framework for insurance SLHCs and insurance SIFIs. Capital strength is core to our business proposition – providing our policyholders with financial protection when they need it the most.

However, it is critically important that any capital framework established by the Federal Reserve for insurance SIFIs and insurance SLHCs utilize the appropriate tools. These institutions are predominantly insurance organizations and it would be inappropriate to measure their capital needs using a tool that is designed for banks.

By way of analogy, it would be wholly inappropriate to apply an insurance-centric capital framework on a group-wide basis to bank holding companies, bank SIFIs like JP Morgan or Wells Fargo, or to banks that each happened to own small insurance operations.

The Statutory Construction Issue

As you know, the purpose of the Collins Amendment is to ensure that certain financial institutions are subject to a minimum capital requirement. The economic crisis underscored the need to ensure that financial institutions hold enough capital to weather severe economic stress. We wholeheartedly support strong capital rules, which protect financial institutions, the broader economy, and everyday Americans.

Again, we are not seeking lower capital requirements for insurers or their depository institution subsidiaries. We only seek to ensure that any capital standards established by the Federal Reserve utilize appropriate methodologies and accurately reflect the risks inherent in the business of insurance, which we believe is consistent with Congress' intent in adopting the Collins Amendment.

We also believe that the plain language of the Collins Amendment permits the Federal Reserve to establish a separate, tailored, group capital framework for insurance SLHCs and insurance SIFIs. However, the Federal Reserve has maintained an interpretation of the Collins Amendment that constrains their ability to tailor the rules and would require the imposition of bank-centric Basel capital rules on insurance SLHCs and insurance SIFIs. Despite this interpretation, Federal Reserve officials have repeatedly agreed with policymakers and industry officials that a one-size-fits-all approach is undesirable.

We respectfully, but strongly, disagree with an interpretation of the Collins Amendment that would prevent the Federal Reserve from establishing a separate capital framework that is appropriately tailored to the risks inherent in the business of insurance. Our company and trade association comment letters articulate this view in detail, as do several comment letters from respected attorneys who are experts in the field. Of prominent note, the author of the Collins Amendment, Senator Susan Collins, has stated that "it was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime…[C]onsideration should be given to the distinction between banks and insurance companies…I believe it is consistent with my amendment that these distinctions be recognized in the final rules."[1] We are pleased that the Federal Reserve is still examining this issue carefully and are hopeful that the agency will ultimately agree that the existing statutory language provides sufficient flexibility to establish a capital framework for insurance SLHCs and insurance SIFIs that more accurately accounts for the unique risk and capital profiles of insurers.

[1] Letter from Senator Susan Collins to the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, November 26, 2012.

Support for a Legislative Solution

However, we are cognizant that if the Federal Reserve continues to hold the view that the Collins Amendment prevents the agency from establishing a tailored capital framework for insurance SLHCs and insurance SIFIs, the result will be the application of bank standards on insurers. This could have unintended negative consequences for consumers, the insurance market, and the economy. For these reasons, we support Congress passing legislation to clarify that the Federal Reserve, consistent with the original intent of the Collins Amendment, can and should establish a separate, tailored capital regime for insurers that appropriately reflects the industry's unique business model, risk profile, and asset-liability management practices.

Specifically, we support S. 1369, legislation introduced by Senators Brown and Johanns last year which has a broad, bipartisan group of cosponsors. S. 1369 would clarify that the Federal Reserve is not required to impose a bank regime on insurers by exempting insurers from the Collins Amendment. The bill would leave intact Sections 616 and 165 of the Dodd-Frank Act, which are the Federal Reserve's two other sources of legal authority to impose robust capital standards on insurers supervised by the Federal Reserve. In addition, under the Brown-Johanns bill, Basel III banking standards would continue to appropriately apply to depository institutions owned by an insurance company. Simply put, the Brown-Johanns bill would not affect the Federal Reserve's ability to impose group capital requirements on insurers; it would only clarify that the agency has the authority to tailor those standards to insurers' business models by utilizing the appropriate tools.

We strongly support this legislation and applaud the bill's sponsors for their leadership on this issue. We also greatly appreciate the helpful involvement of Sen. Collins in the legislative effort. We look forward to being part of any sensible solution that protects policyholders without subjecting our companies to a capital framework that was designed for banks and which is inappropriate for our business model.

The Role of Nationwide Bank in Nationwide Enterprise

As an SLHC, Nationwide is subject to the Collins Amendment by virtue of its ownership of Nationwide Bank. The same is true for the other SLHCs, including TIAA-CREF, who is also testifying today.

As an insurance SLHC, Nationwide has opted to continue to offer competitively priced, reliable banking products despite the obvious regulatory costs. Nationwide's online bank represents a way to supplement the insurance services we provide to our life and property casualty members.

As an example, Nationwide Bank played a critical role in the aftermath of the tornado that devastated Joplin, Missouri in 2011. Nationwide was able to quickly make insurance claims payments through Nationwide Bank debit cards issued to its policyholders who did not have access to bricks-and-mortar banks and who desperately needed these insurance payments in the wake of the disaster. The ability to offer this type of product through Nationwide Bank helps our policyholders get back on their feet sooner during a difficult situation.

Other insurance SLHCs have similar stories – we are not striving to become large commercial banks, but rather, to provide important complementary products to our insurance customers. Some insurers have divested their banks; however, we believe strongly that it is in the best interest of our customers (and indeed the banking system) to have access to affordable retail banking products from the strong insurance companies they trust.

The Bank-centric Basel III Framework is Inappropriate for Insurers

I'd now like to turn to why imposing a bank-centric capital regime on insurers is inappropriate for assessing their capital adequacy.

The Basel Committee on Banking Supervision developed the Basel banking capital regime, including its most recent iteration, Basel III, specifically for banks and not insurers. At a very high level, the Basel framework is almost entirely focused on the asset side of a company's balance sheet, because in the banking industry, that is primarily where risk resides. The predominant risks facing a banking organization include credit risk, market risk, counterparty risk and liquidity risk. As a result, an asset-based capital framework that is primarily focused on a these risk types is suitable for assessing capital for a banking organization.

However, Basel III, as implemented in the United States does not provide for critically important differences in company liability structures, liquidity profiles, or asset-liability management requirements. Consequently, such banking frameworks are not appropriate for insurers because they do not capture important liability based insurance risks (and associated risk management practices) that must be considered when determining capital requirements for such companies.

Relative to insurers, banking organizations tend to hold riskier assets that are funded by short-term liabilities, making the traditional banking model more sensitive to changes in asset prices and vulnerable to a risk of runs on deposits and a pull-back from short-term creditors in a very short period of time. Consequently, systemic economic events can subject banks to destabilizing "runs" and force them to quickly sell assets at a loss to meet their demand deposit obligations and funding needs. Furthermore, without a sufficient level of loss-absorbing capital, these banks would likely be unable to act as a source of credit to the U.S. economy. Without an appropriate level of capital, the fire sale of assets and pull-back of credit could have further systemic implications. This occurred during the most recent financial crisis due to the interconnectedness of the banking industry with the rest of the financial system.

Conversely, the primary risks facing insurers, found on the liability side of the balance sheet, are generally not as sensitive to the same systemic economic risks. These insurer liability risks include, for example, weather risk, mortality risk and morbidity risk. Both life and property and casualty insurers invest upfront premium payments in assets to satisfy liabilities that, by their nature, are generally longer-term and typically dependent upon the occurrence of uncertain events that are not highly correlated to macroeconomic cycles.

While insurers are subject to asset risks based on the investments held to meet long-dated liabilities, these risks do not expose insurance companies to the same "run" scenarios as found in banking. These asset risks manifest themselves in different ways for insurance companies due to the nature of the insurance liabilities and asset liability management practices which include accepting premiums up front and investing them to meet future liabilities.

Again, property and casualty and life insurance policies are typically payable only upon the occurrence of a certain idiosyncratic trigger event not tied to economic cycles. While premature surrenders of life insurance policies can occur, significant penalties discourage this behavior and mitigate its impact. As a result, insurance policies are not prone to sudden and widespread "withdrawals" as bank deposits can be and, therefore, insurer liability and asset risks do not pose the same systemic risk implications that are found in the business of banking.

Imposing the Basel III Banking Framework Would be Potentially Harmful to both the Insurance Industry and the Economy

In addition to being inappropriate for insurers, the Basel regime is potentially harmful when applied to these companies because of their distinct business models. Insurers hold longer duration assets than banks. Insurers are significantly less reliant than banks on borrowed debt, especially short-term debt, and do not require the same level of liquidity as banks. However, insurance companies must engage in careful asset-liability management to ensure policyholder are protected, a business need the Basel regime also ignores.

One salient example of the inappropriateness of the Basel III capital framework as applied to insurers is its 100% risk weight to all corporate exposures, which fails to distinguish corporate exposures based on the credit quality of the borrower. As has been raised in comment letters, a 100% risk weight for investment-grade corporate bonds held by insurers overstates the risk associated with these assets, particularly when compared to a bank's commercial and industrial loans, which are materially more risky but which receive the same 100% risk weight. The insurance industry writ large has substantially larger holdings of corporate bonds than banking, and is, in fact, the largest investor in corporate bonds in the entire U.S economy. As of year-end 2012, corporate bonds comprised about 48% of life insurer general account assets as compared to around 6% for banks. Corporate bonds can provide an effective investment for meeting a long-dated policyholder obligation. Thus, overstating the risk on such a substantial portion of an insurer's investment portfolio will have a significant impact on insurance SLHCs and insurance SIFIs. These companies would be required to hold more capital for these high-quality investments, which could in turn impact the affordability and availability of insurance products with long-term liabilities.

As an alternative to incurring high capital charges for investment-grade corporate bond holdings, insurers subject to a Basel regime could decide to take on additional credit risk by shifting their investment portfolios to higher-yielding, lower-quality corporate bonds that would receive the same 100% risk weight under the Basel III final rule. Taking on additional credit risk would, as one would expect, worsen the insurer's capital position under the state risk-based capital framework, even though the insurer's capital adequacy would be unchanged under the Basel III framework.

Simply put, the Basel III framework's 100%, "one-size fits all" risk weight for corporate exposures provides a clear example of a framework that was designed for banks, which do not invest heavily in corporate bonds, and which is inappropriate for assessing the capital needs of an insurance company.

The risk-weight for corporate bonds is just one example of why the Basel regime is inappropriate and harmful as applied to insurers. There are many others, including the regime's treatment of insurer separate accounts, which we believe receive inappropriate treatment under the Basel regime. These separate account assets would potentially receive capital charges for risk not borne by the insurer, resulting in a substantial and unreasonable capital cost which likely would impact insurers' ability to offer these important products. Furthermore, the risk weights applied in the Basel regime would over-charge for some risks, entirely ignore others and potentially incent the wrong risk measurement and therefore the wrong risk taking behavior. In total, it is likely some insurers would be forced to hold excessive capital that could cause a contraction in credit, and negatively affect availability and affordability of many insurance products.

The State Risk-Based Capital Regime

The regulatory cornerstones to any discussion of group-wide insurance capital requirements are the state risk-based capital (RBC) models. Insurance is already heavily regulated by state law. Shortly after the U.S. adopted the Basel I framework for banks in 1989, insurers became subject to the state RBC regime. The state RBC framework actually consists of three distinct capital models, each tailored to the unique risk profiles of life, property and casualty, and health insurers separately. Each model determines the amount of risk-based capital required by an insurance company given its investment portfolio, business activities, and the liability risks it has assumed. Regardless of what regime the Federal Reserve imposes on insurers that are federally supervised, we will also continue to be subject to state RBC requirements. We strongly support the RBC regime and the appropriate capital standards it requires for each of the life, property and casualty, and health insurance business models.

The RBC system places particular emphasis on policyholder protection and the important differences between insurance business risks. The purpose of the RBC regime is to provide customers and regulators with a high degree of confidence that an insurer can pay all claims over the entire duration of its insurance contracts in force.

Under the state RBC system, insurers hold capital to appropriately reflect the risks of their assets and their liabilities (and indeed potential mismatches between the two). The value of certain insurance company liabilities (current and future claims) are measured by the probability and severity of likely claims over a given period of time. While insurance companies are in the business of managing risk, and most do an excellent job of it, any capital regime such as Basel III that does not properly reflect insurer liabilities and the insurance business model has the potential to increase risk, not contain it.

Conclusion

Again, thank you for the opportunity to appear before you to discuss our views on the appropriate capital regime for insurers. In conclusion, I would like to reiterate a few important points. First, we are not objecting to group supervision by the Federal Reserve. Second, we are not objecting to the concept of comprehensive group capital requirements for SLHCs or insurance SIFIs. Third, we are not objecting to utilization of the Basel III framework for our bank. Finally, we are not seeking lower capital standards – indeed we support strong capitalization as part of our core business proposition. We are simply advocating that there is no "one size fits all" model for assessing risk and by extension no universally applicable framework for determining capital requirements, that can be effectively applied regardless of business model. We believe strongly that the Federal Reserve should have the latitude to utilize any tool (or combination of tools) necessary to *effectively* assess the risk profile, and therefore capital requirements, of a holding company, taking into account material differences in their business models. Therefore, we strongly urge the passage of legislation that clarifies that the Federal Reserve has the flexibility to tailor capital rules to insurance companies under the agency's supervision. We thank you for the opportunity to comment, and look forward to being part of a bipartisan policy solution to this important issue.