Hearing before the Senate Banking, Housing & Urban Affairs Subcommittee on Financial Institutions and Consumer Protection

"Finding the Right Capital Regulations for Insurers"

March 11, 2014

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I. Introduction

Chairman Brown and Ranking Member Toomey, Members of the Subcommittee, thank you for providing TIAA-CREF with the opportunity to testify on a very important issue to both TIAA-CREF and the clients we serve.

Our testimony today focuses on the final rules governing capital standards and the Basel III accords issued by the Federal Reserve Board ("FRB") in conjunction with the Office of the Comptroller of Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively the "Agencies").[1] The final rule contained a number of changes from the proposed rulemaking, most notably it temporarily exempted bank holding companies subject to the FRB's Small Bank Holding Company Policy Statement and Savings and Loan Holding Companies ("SLHCs") substantially engaged in insurance underwriting or commercial activities. In statements accompanying the final rule, the FRB indicated that the temporary exemption for insurance SLHCs was provided in recognition of policy concerns expressed regarding the imposition of bank capital rules on insurance companies.

We appreciate the temporary exemption and its acknowledgment that the insurance business model is quite different from the banking model. However, given the FRB's public statements regarding their current interpretation of the Collins Amendment, we are concerned that any final rule will impose Basel III on

[1] 12 CFR Parts 208, 217, and 225. Regulatory Capital Rules: Regulatory Capital, Implementation of Basel II, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule.

insurance companies with only modest and incomplete adjustments from the proposed rule.

II. Background

TIAA-CREF is a leading provider of retirement services in the academic, research, medical and cultural fields managing retirement assets on behalf of 3.9 million clients at more than 15,000 institutions nationwide.[2] The mission of TIAA-CREF is "to aid and strengthen" the institutions we serve by providing financial products that best meet the needs of these organizations and help their employees attain financial well-being. Our retirement plans offer a range of options to help individuals and institutions meet their retirement plan administration and savings goals as well as income and wealth protection needs.

TIAA-CREF is comprised of several distinct corporate entities. Teachers Insurance and Annuity Association of America ("TIAA"), founded in 1918, is a life insurance company domiciled in the State of New York operating on a non-profit basis with net admitted general account assets of $232 billion.[3] TIAA is a wholly-owned subsidiary of the TIAA Board of Overseers, a special purpose New York not-for-profit corporation. The College Retirement Equities Fund ("CREF") issues variable annuities and is an investment company registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. TIAA-CREF also sponsors a family of equity and fixed-income mutual funds.

[2] As of December 31, 2013.
[3] As of January 31, 2014.

While we are primarily engaged in the business of insurance, TIAA and the Board of Overseers hold a small thrift institution within their structure and as a result are registered as SLHCs. This thrift provides TIAA-CREF with the ability to offer our clients deposit and lending products integrated with our retirement, investment management and life insurance products and enhances our ability to help them attain lifelong financial well-being.

Our status as a SLHC places us under the purview of the FRB and consequently subjects us to the proposed regulatory capital regime the Agencies have set forth. TIAA-CREF supports ongoing progressive financial regulation, including strong and appropriate capital standards that are consistent with SLHCs' operating models and the risks inherent in their business. It is equally important, however, to ensure the standards ultimately implemented by the Agencies fully account for the diverse business models under which different financial services organizations operate. In our analysis of the rules through the prism of a firm predominantly engaged in insurance, we have found the Agencies have taken a bank-centric approach with the final rule. Consequently, this approach does not account for the significant differences between insurers who hold thrifts, but maintain the overwhelming majority of their business in insurance products ("insurance-centric SLHCs"), and those firms that are primarily banking entities.

To be clear, we support appropriate capital regulations for banking organizations and are not seeking to exempt insurers from the tenets of the Dodd-Frank Act ("DFA"). Nevertheless, applying metrics designed for banks to an insurer would be inappropriate and could have a number of negative effects for insurers, customers, and the economy as a whole. TIAA-CREF is particularly concerned about the effects of the rule on our ability to continue providing our clients with a full menu of appropriate and reasonably priced financial services products.

The FRB can use the flexibility permitted by the DFA to tailor capital standards for the insurers that they oversee, which is key to resolving most of the potential negative repercussions that may result from imposing a bank-focused capital regime on insurance companies.

The FRB has taken the position that Section 171 of DFA (the "Collins Amendment"), which requires regulators to establish risk-based capital standards for banking organizations, prohibits the FRB from treating insurance assets differently from banking assets. We, as well as many of our peers, do not share this legal interpretation and instead believe the Collins Amendment provides banking regulators with the necessary flexibility to account for and integrate the existing US insurance regulatory capital regime when developing their new model.[4]

III. Congressional Intent and the Collins Amendment

Congress clearly demonstrated throughout the DFA legislative process, and in the text of various provisions within DFA, its intent to allow insurance-centric SLHCs to

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[4] Comment letter on Regulatory Capital Rules: 1 77 F.R. 52792 (Aug. 30, 2012); 77 F.R. 52888 (Aug. 30, 2012); 77 F.R. 52978 (Aug. 30, 2012), Submitted by Chief Financial Officers of Country Financial, Mutual of Omaha, Nationwide Mutual Insurance Company, Principal Financial Group, Prudential, TIAA-CREF, USAA, Westfield Group, October 22, 2012.

continue to own thrifts and offer their customers banking products and services. During consideration of the DFA, Congress affirmed the importance of the SLHC structure by maintaining the thrift charter, ensuring SLHCs would not need to become Bank Holding Companies ("BHCs"), and maintaining the Gramm-Leach-Bliley ("GLB") grandfather provisions for non-bank activities of certain SLHCs and the qualified thrift lender ("QTL") test for SLHCs. Congress went so far as to instruct the FRB to:

> *"…take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies" in determining SLHC capital standards."*[5]

Indeed, as demonstrated by the original Volcker Rule provisions in the DFA that created a number of insurance exemptions, Congress expected insurance companies to continue to own thrifts.[6] By taking these steps, Congress also confirmed that the public is entitled to more, not less, competition in the banking industry. Unfortunately, the application of the Basel III Capital Rules would make continued ownership of thrifts by insurance organizations economically prohibitive, effectively accomplishing through regulation what Congress not only did not intend to do by statute,[7] but what Congress

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[5] Senate Report 111-176 at footnote 161 (April30, 2010)- discussion of Section 616 amending HOLA to clarify the FRB 's authority to issue capital regulations for SLHCs where the Committee specifically notes: *It is the intent of the Committee that in issuing regulations relating to capital requirements of bank holding companies and savings and loan holding companies under this section, the Federal Reserve should take into account the regulatory accounting practices and procedures applicable to, and capital structure of, holding companies that are insurance companies (including mutuals and fraternals), or have subsidiaries that are insurance companies."* [emphasis added].

[6] Section 619(d)(1)(F) of the DFA.

[7] "Dodd-Frank Amps Insurers for Banking Exit," SNL Financial (July 11, 2012).

specifically directed the FRB to avoid doing.

The Collins Amendment requires banking regulators to establish minimum risk-based and leverage capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies and non-bank financial companies supervised by the FRB (collectively, "Covered Companies"). However, nowhere in the language of the Collins Amendment is there a directive to ignore the differences between insurance companies and banks. Rather, the language only requires that the risk-based and leverage capital requirements applicable to covered companies shall not be:

1) Less than the generally applicable risk-based capital and leverage capital requirements, which shall serve as a floor for any capital requirements that the Agencies may require ("Bank Standard"); or

2) Quantitatively lower than the generally applicable risk-based capital and leverage capital requirements that were in effect for insured depository institutions as of the date of enactment of the DFA ("2010 Regulations”).[8]

The Collins Amendment did not intend for banking regulators to ignore the differences between banks and insurance companies in formulating the capital standards for banking entities, nor for the standards applicable to other Covered Companies. In a letter to the Agencies on the proposed rules implementing capital standards, Senator Susan Collins (R-ME) stated, “it was not Congress’s intent that federal regulators

[8] Section 171(b)(1) of the DFA.

supplant prudential state-based insurance regulation with a bank-centric capital regime."[9] Rather, the Bank Standard outlined in Section 171(a)(2) of the Collins Amendment, which sets a floor for SLHC risk-based capital standards, allows the FRB to specifically address insurance activities. The requirement of Section 171(b)(2) sets the "generally applicable risk-based capital requirements" floor and does not require an asset-by-asset testing of risk-weights.[10] Instead, the requirement speaks to a "numerator" of capital, a "denominator" of risk-weighted assets and a ratio of the two. The Collins Amendment also does not require asset-by-asset or exposure-by-exposure minimum requirements, but instead calls for holistic floors. The second requirement that the standards not be quantitatively lower than the 2010 Regulations can be satisfied by either following the terms of the 2010 Regulations or through a holistic quantitative analysis of equivalence with appropriate capital standards, which would meet the "not less than" language of the statute.

The FRB has stated publicly before the committee and others that the business of insurance is different than that of banking, but the Collins Amendment ties their hands in addressing these differences. They believe the language imposes a consistent set of asset specific risk-weights for all covered companies. We have expressed to the FRB, both in person and in our comment letter (see Appendix A),[11] our view that the language of the Collins Amendment provides adequate flexibility to interpret the statute in a way that permits them to account for the differences between banking and insurance. This point of

[9] Letter to Agencies regarding proposed rulemaking for capital standards from Senator Susan Collins (R-ME), November 26, 2012.

[10] U.S. Senate Committee on Banking, Housing and Urban Affairs, "Oversight of Basel III: Impact of Proposed Capital Rules," Statement of Michael S. Gibson, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, November 14, 2012.

[11] See Appendix A. Comment letter to Agencies on Regulatory Capital Rules, Brandon Becker, Executive Vice President and Chief Legal Officer, TIAA-CREF, October 22, 2012.

view is validated by nine leading law firms, which sent a letter to the Agencies concurring with our interpretation of the Collins Amendment (see Appendix B).[12]

Consequently, we support and applaud the efforts of Senators Sherrod Brown (D-OH) and Mike Johanns (R-NE) in introducing S. 1369 (Brown-Johanns), legislation to address the potential imposition of banking capital rules on insurance companies under the Collins Amendment. The Brown-Johann's bill would clarify that the Collins Amendment does not require the FRB to impose a banking capital regime by exempting insurers from the Collins Amendment, while leaving intact the FRB's other sources of legal authority to impose robust capital standards on federally-supervised insurance companies. In addition, under Brown-Johanns, Basel III bank-centric capital standards would appropriately apply to any depository institutions owned by an insurance company. We strongly support this legislation and look forward to being part of the dialogue as the bill makes its way through the Senate.

IV. Macro-economic effects of the application of the Basel III standards on insurers

Bank-centric capital standards, which do not effectively recognize the long dated nature of insurance activities, would likely encourage insurers to modify certain practices and strategies that would be detrimental to their core activities. Fundamentally, banks' core business is lending and maturity transformation. As a result, insurers' investment portfolios involve duration matching of assorted longer term liabilities. That is, insurers match their long-term liabilities with long-term

[12] See Appendix B. Comment Letter and Cover to Agencies on Regulatory Capital Rules, Signed by attorneys specializing in regulatory advice to insurance companies from Arnold & Porter LLP, Gibson, Dunn & Crutcher, Venable, Wachtell, Lipton, Rosen & Katz, Winston & Strawn LLP, Shearman & Sterling, LLP, Dechert LLP, Debevoise & Plimpton LLP, and Paul Hasting LLP, March 20, 2013.

investments. There are a number of distinct features that differentiate banks from insurers, including:

1) Stable illiquid liabilities. The stability of life insurance liabilities and their relative illiquidity is a fundamental difference from banking deposit liabilities.
2) Long-term savings and asset protection products. Insurance products serve long-term savings and asset protection goals, which are fundamentally different from the objectives of bank depositors.
3) Long duration assets. Based on the long-term nature of their liability structure, insurance companies invest for a longer duration than banks.
4) Adverse Deviation. The business of insurance is built on sound, well tested and proven actuarial science. Reserves are based on assumptions that are reasonably conservative and include provisions for the risk of unfavorable deviation from such assumptions (i.e., mortality, interest rates, withdrawals, and expenses). Insurers apply this discipline to a large range of uncertain events in their long dated portfolios.
5) Source of long-term funding for the economy. Insurance companies are a significant source of long-term, stable funding for the corporate, real estate, and governmental sectors of the economy, while banks are primarily a source of short-term financing to these sectors.

Imposing a capital framework designed to address the maturity mismatch inherent to banking on an insurer would create an investment portfolio construction challenge where none previously existed. Under the Rules, certain long-term investments, which are typically less liquid than shorter-term investments, are discouraged. Because the Basel III capital framework focuses substantially on assets, rather than taking a holistic approach, it does not consider the importance of matching the duration of assets and liabilities. To ignore the fundamental importance of this concept challenges an insurer's ability to properly consider one of the most important elements of insurer risk management. The application of enhanced bank-focused standards as outlined in the Rules, without considering the existing strict capital rules to which insurers already adhere, would have a number of negative effects for TIAA-CREF and other insurance-centric SLHCs including:

1) Adherence to two regulatory reporting structures which have very different incentives surrounding liquidity and consumer protection;
2) Greater costs for insurance products;
3) Pressures on insurance reserve conservatism to meet bank definitions of capital; and
4) Recording unrealized gains/losses causing short term strategic capital management incentives.

Simply put, applying bank capital standards to an insurer would create a disincentive to invest in the very assets that most promote stability and solvency.

V. Conclusion

The Rules set forth by the Agencies, if applied to insurers, would have a detrimental effect on the insurers' ability to offer affordable financial products, which would in turn trickle down to individuals who utilize insurance products to help them build a secure financial future. The Rules also could have macroeconomic implications that, for example, would create disincentives for insurers to invest in asset classes that promote long-term economic growth such as long-term corporate bonds, project finance and infrastructure investments, commercial real estate loans, private equity and other alternative asset classes.

Strong capital standards are vital to strengthening the overall structure of the U.S. financial system. The existing capital regime under which insurers operate has served the industry well and proved extremely effective when put to the test during the recent financial crisis. We are confident the FRB can develop alternative proposals to ensure a strong capital regime that also accounts for the business of insurance. Indeed, in our comment letter to the FRB and in our subsequent conversations with them, we have proposed alternative methodologies for measuring an insurer's capital that support both the policy goals of the FRB and ensure a strong capital regime, while also accounting for the business of insurance. We hope as they continue to study the issue, regulators will find a sensible way to integrate a capital structure appropriately designed for insurers. In the meantime, we ask Congress to explicitly give the Agencies the ability to ensure capital standards are appropriately tailored for insurers.

Thank you again for the opportunity to testify. Given the potential affect the Rules could have on our business and our clients, we have been very active in our efforts to educate policy makers about our concerns and will continue to leverage all opportunities made available to us. We appreciate the Subcommittee taking an interest in this issue and having afforded us another venue in which to discuss our concerns.