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October 19, 2012

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attn: Comments/LegalESS

Mr. Thomas J. Curry
Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219

Re: Regulatory Capital Rules: OCC Docket OCC ID-2012-0008, 0009; Basel III Federal Reserve Board Docket No. R-1442; Basel III FDIC Docket RIN 3064-AD95, AD96

Dear Ms. Johnson, Mr. Feldman and Mr. Curry:

Introduction

State Farm Mutual Automobile Insurance Company ("State Farm Mutual"), a savings and loan holding company (SLHC), appreciates the opportunity to submit these comments on the joint notices of proposed rulemaking (the "Proposals") regarding capital requirements published by the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Board"), and the Federal Deposit Insurance Corporation (the "FDIC") (collectively, the "Agencies") in the Federal Register on August 30, 2012.[1] Our comments are directed primarily to the Board, as the federal regulator of SLHCs.

State Farm Mutual fully supports the fundamental goals of capital adequacy that underlie the Proposals. However, rigorous analysis will clearly demonstrate that utilizing the Basel banking–oriented framework for SLHCs engaged predominantly in the business of insurance (hereinafter, "insurance-based SLHCs"), does not satisfy these goals. Instead, this framework would utilize measures that could fail to identify significant financial problems occurring within the SLHC and may encourage capital management practices that could make insurance-based SLHCs financially weaker. In contrast, insurance risk-based capital (RBC) captures the risks associated

[1] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52,888 (Aug. 30, 2012).

with insurance operations and investments in a manner that is tailored to the business models and asset utilization strategies of insurance-based SLHCs. This is especially true where the top-tier holding company is a functionally regulated operating insurance company itself.

We are cognizant of 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").[2] 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 sufficient, if any, consideration to insurance-based SLHCs or to the most appropriate and effective alternatives to implement congressional directives. Instead of recognizing fundamental differences between different types of SLHCs, the Proposals treat all SLHCs as financial conglomerates that are supposedly easily regulated under traditional and evolving bank capital standards developed through the Basel process, and would simply squeeze these companies into the existing Basel framework.

To the extent the Proposals did address the unique needs of insurance companies, they did so almost exclusively by focusing on how the Board should treat an insurance subsidiary within a larger banking organization. Unfortunately, the failure to recognize the opposite situation—where a thrift is a small part of an insurance-based SLHC--defeats congressional intent to achieve capital adequacy by imposing an ill-fitting and structurally flawed, bank-oriented standard on companies that have starkly different business models, risk exposures, and capital needs than banks and traditional bank holding companies (BHCs). Far from promoting safety and soundness for insurance-based SLHCs, these bank-oriented rules and requirements are counterproductive and would promote capital structures and practices that undermine prudential management of an insurance company.

In addition, as a practical matter, this 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. For a company such as State Farm Mutual, the Proposals would require a significant duplication of its accounting systems by requiring the adoption of Generally Accepted Accounting Principles ("GAAP") in addition to Statutory Accounting Principles ("SAP"). Adopting GAAP would entail a multi-year implementation effort, with initial startup and subsequent maintenance costs estimated in the hundreds of millions of dollars over a ten-year period.[3] These costs would be imposed notwithstanding the fact that our existing SAP system, which is mandated by state law, provides a proven and far more reliable foundation in giving the Board the information it needs to ensure our financial strength. In fact, the Proposals are in direct conflict with the prudential RBC requirements set by state functional regulators of insurance companies and Congress's direction to preserve such functional regulation, which may also run afoul the McCarran-Ferguson Act of 1945.[4]

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2 Pub. L. No. 111-203 (2010).

3 These figures do not include the high opportunity costs associated with dedicating top-level financial managers and executives, as well as systems employees and related resources, toward implementing the new accounting system as opposed to focusing on matters that meaningfully benefit the business operations.

4 15 U.S.C. § 1011 et seq.

We respectfully submit that the Proposals are not what Congress directed the Board to effectuate under the Dodd-Frank Act and nothing in the law compels the Board to apply these bank standards to insurance-based SLHCs. Given the tremendous inherent problems created by the Proposals for insurance-based SLHCs, State Farm Mutual believes these deficiencies must be addressed through the Board's additional study and consultation with insurance experts both inside and outside of government, followed by a new notice and comment rulemaking concerning such SLHCs.

Our comments below explain in more detail why we believe additional analysis followed by a new proposed rule is the best course of action. These comments address:

- State Farm Mutual's history and the role of its thrift as part of the State Farm enterprise.
- A description of State Farm Mutual as an operating insurance company functionally regulated on a consolidated basis under state law and the conceptual fallacy of regulating an insurance-based SLHC in the same manner as a BHC.
- The superiority of the existing RBC requirements and the solvency framework for insurers required under state law compared to the Basel capital framework.
- A review of SAP and the lack of justification for requiring insurance-based SLHCs using only SAP to prepare GAAP financial statements.
- Congress's treatment of insurance companies under the Dodd-Frank Act, its direction to preserve functional regulation, and why the Basel rules are not required to be imposed on insurance-based SLHCs.
- Implications under the McCarran-Ferguson Act.
- Specific flaws in the Proposals as they apply to insurance-based SLHCs.
- Alternative approaches that support the need for further analysis by the Board as part of a new and separate rulemaking.

I. Background on State Farm and its Thrift

State Farm Mutual is a state-regulated mutual insurance company that was established in 1922 and is the parent of the State Farm group of companies. Headquartered in Bloomington, Illinois, State Farm Mutual itself is the largest insurer of automobiles and, through its subsidiaries, the largest insurer of homes in the United States. State Farm Mutual and its subsidiaries comprise nine property and casualty insurance companies, four life insurance companies, and a small number of noninsurance entities, including State Farm Bank, F.S.B. (the "Thrift"), an FDIC-insured federal savings bank established in 1999.

The State Farm Mutual group is a multiple-line insurance provider with its primary business focus on personal lines of insurance, and the vast majority of its customers are individuals, families, and small businesses. State Farm Mutual is a "grandfathered" unitary SLHC, as defined in Section

10(c)(9)(C) of the Home Owners' Loan Act ("HOLA").[5] State Farm Mutual established the Thrift in 1999 to support its key organizational objectives and to provide an additional source of diversified income. The Thrift helps State Farm Mutual to enhance present and future insurance customer relationships through the offering of banking products and services. With the addition of the Thrift, State Farm Mutual has been able to respond to its customers' demands for an efficient and convenient "one-stop shopping" source of products and services for the broad range of their financial services needs. From the consumer's perspective, the affiliation between an insurance company and a bank provides important benefits, including the security of financial strength, convenience, more consistent and personalized service, and account-maintenance efficiencies. Moreover, the Thrift injects competition into the market for banking products and services, expanding consumer choices.

Quite simply, being able to offer the Thrift's products and services to the State Farm group's insurance customers enhances and solidifies its customer relationships and establishes long-term goodwill. Customer satisfaction with the Thrift's products augments loyalty to State Farm Mutual and thus contributes to the success of the overall operations of the State Farm group. Notwithstanding these benefits, however, the Thrift remains a small part of the State Farm group's total operations.

As of December 31, 2011,[6] the State Farm group held consolidated assets of approximately $197 billion, total liabilities of approximately $136 billion, and total net worth of approximately $61 billion. More than 91% of the consolidated assets of the State Farm group are related to the insurance operations (see Figure 1), and the insurance operations account for more than 98% of the group's total revenues (see Figure 2). The Board of Directors of State Farm Mutual, in the exercise of its business judgment, regularly reviews this capital position and the risks undertaken by the company and its subsidiaries.

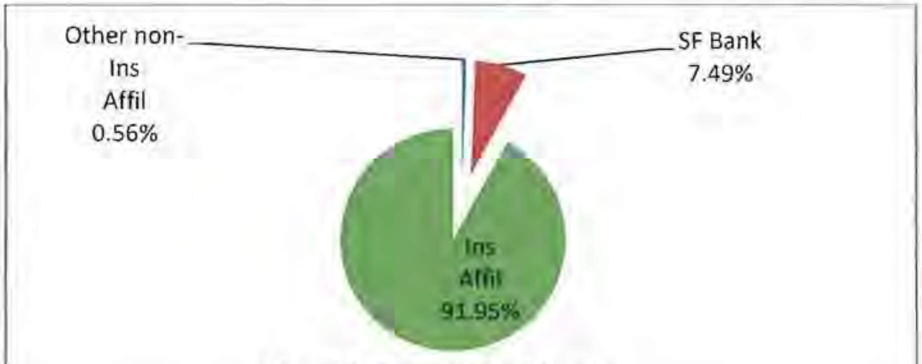

Figure 1: Consolidated Assets

[5] Section 10(c)(9)(C) of the HOLA refers to a company that was an SLHC on May 4, 1999 (or became an SLHC pursuant to an application pending on or before May 4, 1999) and that, *inter alia*, continues to control not fewer than one savings association that it controlled on May 4, 1999. 12 U.S.C. § 1467a(c)(9)(C). If a savings association so controlled qualifies as a "qualified thrift lender" as defined in § 10(m) of the HOLA, then its SLHC parent is not subject to the HOLA's restrictions on certain SLHC activities. 12 U.S.C. § 1467a(m).

[6] The figures cited are based on State Farm Mutual's unaudited estimates using SAP as the basis for the insurance affiliates."

Figure 2: Consolidated Revenues

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

A. Financial Regulation of State Farm Mutual as a Top-Tier Holding Company

It must be emphasized that State Farm Mutual, the holding company for the State Farm group of companies, and which is the regulated SLHC, is a regulated insurance company in its own right. It is not a shell nor is it simply a holding company. State Farm Mutual and its holding company system are directly regulated by the Illinois Department of Insurance (the "Illinois Department"). Consequently, all parts of the State Farm group are comprehensively regulated. All of State Farm Mutual's subsidiaries, as assets of State Farm Mutual, are subject to holding company system examination by the Illinois Department. Indeed, there is no material aspect of our business that is not currently subject to comprehensive prudential regulation by either state or federal regulators.[7]

Insurance is among the most highly regulated industries in the United States. Insurance companies are subject to strong state solvency rules and regulations governing operations and

[7] In addition to the Board's regulation of State Farm Mutual as an SLHC and state regulation of the holding company system, the material operating subsidiaries are subject to direct state or federal regulation. For example, the Thrift is regulated by the OCC and the FDIC, State Farm Mutual and each of its insurance subsidiaries is regulated by the insurance department in its state of domicile, and the investment management and broker-dealer subsidiaries of State Farm Mutual are regulated by the Securities and Exchange Commission. Indeed, the presence of comprehensive regulation, both at the holding company and subsidiary levels, and with regard to specific activities, leaves us puzzled as to why the Board made the blanket assertion that the Basel framework must be applied to all insurance-based SLHCs in order to avoid regulatory arbitrage. Not only did the Board fail to identify where these arbitrage concerns might exist and explain why they were harmful, any limited circumstances offering theoretical arbitrage "opportunities" within an SLHC like State Farm Mutual are more than offset by countervailing considerations and costs. Consequently, a mere reference to a pernicious sounding term such as "regulatory arbitrage" should not serve as the foundation for a radical overhaul of the capital rules governing insurance-based SLHCs.

investments. Solvency regulations are designed to ensure that all insurance companies, including State Farm Mutual, have the financial ability and liquidity to pay claims. For example, insurers prepare financial statements on the basis of SAP that are generally more conservative than GAAP in the valuation of assets and liabilities designed to satisfy these solvency and claims paying objectives. 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.

In numerous trade association and individual company discussions with Board staff, efforts were made to identify the Board's concerns with state regulation of insurer capital and financial condition that could be addressed in setting capital rules for SLHCs. We are unaware of any concerns expressed other than that state rules do not provide for "consolidated" regulation—that is, insurance groups are regulated on a legal entity basis rather than a group basis. However, we believe the Board's uneasiness on consolidation relating to insurance-based SLHCs can be fully addressed if it takes a more holistic view on how state insurance regulation operates to promote capital adequacy and financial strength of insurance companies within a group (including affiliates and subsidiaries) as opposed to a formalistic approach that ignores the economic realities of the entities subject to regulation. This is especially true where an SLHC is a functionally regulated insurer itself. Indeed, there are numerous steps the Board could take that would ensure its proper recognition of state functional regulation of insurers as both appropriate and adequate in satisfying consolidated regulatory requirements.

First, the Board should formally acknowledge and accept the conclusions of its own staff that the business of banking and the business of insurance are fundamentally different--as are the regulatory rules governing each industry's distinct business models.[8] Such acknowledgement would be fully consistent with Board Chairman Benjamin Bernanke's statement to Congress distinguishing the regulatory requirements for banking and insurance.[9] To better appreciate this regulatory mismatch, it is helpful to consider the reverse situation. For instance, the Board would likely object to the appropriateness and sensibility of any effort seeking to apply insurance rules to an entire BHC simply because the BHC owned an insurer as a small part of its business. At a minimum, we suspect the Board would contend that imposing insurance rules on a BHC would create extraordinary complications in the bank's ability to manage its risk and capital in a sound manner. However, this is exactly the type of regulatory approach the Board proposes for an insurance-based SLHC owning a much smaller thrift, without any regard for the unnecessary problems created by mandating that an insurance-based SLHC abide by anomalous banking rules.

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8 Report of the NAIC and the Federal Reserve System Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage (May 24, 2002).

9 *See Monetary Policy and the State of the Economy: Hearing Before the H. Fin. Services Comm. 112th Cong.* (July 18, 2012) ("The Federal Reserve will impose capital requirements at the holding company level to make sure that overall the company is well capitalized but even in doing that we will try to take into account differences between insurance companies and other types of firms.... [T]here'll be a lot of similarities, admittedly, at the holding company level. But we recognize 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.") (testimony of Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System).

Second, given the differences between banking and insurance, the Board should affirmatively recognize and accept state-based functional regulation as providing more appropriate and specifically tailored financial and regulatory mechanisms designed to manage risk and ensure the capital adequacy of insurance companies. To a limited extent, the Proposals attempted to accommodate insurance issues within the context of the Basel framework. However, such provisions were clearly directed to situations in which the insurer is a smaller subsidiary within a larger banking organization. Consequently, as applied to insurance-based SLHCs, the supposed accommodations are at best insufficient and, at worst, actually produce more harm by creating conflicts with state regulatory requirements, encouraging unsound asset-liability mismatches, and improperly weighting assets within the holding company system. Once again, these problems are exacerbated for insurance-based SLHCs like State Farm Mutual that are functionally regulated operating insurance companies in their own right.

Third, the Board should recognize the qualitative fact that State Farm Mutual and its insurance subsidiaries are subject to comprehensive supervision and regulation by the states. This includes strict RBC required by state insurance law and regulation. Because State Farm Mutual is itself not only an insurance holding company, but also a licensed operating insurance company, it is subject to statutory investment limitations and solvency requirements enforced by the Illinois Department. These rules are specifically designed to address the particular risks facing insurers, which are starkly different from those facing banking institutions. State Farm Mutual, as an insurance company itself, is subject to substantial financial, solvency and market conduct regulation. This comprehensive supervisory framework is similar in approach to the supervisory system developed by bank regulators for BHCs and SLHCs that are not insurance companies, but it has been designed to specifically address the business of insurance and the risks insurance companies face. The insurance supervisory framework has been developed over time by the National Association of Insurance Commissioners ("NAIC") and is best defined by seven core areas of focus, which include:

- Regulatory Reporting
- Disclosure and Transparency
- On-site Risk-focused Examinations
- Reserves, Capital Adequacy and Solvency
- Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities
- Preventive and Corrective Measures, Including Enforcement
- Exiting the Market and Receivership

The combination of direct state regulation of specific insurance operations and investments, and insurance holding company laws means every area and aspect of State Farm Mutual's business is subject to close regulatory scrutiny. Under state law, there are simply no "regulatory shadows" within which any aspect of the enterprise's operations could hide. While we recognize that federal regulation of SLHCs provides an additional layer of supervision and capital regulation sought by Congress, existing functional regulation should not be ignored or displaced where it is working.

Given the existing comprehensive and consolidated regulation of State Farm Mutual as an SLHC that is itself a regulated insurance company, as well as of each of the State Farm insurance company subsidiaries that are part of the State Farm group, we believe the Board should have proposed utilizing, or sought comment on how to utilize, state regulation of insurance-based SLHCs as part of its consolidated capital framework.

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

Notwithstanding the existing presence of effective functional regulation for top-tier insurance-based holding companies like State Farm Mutual, 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. 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.

It is unnecessary to repeat in detail the well-documented history of AIG's financial distress, but it is important to distinguish AIG from enterprises like State Farm Mutual that are top-tier insurance-based SLHCs. Unlike State Farm Mutual, 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.[10] This lack of effective supervisory oversight is not a factor for top-tier functionally regulated insurance-based SLHCs such as State Farm.[11] We are not arguing against applying strong capital standards at the holding company level. Rather, we are urging the Board to adopt standards that best match the insurance business model that is at the heart of the risks the Board is seeking to avoid. In sum, nothing that occurred at AIG alleviates the Board's responsibility to utilize capital and reporting standards that are most appropriate and effective for insurance-based SLHCs, or from acknowledging and deferring to existing functional regulatory authorities and standards that already work.

III. Insurance Risk-Based Capital Requirements are Superior to the Basel Framework for Insurance-Based SLHCs

A critical component of solvency regulation is the maintenance of adequate capital and reserves.[12] The insurance RBC calculation is intended to assess the capital adequacy of insurers and

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[10] See e.g., Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis (Jan. 27, 2011), at 279.

[11] State insurance examinations first uncovered problems with AIG's securities lending program in 2007. See, e.g., Congressional Oversight Panel, June Oversight Report, The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy (June 10, 2011), at 56-57.

[12] Principle 4 of the NAIC's Financial Solvency Core Principles (Reserves, Capital Adequacy and Solvency) states that "[i]nsurers are required to maintain reserves and capital and surplus to provide an

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).[13] 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 a life insurer's investment portfolio because the insurer must match long-term 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.

To support the notion that insurance RBC should be considered a "consolidated" view, consider the following. For RBC purposes, State Farm Mutual's assets, excluding the insurance affiliates' carrying values, are appropriately risk weighted and appropriate charges are calculated for insurance and other non-asset risk. The RBC calculations are also performed individually for each of the other State Farm insurance affiliates. The required RBC for each of the insurance affiliates, calculated on their individual assets and insurance risk is added to (or consolidated with) State Farm Mutual's RBC.

In other words, rather than adding together (consolidating) the assets and liabilities of the affiliates and then applying the RBC charges, the RBC charges are applied individually and then the resulting charges are added together to consolidate the results. The Thrift is included in the common and preferred stock risk charges applied to State Farm Mutual's assets. However, this could easily be eliminated from State Farm Mutual's RBC calculations, and the required capital for the Thrift based on bank-oriented capital ratios could be used in its place.

Using a combination of the insurance RBC calculations for State Farm Mutual's insurance affiliates plus the bank-oriented calculations for the Thrift provides a consolidated view of State Farm Mutual as it would cover over 99% of the consolidated assets of the State Farm enterprise. The remaining assets are included in State Farm Mutual's balance sheet and RBC calculations as

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adequate margin of safety for policyholders and others." According to the NAIC, "[a]ccounting standards, risk-based capital requirements, minimum statutory reserves and state-specific minimum capital requirements form the backbone of the reserve and capital adequacy requirements."

[13] Generally, if an insurer's Total Adjusted Capital exceeds 200% of its Authorized Control Level, no regulatory intervention is required (the "Authorized Control Level" is calculated for the specific risks of each insurer and is used to determine the minimum amount of capital an insurer should hold). As an insurer's Total Adjusted Capital falls in respect to its Authorized Control Level, the following heightened regulatory intervention measures are prescribed: company submission of a corrective plan (150%-200%), the issuance of corrective orders by the state regulator (100%-150%), taking control of the insurer by the state regulator at the regulator's discretion (70%-100%) and mandatory seizure of the company by the state regulator (below 70%).

equity holdings. Such an approach has the benefit of applying more appropriate capital requirements tailored to the specific risks of the entire State Farm enterprise and correctly recognizes that insurance risk and required capital are necessarily different than banking risk and required capital.

In sum, any notion that the insurance regulatory system is inadequate to satisfy consolidated capital requirements for an operating insurance company that is also an SLHC is simply untrue. 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 financial adequacy and safety of all depository institution holding companies ("DIHCs"), they contain gaping holes that fail the test for insurance-based SLHCs.

We would welcome the opportunity for meaningful dialogue with the Board to address how RBC-based measurements can fully satisfy the Board's need for "consolidated" reporting.

IV. Mandating GAAP Accounting is Costly and Counterproductive to Prudential Regulation

For State Farm Mutual, the most significant, costly, and most obvious example of a regulatory mismatch in the Proposals 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.[14] 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.[15] 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 insurance companies.

[14] State Farm Bank, as a federally-chartered and regulated thrift, prepares GAAP financial statements.

[15] On October 15, 2012, U.S. Senator Richard Shelby wrote to the Agencies expressing, among other things, his concerns about the underlying analysis utilized in developing the Proposals and the need for cost-benefit analysis to be incorporated in any rulemaking.

We were very pleased that when the Board assumed responsibility for overseeing SLHCs from the Office of Thrift Supervision (OTS), it recognized the burdens associated with imposing GAAP requirements and made an exception for certain insurance-based SLHCs.[16] However, Board staff has signaled on numerous occasions that the use of financial statements utilizing SAP is viewed as unacceptable because, under present accounting conventions, SAP statements are not prepared on a "consolidated" basis. Notwithstanding this perspective, we believe there are far less costly and burdensome alternatives to provide a "consolidated" picture of an insurance-based SLHC like State Farm Mutual that is a functionally regulated insurer at the top of the holding company structure.

While SAP and GAAP are both proven and reliable accounting methods, the purposes of the systems are different. One of the primary objectives of GAAP accounting is to provide important financial information to enable the investment community to make informed decisions on a going-concern basis (focusing on the income statement). SAP accounting, in contrast, is designed to provide regulators with the information necessary to monitor for solvency and financial soundness (focusing on the balance sheet). Such a focus is also naturally appropriate for federal financial regulation.

Utilizing SAP accounting for assessing an insurance-based SLHC is more effective and superior to GAAP accounting for several reasons. SAP accounting is a fundamental element of the state insurance regulatory regime, and it reports an insurance company's financial condition in a manner that is tailored to facilitate review by a state insurance regulator by capturing the unique risks faced by insurance companies. It is also the basis upon which RBC requirements are calculated.

Although SAP is based on a foundation of GAAP, as acknowledged by the Board's staff in their joint paper with the NAIC,[17] it is generally considered to be more conservative than GAAP given its focus on solvency. This conservatism and solvency focus is reflected in the measures of insurance assets and liabilities designed to ensure that an insurer can meet its most solemn obligation—the ability to keep its promises to policyholders and pay claims as they become due. Consequently, SAP treats certain assets that are not readily available to pay policyholder obligations as "non-admitted" and excludes them from admitted assets on the balance sheet. In addition, investment valuations may be different such as the use of amortized cost for long-term bonds. Life insurers also are required to hold interest and asset valuation reserves to limit the impact of investment fluctuation changes (interest rate and credit) on income and net worth. SAP further requires the use of conservative standardized life policy reserve valuations and disallows prepaid acquisition costs as assets that are allowable under GAAP. In fact, under GAAP, State Farm Mutual would report an increase in net worth due to the differing treatment of particular asset and liability categories under the two methods.

As the National Association of Mutual Insurance Companies ("NAMIC") has explained: "The use of SAP is codified in all states because its more conservative approach in assessing an

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16 Agency Information Collection Activities Regarding Savings and Loan Holding Companies: Announcement of Board Approval Under Delegated Authority and Submission to OMB, 76 Fed. Reg. 81,933 at 81936 (Dec. 29, 2011).

17 Report of the NAIC and the Federal Reserve System, supra note 8.

insurance company's solvency and ability to pay claims, and meet its obligations is the very foundation of financial entity regulation."[18] 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. This is discussed more fully in Section V.C. below, as well as the Board's similar acceptance of reporting from foreign entities utilizing different accounting systems.

V. Congress Directed Regulators to Preserve Functional Regulation and SAP Accounting for Insurance-Based SLHCs

A. Functional Regulation Preserved Under the Dodd-FrankAct

Several sections of the Dodd-Frank Act address the status of SLHCs, particularly diversified, "non-shell" companies, and the regulation of both the SLHCs themselves and their various non-bank subsidiaries. As a threshold matter, Congress considered, but rejected, elimination of the federal savings and loan/savings bank charter – and consequently the elimination of SLHCs – as well as limitations on the permissible activities of SLHCs and their nonbank subsidiaries. Moreover, the Dodd-Frank Act preserves the authorities of "grandfathered" SLHCs such as State Farm Mutual, a clear confirmation that those particular entities merit a continuation of the special and distinct treatment, as provided by Congress in the Gramm-Leach-Bliley Act.[19] Other examples of Congress's intent to preserve functional regulation of financial institutions, including insurance companies, or to defer to the state insurance regulator, include the following sections of the Dodd-Frank Act:

Section 604. Section 604 amended the Bank Holding Company Act and the HOLA to include new requirements for regulatory supervision, examinations, and reporting. Congress explicitly preserved functional regulation for BHC and SLHC subsidiaries in the Section 604 amendments. With respect to reports by SLHC subsidiaries, Congress specifically required the Board to use, to the fullest extent possible, reports and information provided to other federal and state regulatory agencies, including externally audited financial statements of an SLHC subsidiary.[20] Congress also required the Board to rely, to the fullest extent possible, on "the examination reports made by other Federal or State regulatory agencies relating to a savings and loan holding company and any subsidiary."[21] Further, Congress required the Board to coordinate and consult with "the appropriate . . . State regulatory agency . . . for a functionally regulated subsidiary of a [SLHC] before commencing an examination of the subsidiary under this section."[22] All of these provisions

[18] Hearing on Dodd-Frank: The Cost to Insurance Consumers and Investments in Business and the Economy Before the House Subcomm. on Insurance, Housing and Community Opportunity, 112th Cong. at 13 (2012) (comments of the National Association of Mutual Insurance Companies).

[19] Pub. L. No. 106-102 (1999).

[20] 12 U.S.C. § 1467a(b)(2)(B).

[21] *Id.* § 1467a(b)(4)(B).

[22] *Id.* § 1467a(b)(4)(C).

reflect Congress's determination that the Dodd-Frank Act should continue to recognize existing regulatory frameworks that are fully and effectively functioning.

Section 113. Under Section 113(a)(2)(H), prior to designating a nonbank financial company as systemically important, the Financial Stability Oversight Council (FSOC) must consider, among other factors, "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies." In addition, the FSOC must consult with the primary financial regulatory agency of any such nonbank financial company prior to designating it as systemically important.

Section 115. Section 115, which requires the FSOC to conduct a study of the feasibility, benefits, costs and structure of a contingent capital requirement for nonbank financial companies, similarly provides that the FSOC must consider, among other things, "capital requirements applicable to a nonbank financial company . . . and subsidiaries thereof."

Section 165. Section 165(d)(1)(A) provides for reporting to the Board, the FSOC, and the FDIC regarding resolution plans and credit exposure risk, including "information regarding the manner and extent to which any insured depository institution affiliated with the [reporting] company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company," which would include the resolution plans for insurance company subsidiaries in accordance with state law.

Section 169. Section 169 requires the Board to "avoid imposing requirements . . . that are duplicative of requirements applicable to BHCs and nonbank financial companies under other provisions of law."

Section 203. Section 203(e) provides that orderly liquidation of a covered financial company that is an insurance company, or an insurance subsidiary of a covered financial company, shall be conducted under applicable state law.

Section 619. Section 619 (commonly known as the "Volcker Rule") provides that a "regulated insurance company directly engaged in the business of insurance" may make investments for its general account that would otherwise be considered impermissible proprietary trading under the Dodd-Frank Act, provided the investment complies with state insurance company investment laws. Federal banking agencies may only disallow such investments under certain conditions and "after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners . . . ."[23]

All of these sections of the Dodd-Frank Act are clear confirmations of Congress's recognition that state insurance regulators and other functional regulators other than the federal banking agencies have expertise, experience, information, and regulatory systems to which the Board should defer in appropriate circumstances as a means to properly implement the statute in order to achieve its central purpose of promoting national financial stability. Congress's creation of the Federal Insurance Office ("FIO") and the statutory mandate for two insurance experts on the FSOC underscores the importance of serious, informed consideration of the impact of the proposed capital requirements on SLHCs that are, and whose combined enterprises are, engaged predominantly in the business of insurance.

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23 *Id.* at § 1851(d)(1)(F).

B. Minimum Capital Levels for SLHCs

We do not believe the Board is constrained under Section 171 from appropriately designing capital regulations that recognize and take into consideration a preexisting comprehensive capital system imposed by the functional regulator of an SLHC.[24] Under Section 171 of the Dodd-Frank Act (commonly known as the Collins Amendment),[25] 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.[26]

Although Section 171 requires the Board to set minimum capital requirements for DIHCs, it does not preclude the Board from taking into account the existing and comprehensive RBC structure of insurance-based SLHCs in establishing 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.[27]

To the contrary, as explained above, 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 and the distinct types of products and services they offer and the comprehensive regulatory environment in which they operate. Under Section 10(g) of the HOLA, as amended by Section 616 of the Dodd-Frank Act, the Board is authorized to "issue such regulations and orders, including regulations and orders related to capital requirements for savings and loan holding companies, as the Board deems necessary or appropriate . . . and to require compliance therewith and prevent evasions thereof." But such authority cannot be unmoored from other provisions in the Dodd-Frank Act. Proper exercise of that authority must recognize, as did Congress in enacting the Dodd-Frank Act, the differences among DIHCs including SLHCs such as State Farm Mutual that are themselves functionally and comprehensively regulated

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24 Indeed, Title I of the Dodd-Frank Act specifically requires tailoring of capital and other regulatory requirements to fit the regulatory context applicable to each financial institution that is designated as a "systemically important" financial institution by the FSOC. See, e.g., Dodd-Frank Act §§ 115(a)(2), 165(b).

25 Pub. L. No. 111-203, § 171, 124 Stat. 1376, 1435-38 (2010), codified at 12 U.S.C. § 5371.

26 12 U.S.C. § 5371(b)(1)-(2).

27 Most recently, in October 17, 2012 letter, 24 U.S. Senators wrote to the Agencies expressing their concern over the Proposals as applied to insurance-based SLHCs, stating: "While we recognize that the Dodd-Frank Act directs the federal banking agencies to establish minimum capital standards on a consolidated basis, Congress did not intend for federal regulators to discard the state risk-based capital system in favor of a banking capital regime."

insurance companies and, along with their subsidiaries, are primarily engaged in the business of insurance.

The legislative history of Section 171 does not suggest otherwise.

Additionally, in recent testimony before Congress, former FDIC Chairman Sheila Bair, who is widely acknowledged for promoting the language that eventually became the Collins Amendment, made clear that highly leveraged large BHCs and nonbank companies supervised by the Board after a designation as a systemically important financial institution ("SIFI") by the FSOC were the focus of the Collins Amendment. Speaking before a subcommittee of the House Committee on Oversight and Government Reform, Chairman Bair testified:

> In my view, this is the single most important provision of the Act for strengthening the capital of the U.S. banking system and leveling the competitive playing field between large and small U.S. banks. Section 171 essentially says that risk-based and leverage capital requirements for large banks, bank holding companies, and nonbanks supervised by the Federal Reserve Board may not be lower than the capital requirements that apply to thousands of community banks nationwide. Without the Collins amendment, our current rules set a course to allow the risk-based capital requirements of our largest banks to be governed by the assumptions of bank management regarding the riskiness of their own exposures. In my view, such an approach would eventually create the conditions for another leverage-driven banking collapse.[28]

Implicit in Ms. Bair's remarks, as well as the legislative history of the Collins Amendment is the very legitimate concern that the burden of resolving complex BHCs and SIFIs that experience financial difficulties will again fall on taxpayers as it did during the financial crisis. The same concern, however, does not apply to insurance-based SLHCs. As discussed above, insurance companies – including insurance companies that themselves are SLHCs as well as their insurance subsidiaries – are resolved according to the procedures set forth in state insurance solvency laws. The burden of an insolvent insurance company does not fall on the FDIC or the federal government and federal taxpayers generally. To the extent that consolidated capital requirements for BHCs and "shell" SLHCs are necessary to limit FDIC exposure or to prevent taxpayer involvement that is not the case with respect to insurance-based SLHCs.

Indeed, there is demonstrable evidence that, during the recent financial crisis, notwithstanding the outlier example of AIG, insurance companies were not among those who contributed to the weaknesses that precipitated the crisis, and the insurance industry fared well compared to other industries –particularly the banking and securities industries.[29]

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28 The Changing Role of the FDIC Before the Subcomm. on TARP, Fin. Services, and Bailouts of Public and Private Programs of the H. Comm. on Oversight and Government Reform, 112th Cong. (June 22, 2011) (statement of Sheila C. Bair, Chairman, FDIC).

29 The FSOC's 2011 Annual Report notes on page 61 that only 28 of approximately 8,000 insurance companies became insolvent in 2008 and 2009 and on page 58 that "...as the crisis has unfolded, 370 bank and thrift failures occurred through June 30, 2011, or 4.5 percent of institutions operating at the beginning of 2008." During that same time, 0.35% of insurers became insolvent.

In sum, any Basel type regulation, whether Basel I or Basel III, not only is 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. In cases where the holding company is a functionally regulated, operating insurer, we submit that the insurance RBC methodology is in fact the most reasonable interpretation of this floor and should be used for such purpose. 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.

C. Preserving SAP Accounting

Consistent with its preservation of the functional regulation of insurance-based SLHCs, the Dodd-Frank Act does not mandate that the Board require GAAP reporting. To the contrary, the Act states that "to the fullest extent possible," the Board must rely on the "reports and other supervisory information that the savings and loan holding company or any subsidiary thereof has been required to provide to other Federal or State regulatory Board . . . ."[30] According to the Senate Report accompanying Section 604 of the Dodd-Frank Act:

> While the Committee supports consolidated regulation, it also supports coordinated regulation. Accordingly, section 604(b) requires the AFBA [appropriate Federal banking agency] for a bank holding company to give prior notice to, and to consult with, the primary regulator of a subsidiary before commencing an examination of that subsidiary. The section contains an identical requirement with respect to the examination by the AFBA for a savings and loan holding company [or] a subsidiary of a savings and loan holding company. Other provisions in section 604 specifically require the holding company regulator to rely "to the fullest extent possible" on reports and supervisory information that are available from sources other than the subsidiary itself, including information that is "otherwise available" from other Federal or State regulators of the subsidiary. These provisions effectively require that the holding company regulator provide notice to and consult with the primary regulator, e.g., the appropriate Federal banking agency for a depository institution, to identify the information it wants and ascertain whether that information already is available from the primary regulator. In addition, section 604 specifically requires the AFBA for the holding company to coordinate with other Federal and state regulators of subsidiaries of the holding company, "to the fullest extent possible, to avoid duplication of examination activities, reporting requirements, and requests for information."[31]

In the case of an insurance-based SLHC that is an insurance company, the insurance company's primary regulator would be the holding company's state insurance regulator.

Further, the Senate Report specifically directs the Board to accommodate the accounting practices of SLHCs when issuing capital regulations under related section 616:

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30 Dodd-Frank Act § 604(g).

31 Senate Report 111-176 at 84.

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 Board 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.[32]

By forcing mutual insurance companies to prepare financial statements both according to GAAP (for the sole purpose of reporting to the Board under the proposed capital rules) and SAP (as required by their functional regulator), with little explanation of any compelling necessity to do so, the Board has clearly declined to rely to the fullest extent possible on existing reports and supervisory information already provided by the entities, and has therefore ignored the expressed intent of Congress. Importantly, as explained in Sections II and III above, we believe there are far less costly and burdensome alternatives to provide a "consolidated" picture of an insurance-based SLHC like State Farm Mutual that is a functionally regulated insurer at the top of the holding company structure.

We also note that foreign subsidiaries of United States Banking Organizations filing FR 2314 financial statements may submit reports based on the foreign country's accounting standards if submitting reports on this basis would materially reduce the reporting burden. We believe that U. S. regulated insurance-based SLHC's, which do not prepare GAAP-based statements, should be afforded similar treatment and allowed to submit SAP-based financial reports. As indicated above, such treatment would avoid the material cost and burden associated with implementing GAAP reporting processes.

D. Timing of Capital Requirements for SLHCs

The statutorily imposed timing of the application of new minimum capital requirements to SLHCs under Section 171 is further evidence that Congress intended special consideration of the capital requirements that should be imposed on SLHCs. During the House-Senate conference on the Dodd-Frank Act, the conferees determined that the Section 171 capital requirements should be delayed for any depository institution holding company that was not supervised by the Board as of May 19, 2010, which includes any SLHC. This was deemed appropriate in light of the substantial compliance burdens placed on any holding company not previously subject to Board standards. Thus, Congress expressly provided in Section 171 a provision that postpones the applicable date of the minimum capital requirements for such holding companies, including SLHCs, to July 21, 2015. Specifically, Section 171(b)(4)(D) provides:

> (D) DEPOSITORY INSTITUTION HOLDING COMPANIES NOT PREVIOUSLY SUPERVISED BY THE BOARD OF GOVERNORS. – For any depository institution holding company that was not supervised by the Board of Governors as of May 19, 2010, the requirements of this section, except as set forth in subparagraphs (A) and (B), shall be effective 5 years after the date of enactment of this Act.

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32 *Id.* at 89.

Despite this express statutory directive, the proposed rules do not incorporate this delayed effective date for SLHCs. In fact, the Board does not even discuss section 171(b)(4)(D) in the Notices. Yet the Proposals do reflect the statutory delay for the application of capital standards to foreign banking organizations' BHC subsidiaries, which is provided for in the subsequent subparagraph of the statute, Section 171(b)(4)(E):

> (E) CERTAIN BANK HOLDING COMPANY SUBSIDIARIES OF FOREIGN BANKING ORGANIZATIONS. – For bank holding company subsidiaries of foreign banking organizations that have relied on Supervision and Regulation Letter SR-01-1 issued by the Board of Governors (as in effect on May 19, 2010), the requirements of this section, except as set forth in subparagraph (A), shall be effective 5 years after the date of enactment of this Act.

In the notices of the Proposals, the Board fails to provide any explanation for the discrepancy in treatment of SLHCs and foreign organizations' BHC subsidiaries. The notices provide no explanation despite the fact that the delay provided for under Section 171(b)(4)(D) was favorably highlighted in several comment letters filed with the Board in response to the Board's April 2011 *Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies*.[33]

Although Section 616(b) of the Dodd-Frank Act provides the Board with general authority to promulgate capital rules for SLHCs, that section does not provide the Board the authority to displace the delayed effective date of capital rules set forth in Section 171(b)(4)(D) for DIHCs not previously supervised by the Board. Like all statutory provisions, Sections 616(b) and 171 (b)(4)(D) should be construed according to basic canons of construction. First, a statute should be read as a whole, and not selectively.[34] Second, statutes should be read so as to avoid rendering superfluous any parts thereof.[35] Third, specific terms in a statute prevail over the general in the same statute that otherwise might be controlling.[36] In other words, the Board cannot choose to use certain statutory authorities granted to it in the Dodd-Frank Act to establish capital rules for SLHCs while ignoring others. Rather, it should establish capital rules pursuant either to Section 171(b)(2) or 616(b) and should do so according to the specific terms of the delay prescribed by Section 171(b)(4)(D). Unfortunately, in looking only to Section 616(b), the Proposals erroneously render Section 171(b)(4)(D) superfluous, impermissibly "legislating" a new effective date where Congress did not intend one.

This point is highly significant to State Farm, which, in accordance with insurance regulatory requirements, does not prepare GAAP financial statements. Of course, to the extent the Board accepts SAP statements, not only in accordance with congressional intent, but also as a valid measure for certain top-tier operating insurance companies that are SLHCs, this issue becomes less critical. However, if the Board mandates the submission of GAAP financial statements, tremendous problems will be created. As discussed above, just the work necessary to apply GAAP to the

33 Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, 76 Fed. Reg. 22662 (proposed Apr. 22, 2011).

34 Brotherhood of Locomotive Engineers v. Atchison, T.&S.F.R.R., 516 U.S. 152, 157 (1996).

35 Astoria Federal Savings & Loan Ass'n. v. Solimino, 501 U.S. 104, 112 (1991).

36 Fourco Glass v. Transmirra Products Corp., 353 U.S. 222, 228 (1957).

operations of State Farm Mutual and to its subsidiaries would be an extremely time-consuming and expensive effort. Indeed, an effective date of July 2015 is not even adequate for such a task.

At a minimum we urge the Board to construe Section 171 of the Dodd-Frank Act, together with Section 616(b), properly to effectuate the specific timing requirements laid out in Section 171(b)(4)(D). This transition period is needed even if the Board agrees to accept SAP financial statements from SLHCs, particularly if the Board requires any modifications to processes and procedures currently followed by SLHCs.

E. Implications of the McCarran-Ferguson Act

Congress's intent regarding the application of Section 171 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. Recognizing that the regulation of insurance companies is primarily the purview of the states, and concerned about the future stability of state regulation of insurance, Congress enacted McCarran-Ferguson to ensure that only where Congress specifically intends to regulate the business of insurance will federal law apply to that business.

To effectuate this intent, McCarran-Ferguson 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."[37] Accordingly, as articulated by the U.S. Supreme Court, under McCarran-Ferguson, state law reverse-preempts a federal statute whenever: (i) the federal statute does not specifically relate to the business of insurance; (ii) the state law was enacted for the purpose of regulating the business of insurance; and (iii) the application of the federal statute would "invalidate, impair, or supersede" the state law.[38]

Applying this framework to Section 171 instructs that close adherence should be paid to insurance regulation in applying its requirements to any SLHC that is and/or that owns one or more insurance companies.

First, Section 171 does not "specifically relate 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 enacting Section 171. Rather, Congress's focus, as discussed above, was on the need for Section 171 to establish uniformity between the capital levels of large, potentially systemically important BHCs and smaller depository institutions. Second, state insurance laws, including state insurance RBC requirements, clearly were enacted for the purpose of regulating the business of insurance. Finally, 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

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[37] 15 U.S. C. § 1012(b).

[38] *Humana Inc. v. Forsyth*, 525 U.S. 299, 306 (1999).

State insurance law requirements. By doing so in the proposed rules without a clearly expressed Congressional directive, the Board runs the risk of legal challenges under McCarran-Ferguson.

VI. Prior Agency Acknowledgment of Congressional Objectives for Appropriate Regulation of Insurance SLHCs

Congress's longstanding and repeatedly reiterated respect for and deference to state regulation of insurance, including the explicit recognition of continued functional regulation under the Dodd Frank Act, has previously been acknowledged by the Board. Indeed, the Board has on various prior occasions expressly stated its understanding that insurance companies cannot properly be regulated under the same regime as banking organizations, for multiple reasons. Yet in the Proposals and the Notices explaining them, the Board fails to defer to the insurance regulators.[39] And they do so despite substantial input from members of the insurance industry explaining the RBC framework applicable under state insurance law and its distinct incongruity with the capital rules generally applicable to insured depository institutions and their holding companies. The Board's current posture cannot be squared with the intent of Congress, the input provided from the insurance industry and insurance regulators, or the Board's own prior stated views.

For example, shortly after the enactment of the Collins Amendment and the other provisions of the Dodd-Frank Act which transferred regulatory authority for the supervision of SLHCs from the OTS to the Board, the Board "conducted extensive outreach with SLHCs to learn about their structure[,] activities and practices."[40] According to the Board's Director of Banking and Supervision, "During the first round of inspections of SLHCs, Federal Reserve examiners are becoming acquainted with each SLHC's management and are seeking to fully understand the organization's operations and business model."[41] The Director reiterated the Board's intention, "*to the greatest extent possible taking into account any unique characteristics of SLHCs and the requirements of HOLA*, to assess the conditions, performance, and activities of SLHCs on a consolidated basis in a manner that is consistent with the Board's risk-based approach regarding bank holding company supervision."[42]

The Board's awareness of the unique characteristics of banks and BHCs, on the one hand, and insurance-based SLHCs on the other, precedes the Board's recent outreach as the principal regulator of SLHCs. 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 NAIC which 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

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39 Indeed, there are no questions in the Proposals regarding whether and to what extent the insurance regulators should have a role in determining capital adequacy for insurance SLHCs.

40 Letter from Michael S. Gibson to Chairman Shelley Moore Capito (July 30, 2012) (responding to questions posed by Chairman Capito in connection with the May 16, 2012 hearing before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit).

41 *Id.*

42 *Id.* (emphasis added).

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."[43] 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.[44]

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."[45] 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."[46]

More recently, the Board in its rule releases has been consistent in recognizing that SLHCs, including insurance companies, are institutions with unique assets, exposures, and risks, and that "all aspects of the Act should be implemented so as to avoid imposing conflicting or inconsistent regulatory capital requirements."[47] Most recently, both the Chairman of the Federal Reserve[48] and

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43 Report of the NAIC and the Federal Reserve System, supra note 8 at 1.

44 *Id.* at 2.

45 *Id.* at 1.

46 Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, 76 Fed. Reg. 22662, 22665 (Apr. 22, 2011).

47 Risk Based Capital Standards: Advanced Capital Adequacy Framework–Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37620 (June 28, 2011). *See also* Risk Based Capital Standards: Advanced Capital Adequacy Framework–Basel II; Establishment of a Risk-Based Capital Floor, 75 Fed. Reg. 82317 (proposed Dec. 30, 2010) ("Certain covered institutions may not previously have been subject to consolidated risk-based capital requirements. Some of these companies are likely to be similar in nature to most depository institutions and bank holding companies subject to the general risk-based capital rules. Others, may be different, with exposure types and risks that were not contemplated when the general risk-based capital rules were developed."); Notice of Intent to Apply Certain Supervisory Guidance to Savings and Loan Holding Companies, 76 Fed. Reg. 22662 (Apr. 22, 2011) ("Although the Board believes it is important for SLHCs to be subject to the same consolidated leverage and risk-based capital requirements as BHCs, it recognizes that SLHCs have traditionally been permitted to engage in a broad range of nonbanking activities that were not contemplated when the general leverage and risk-based capital requirements for BHCs were developed. The Board is seeking specific comment with respect to any unique characteristics, risks, or specific activities of SLHCs . . . .").

48 Supra note 7.

the Secretary of the Treasury[49] have acknowledged that differences exist in the capital structure of insurance companies and banks.

Yet now, disregarding all of this previous research and study, the Board is proposing to address the differences between SLHC and BHC capital and asset structures almost exclusively through risk-weighting. Given the Board's recognition of the unique characteristics of SLHCs engaged in insurance, which dates back at least to 2002, it is difficult to perceive a principled prudential basis for the Proposals' approach. The Proposals attempt to do what the Board's staff said should not be done and what the Board has maintained throughout the rule writing process it did not intend to do – that is, to impose a bank-oriented regulatory framework on insurance companies with only the most nominal of accommodations provided through the risk-weighting of certain insurance assets. Sound prudential regulation requires more considered action and should not be about what is most familiar to the Board. It should be about what is the best way to regulate the capital standards for functionally regulated insurance SLHCs.[50]

As noted in the Board's proposed *Standardized Approach for Risk-weighted Assets*, in response to prior requests for public input, commenters suggested the Board "defer its oversight of savings and loan holding companies, in part or in whole, to functional regulators or impose the same capital standards required by insurance regulators."[51] These commenters had urged the Board to reflect in its regulatory practices what Congress and the Board itself have recognized to be critical distinctions between banking and non-banking activities of SLHCs and their subsidiaries, including insurance activities. "Other commenters suggested that certain savings and loan holding companies should be exempt from the Board's regulatory capital requirements in cases where depository institution activity constitutes only a small part of the consolidated organization's assets and revenues."[52] Such an exemption, as the commenters had explained, would prevent the inappropriate extension of bank-oriented capital requirements to SLHCs whose activities are predominantly not banking and whose assets and capital needs are necessarily distinct and distinguishable from those of depository institutions.

The Board noted these comments, but effectively ignored them, stating summarily that it "believes both of these approaches would be inconsistent with the requirements set out in section 171 of the Dodd-Frank Act."[53] The Board does not explain the specific nature of the purported inconsistency with Section 171, nor does it even address the substance of the problems highlighted

49 *The Annual Report of the Financial Stability Council: Hearing Before the H. Fin. Services Comm.*, 112th Cong. (July 25, 2012) (testimony of Timothy Geithner, Secretary of the Treasury) ("I am aware of that concern and what the Federal Reserve has said in response to that concern is that they recognize that if they were in a position where they had to apply these broad standards on capital and leverage to a financial institution that includes an insurance company, they would have to make some changes to it to recognize the specific differences between the insurance business and the banking [business].").

50 We are cognizant that the Board has taken steps to enhance and strengthen its insurance expertise within its research function. We are also very appreciative of the efforts undertaken by the Federal Reserve Bank of Chicago to gain a better understanding of the business of insurance as they assumed responsibility for SLHC supervisory oversight of State Farm Mutual from the OTS.

51 77 Fed. Reg. 52,928.

52 *Id.*

53 *Id.*

by the commenters. Rather, it simply dismisses these problems. And, where some rationale is suggested for rejecting the commenters' concerns, the rationale is one that most reasonably supports treating insurance-based SLHCs differently from banks – not in the same manner: "[T]he Board believes it is important to apply consolidated risk-based and leverage capital requirements to insurance-based holding companies because *the insurance risk-based capital requirements* are not imposed on a consolidated basis and *are based on different considerations, such as solvency concerns, rather than broad categories of credit risk.*"[54] Since solvency concerns are broader than credit risk, which is one of many considerations in assessing an insurer's solvency, it is extremely difficult to understand the justification for allowing the singular issue of credit risk to trump the far more comprehensive RBC regime used by insurance functional regulators.

VII. Additional Deficiencies of the Proposed Rules in the Treatment of Insurance Assets, Capital, and Liabilities

Among many troubling aspects of the Proposals are: their bank-oriented focus on asset risk and inadequate recognition of insurance and other non-asset risk; their inappropriate capital treatment of insurance underwriting subsidiaries whereby asset risk is double counted; their failure to recognize that mutual insurance companies that are SLHCs do not issue stock, but rather raise external capital through other instruments such as surplus notes; their assignment of inappropriate risk weights to common insurance assets such as separate accounts and policy loans; and their treatment of long-term corporate bonds and publicly-traded equities. We are aware that some of these flaws are addressed in a comment letter submitted by the American Council of Life of Insurers on October 12, 2012, and we state for the record that we agree with its observations.

In addition, we would also like to comment on the proposed risk weights under the Standardized Approach NPR that would assign a 300 percent, rather than 100 percent, risk weight to publicly traded equity exposures. State Farm Mutual holds a diversified portfolio of publicly traded equity exposures as a long-term hedge against inflation and to grow capital. The investment strategy reflects the business profile, financial strength and long-term focus of State Farm Mutual as a mutual insurance organization. The equity portfolio, which has very low turnover in-line with the long-term focus of the organization, and is in compliance with state insurance investment limitations, has resulted in very strong capital growth over a long period. The proposed change from 100 to 300 percent risk weighting is very significant for an insurer like State Farm Mutual. This is one more example of where additional analysis is required as the Board seeks to apply effective capital rules to an insurance-based SLHC.

What should be indisputable without any further study, however, is that in stark contrast to the existing functional regulatory regime governing insurers, both the Basel I and the proposed Basel III standards when applied to insurance-based SLHC's like State Farm Mutual, fail to adequately capture the essence of insurance risk and other non-asset risks that are the heart of sound financial regulation of an insurance company. As the largest writer of insurance for automobiles and homes in the United States, the State Farm group is exposed to substantial insurance risk. Unlike the asset risks faced by banks and most BHCs, approximately 55% of the consolidated RBC for State Farm Mutual is attributable to insurance risk. While a portion of the insurance risk of the group is considered in the Proposals through the deduction of regulatory capital of insurance subsidiaries, the insurance risk of the parent, if it, like State Farm Mutual, is an operating insurer, is

54 *Id.* (emphasis added).

completely ignored. As such, no insurance regulator in the world would accept the asset-centric approach embodied in the Proposals as sufficiently accurate to ensure the desired level of safety and soundness and desired source of strength sought for insurance-based SLHCs that are the foundation of the Collins Amendment and the proposed capital requirements. The square peg simply does not fit into the round hole.

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

All of the foregoing demonstrates how the bank-oriented proposed rules are inappropriate for insurance-based SLHCs. It is hard to avoid the conclusion 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 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 – which, as we have emphasized, relies on a comprehensive, long-standing RBC system that has served the insurance industry and consumers extremely well. In sections 115 and 165 of the Dodd-Frank Act, Congress specifically required the Board to tailor the capital and other regulatory requirements imposed on designated SIFIs to the context of the particular industry involved. Surely the Board has authority to tailor the capital requirements applicable to insurance-based SLHCs to fit the context involved. The current proposed rules do not improve supervision over the financial strength of the insurance industry or the thrift industry; they detract from it. As discussed below, we believe the Board must, to fulfill Congress's objectives, fundamentally rewrite the proposed rules for insurance-based SLHCs such as State Farm Mutual whose entire enterprise is devoted overwhelmingly to insurance underwriting, not banking.

IX. Effective and Efficient Regulation Necessitates Additional Analysis Followed by a New Notice and Comment Rulemaking that Explores Alternatives for Insurance-Based SLHCs

Given Congress's objectives for appropriate functional regulation of insurance companies, we believe it is imperative that the Board withdraw the proposed rules 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 FIO. We also request the Board to work with the insurance experts on the FSOC, the NAIC, and industry members such as State Farm Mutual. We are confident that, 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 SLHCs. This includes meeting the Board's need for "consolidated" reporting and RBC measurements.

For example, alternatives could seek to incorporate comprehensive RBC requirements that insurance-based SLHCs are subject to under state insurance laws. The insurance RBC framework is uniquely tailored to identify and access the various risks facing insurance companies and sets proper reserve and capital levels on that basis. The Board may appropriately find that the insurance RBC framework satisfies and indeed surpasses the minimum risk based and leverage capital requirements of the Basel I benchmark established under of Section 171. Moreover, nothing in Section 171 precludes the Board from taking into account the existing and comprehensive RBC structure of insurance-based SLHCs in establishing minimum capital requirements. Nor does anything in the Dodd-Frank Act as a whole suggest any such limitation. Recognition of such equivalence for Section 171 purposes is appropriate given the distinct assets and liabilities held by insurers in contrast to banks. The Board could also explore mechanisms to calibrate or translate state RBC calculations into minimum capital and leverage requirement ratios required under its banking framework. Such a model was illustrated in the ACLI's comment letter. In either case, it would also allow the Board to supervise insurance company SLHCs with a superior mechanism for assessing their financial positions.

Another approach to capital adequacy under Section 171 could combine the requirements of both the insurance RBC framework and the bank capital requirements as discussed above in Section III. That is, the insurance RBC framework could be applied to the insurance operations of the SLHC with the bank capital requirements applied to the federal savings bank subsidiary. We believe such an approach would be superior for those holding companies where the top-tier holding company is a functionally regulated insurer and where the combined assets of the insurance affiliates plus the banking affiliates represent a significant portion of the enterprise's consolidated assets.

In short, it is critical that alternatives beyond the Basel framework be considered in formulating an appropriate and effective regulatory approach for insurance-based SLHCs.

X. Conclusion

The Board's emphasis on applying bank-centric regulations to insurance companies creates a regulatory anomaly whereby rules intended to make DIHCs financially stronger may compel behavior that weakens the capital strength of an insurance-based SLHCs. In essence, the rules designed to fix problems in one industry, wreak harm if applied to another industry. Such misplaced application is not what Congress had in mind in enacting Section 171 or the Dodd-Frank Act as a whole. 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. 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.

State Farm Mutual very much appreciates the Agencies' consideration of these comments and would be pleased to answer any questions the Agencies might have.

Very truly yours,

Jeffrey W. Jackson

Jeffrey W. Jackson
Senior Vice President and General Counsel