

November 28, 2012

Alfred M. Pollard, General Counsel  
Attention: Comments/2012-N-14  
Federal Housing Finance Agency  
Eighth Floor, 400 7th Street, S.W.  
Washington, DC 20024

Dear Mr. Pollard,

We write today on behalf of the National Association of Insurance Commissioners (NAIC) in response to your recently issued Advisory Bulletin No. 2012-N-14 on Collateralization of Advances and Other Credit Products Provided by Federal Home Loan Banks to Insurance Company Members. Founded in 1871, the NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer reviews, and coordinate their regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S. The NAIC respectfully submits the following comments to the Notice of the Advisory Bulletin and Request for Comment published in the October 5, 2012 issue of the Federal Register.

The members of the NAIC are deeply troubled with several aspects of this bulletin, which appear to reflect a serious misunderstanding of the national state based system of insurance regulation, as well as its historical track record. While we recognize your agency's interest in subjecting Federal Home Loan Banks to appropriately stringent regulation, the notion that "lending to insurance companies exposes the Banks to a number of risks that...in large part... arise from the fact that insurance companies are regulated at the state level" is simply without merit.<sup>1</sup> For more than 140 years, state-based insurance regulation has effectively protected policyholders by ensuring insurance companies' solvency and their ability to pay claims. The success of the state-based system of insurance regulation was illustrated dramatically by the financial crisis; because of state insurance regulators' conservative approach to solvency regulation, insurers and their consumers weathered the financial crisis far better than other, largely federally regulated financial sectors. While hundreds of banks failed, less than 20 insurers became insolvent. The suggestion that lending to such highly regulated companies creates greater exposure than lending to depository institutions is simply unfounded.

The content of this bulletin is even more troubling in light of the recent history of constructive dialogue state insurance regulators and the FHFA have had in fora such as the Financial Stability Oversight Council and in discussions regarding force placed insurance and the oversight of mortgage insurers. We are profoundly

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<sup>1</sup> Advisory Bulletin on Collateralization of Advances and Other Credit Products Provided by Federal Home Loan Banks to Insurance Company Members, 77 Fed. Reg. 60,988 (proposed October 5, 2012).

disappointed that the FHFA made no effort to consult with the NAIC regarding the content of this bulletin to ensure that the agency had an appropriate understanding of the national state based system of insurance regulation, its receivership regime, and its accounting practices prior to its release. Despite our disappointment in this regard, we appreciate the opportunity at this time to clarify the treatment of FHLB loans and collateral by the insurance regulatory system's accounting and receivership regimes.

### **Treatment of FHLB Loans in the Receivership Process**

The advisory bulletin's concerns about "uncertainties"<sup>2</sup> arising from state-based regulation are without merit. If an insurance company is found to be financially unstable, the insurance department in its home state (also known as its 'domiciliary' state) can step in and take control of the company. This begins the "receivership" process, where the company may be placed in "rehabilitation." In rehabilitation, the state insurance department attempts to improve the company's financial status. The state insurance commissioner becomes the "receiver" for the troubled company, or they can appoint a third-party deputy receiver to oversee the company's operations.

If the company's financial difficulties are too great to overcome, the commissioner declares the company insolvent and the company may be placed in liquidation. In liquidation, the receiver attempts to maximize the company's assets to pay off as many creditors as possible. State statutes explicitly lay out a priority scheme by which creditors have claims to the company's assets. Under that scheme, secured creditors are provided recovery to the extent of the value of their collateral ahead of most claimants - including policyholders. In the event the value of the claim exceeds the value of the collateral, the portion of the claim exceeding the value of the collateral will be considered unsecured and will be paid once secured claims and policyholder claims are satisfied.

Under state laws, FHLB loans would generally be considered secured claims and be subject to the treatment set forth above.<sup>3</sup> Where the transaction is structured differently, as a funding agreement such claims are subordinated to secured creditors and treated as policyholder claims. Consequently, there is little "uncertainty" surrounding the treatment of these loans in an insurance receivership. There are two easily identifiable approaches based on the structure of the transaction in question and the state of the insurer. While these structures may suggest different levels of risk to the Federal Home Loan Bank, the underwriting associated with this particular aspect of the loan should be fairly straight forward and well-understood.

### **Statutory Accounting Principles**

Contrary to the bulletin's assertion that "required reporting practices and reporting frequencies, as well as data definitions and data formats may be quite different from state to state,"<sup>4</sup> the use of Statutory Accounting Principles (SAP) is, in fact, fairly uniform across the states, primarily because every state requires its insurers to follow the NAIC's Accounting Practices and Procedures manual. NAIC Interpretation 08-08-Balance Sheet Presentation of Funding Agreements Issued to a Federal Home Loan Bank specifically addresses this issue. This interpretation indicates either funding agreement treatment or borrowed money treatment, depending upon the use of the funds. Such optionality in accounting occurs in all accounting bases, GAAP included, as an appropriate way to handle differing objectives and results to various transactions. Thus, the "data definition" included in statutory accounting is rather straightforward: the FHLB funding is either a funding agreement or a loan.

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<sup>2</sup> Advisory Bulletin at 60,989.

<sup>3</sup> In two states, FHLB loans are treated as qualified financial contracts. These states provide a higher priority for such loans than the protection afforded by the federal bankruptcy code.

<sup>4</sup> Advisory Bulletin at 60,989.

While the bulletin is unclear, in the event the FHFA is referencing the existence of prescribed and permitted accounting practices when suggesting differences among the states in this regard, the FHFA should be aware that the NAIC's Accounting Practices and Procedures manual have specific definitions and rules to address such situations. A "prescribed accounting practice" is an accounting requirement established by state law that differs from the requirement in the NAIC manual. Consistent with the "permitted practices" utilized by other financial regulators, a "permitted accounting practice" is an accounting practice granted by a state on a case-by-case basis that gives an individual insurer the ability to account for a transaction in a different manner from the NAIC manual. In both circumstances, the NAIC Accounting Practices and Procedures manual requires that the insurer disclose any material impact to statutory surplus and net income that results from accounting practices in Note 1 of the Notes to Financial Statements. The NAIC maintains a listing of the state prescribed accounting practices, and none of them indicate contrary treatment to Interpretation 08-08.

Regarding data formats, the NAIC Blanks Working Group establishes a uniform template for statutory financial statement reporting. Over 4,700 insurers file statutory financial statements with the NAIC. Each of those 4,700 insurers utilizes this uniform data template. The NAIC's database has been recognized by international regulatory agencies as "world leading".<sup>5</sup> It is precisely the uniform definitions provided in the NAIC Accounting Practices and Procedures manual combined with the uniform data reporting template that establishes the powerful utility of this database.

### **Conclusion**

As the FHFA moves forward with this advisory bulletin and other regulatory actions related to the regulation of insurance, we appreciate the opportunity to comment and look forward to a more constructive ongoing dialogue in the future. Should you have any questions regarding this comment or any other matter relating to the NAIC's views on this Advisory Bulletin, please do not hesitate to contact Ethan Sonnichsen, Director of Government Relations, at (202) 471-3980 or Mark Sagat, Counsel and Manager of Government Relations, at (202) 471-3987.

Sincerely,



Kevin M. McCarty  
Florida Commissioner of Insurance and  
President, NAIC

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<sup>5</sup> 2010 International Monetary Fund Country report No. 10/126, "United States: Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of IAIS Insurance Core Principles."