THE IMPACT OF INTERNATIONAL REGULATORY STANDARDS ON THE COMPETITIVENESS OF U.S. INSURERS, PART II

HEARING

BEFORE THE

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HOUSING AND INSURANCE

OF THE

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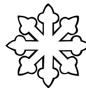

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THE IMPACT OF INTERNATIONAL REGULATORY STANDARDS ON THE COMPETITIVENESS OF U.S. INSURERS, PART II

Tuesday, November 18, 2014

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND INSURANCE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:01 p.m., in room 2167, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Luetkemeyer, Royce, Garrett, Duffy, Hurt, Stivers, Ross; McCarthy of New York, Sherman, and Beatty.

Also present: Representatives Huizenga and Green.

Chairman NEUGEBAUER. Good afternoon, and we will call this hearing to order. The title of this hearing is, "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II."

I would mention that our folks on the other side of the aisle—this is the time of the year, as some of you may have heard, where people are trying to see if they are going to keep their job or get a new job, get a new committee. And that process is going on with our colleagues on the Democratic side. I talked to Mr. Capuano, and he is going to try to attend later on today.

So what we are going to do is, we are going to give the opening statements on our side, and then we will have our witnesses give their testimony. And we will kind of proceed with the question-and-answer period. Then, when Mr. Capuano and some of our Democratic colleagues show up, we may pause and let some of them do an opening statement. And then, we will put them back into the queue for the question-and-answer period.

So with that, I will begin with my opening statement.

Thank you all for attending this important hearing which will examine a range of international regulatory standards being proposed by the International Association of Insurance Supervisors (IAIS). Through this hearing, our members hope to get a better understanding of how our insurance supervisors are balancing the need to coordinate regulatory efforts overseas with their responsibility to promote a global marketplace that benefits domestic policyholders and insurers.

We have somebody here I think is going to—

[Audio problem.]

I think it is kind of ironic. We are getting an upgrade in the sound system in our old committee room and, hopefully, it will be—aha, okay.

The IAIS represents insurance regulators and supervisors in nearly 140 countries. It is tasked with coordinating global insurance policy and promoting globally consistent regulations. Overall, this committee does see the benefit of better international coordination in terms of preventing regulatory gaps and promoting efficiency; however, I am concerned that the IAIS' role has evolved from being an international coordinator to that of an international promulgator.

The IAIS' most recent proposal to harmonize insurance regulation—commonly referred to as ComFrame—would create a one-size-fits-all regime for global insurers, including burdensome group-wide capital assessments and prescriptive prudential standards.

Members of this committee have expressed concerns with the prescriptive nature of the ComFrame proposal, but many are equally concerned that it seems to be a mechanism for the EU to export its consolidated, bank-like approach to regulating insurance here in the United States. While this system might work well for our allies across the Atlantic, it is inconsistent with our system of insurance regulation and I don't believe it is in the best interest of U.S. consumers and insurers.

It is not just the substance of the workstream coming out of the IAIS that worries our members, but also the apparent lack of transparency of the organization. For example, U.S. firms that have been designated systemically important have complained about the opacity of the selection methodology by the IAIS and the Financial Stability Board (FSB), and the lack of due process to appeal such decisions. And more recently, the IAIS, with the support of the FIO, decided to eliminate the "observer status," which was the only avenue for U.S. insurers and consumers to present their views before the organization.

So if I understand international developments correctly, we are on the verge of importing the European model of insurance regulation here at home and exporting the non-transparent FSOC model to our trading partners at the IAIS.

With that being said, I am beginning to receive positive feedback about our insurance regulators and supervisors becoming more unified. In particular, I would like to commend our witnesses for vigorously pushing back against global standards that would include "market-based accounting" for insured assets. I am optimistic that we can continue this momentum and change the direction at the IAIS. I want to thank our witnesses for participating today, and I look forward to hearing how we can work together to achieve beneficial outcomes for our domestic policyholders and insurers.

We will now go to the opening statements of our other Members. And the gentleman from California, Mr. Royce, is recognized for 3 minutes.

Mr. ROYCE. I want to thank you, Mr. Chairman, for your willingness to hold a hearing looking at the governance and oversight of the National Association of Insurance Commissioners (NAIC). I

want to thank our panel, and I am hopeful we can schedule a hearing in the future dedicated to that topic.

There is a clear intersection with the hearing today. The committee's review of international regulatory standards should also examine the transparency and accountability of the bodies making regulatory decisions. As Commissioner Consedine put it in his opening statement—and I will quote him here: "The process of standard-setting should be done in an open and inclusive forum."

And transparency is a key element of effective regulation. The IAIS has clearly failed to meet this mark, but so too has the NAIC. Last October, the NAIC sent me a letter stating that its policy statement on open meetings "applies to all meetings of NAIC committees, subcommittees, task forces, working groups, and that any guidance by any of these bodies is taken in open session." Well, none of that is true. The executive committee holds day-long closed-door meetings during commissioner-only junkets, where it sets the NAIC policy agenda. NAIC efforts to remake international regulatory policy have been veiled, as well.

According to NAIC minutes this year, the group solvency issues working group was given directions on international regulatory policy regarding issues which were outlined in a "regulator-only memorandum." Another memo on group solvency stated that, "The NAIC executive committee directs the working group to use the Pennsylvania Insurance Holding Company Act as the starting point for this work." Well, my staff has found no record of this policy directive being decided in open session. In fact, NAIC minutes and trade press accounts strongly suggest just the opposite.

Just one day after taking these committee actions on group solvency, the NAIC amended its open meetings policy, exempting consideration of strategic planning issues relating to international regulatory matters from its scope, resulting in even less transparency.

So, let me be clear. I support pushing back against closed-door meetings at the IAIS. But shouldn't the NAIC be opening, rather than closing, its own meetings, to build credibility on this subject? Frankly, I am concerned about the NAIC's role as a private corporation, and about its arrogant response to oversight.

I hope the panel can respond to this criticism and answer whether you too are concerned that the NAIC's conflicting statements and actions demonstrate inadequate concern about transparency and policymaking. And, Mr. Chairman, I would also like to hear from Director McRaith regarding any progress made on moving forward with a covered agreement on reinsurance collateral and other potential issues, such as group supervision. The FIO has said previously that it would take initial steps toward a covered agreement by the end of 2014.

Finally, on the issue of equivalence, or temporary equivalence, over Europe's Solvency II regime, I am hoping the panel can expound on whether they think a formal request to the European Commission is needed to start the evaluation process for the United States. And, if so, when should we expect such a request to be made and by whom?

And I thank you again, Mr. Chairman, for this hearing.

Chairman NEUGEBAUER. I thank the gentleman.

The gentlewoman from Ohio, Mrs. Beatty, is recognized for 3 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman. And thank you to our witnesses for being here today.

As you know, today's hearing continues a dialogue this subcommittee started last June, when we heard testimony from international insurance supervisory authorities on the development of policy standards. This is a very important hearing today, and I look forward to our discussion about the reauthorization of terrorism risk insurance, uniform enforcement of international insurance regulations, and supervisory authority at the Federal Reserve.

Given the recent crises, which hurt American families, and certainly sent our Nation into a recession and crippled some of the largest banks in the country, it is critical to clarify and review the regulations of the financial industry. The insurance industry and the banking sectors are separate, but intimately integrated, sectors of our economy. And our job here is to ensure that when there are similarities, regulations make sense and are not duplicative, and protect the American consumer.

We must also recognize that we live in an ever-changing, rapidly-growing global economy, but that uniqueness of the United States insurance market requires open communication and transparency with our foreign partners.

In today's hearing, I look forward to finding ways to ensure domestic and international insurance regulations do not just have strong guarantee funds but, in fact, have the required regulatory structures to prevent failures in the first place.

Also, Mr. Chairman and to our witnesses, I represent the great State of Ohio—specifically, central Ohio—home to one of the Nation's largest insurers in addition to at least three other large insurance companies. And so, I have a great concern in talking to my home district folks and various other insurance trade associations, that I want to hear more about the need for a reauthorization of TRIA prior to its expiration at the end of this year.

Thank you, and I yield back.

Chairman NEUGEBAUER. I thank the gentlewoman.

And now, the chairman of our Capital Markets Subcommittee, the gentleman from New Jersey, Mr. Garrett, is recognized for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman. I appreciate the chairman holding this follow-up hearing on the impact of international regulatory standards and also on the global competitiveness of the U.S. insurance companies. And I would like to thank all our witnesses who are here, as well.

Today, U.S. insurers are facing a critical time, as international regulatory efforts threaten to impose bank-like regulations on U.S.-based insurers. We have seen that international insurance supervisory efforts are moving away from a coordinated approach—instead, towards a top-down prescriptive standard. Because insurance companies maintain very different capital structures from banks, these institutions should not be treated in the same manner when it comes to assessing capital requirements. And while a move towards a top-down standard is certainly a concern to all of us, I am equally troubled that this increased international regulation is

taking place against what you would call a backdrop of less transparency.

For example, the International Association of Insurance Supervisors is looking at whether to hold what they call "closed door meetings," which close all of its workings, the president's and task force meetings to the public, beginning in just a few months, on January 1, 2015. I, for one, cannot see how pulling the curtain over the activities of international regulators will help U.S. consumers or insurers. Unfortunately, we have seen this same type of transparency concerns right here at home in the United States, with both the Federal Reserve and the Financial Stability Oversight Council (FSOC).

With this tidal wave of regulation under the Dodd-Frank Act, I think, Mr. Chairman, that we need to be moving in the direction of more transparency both here at home and abroad as well, and not less. And so, Mr. Chairman, I look forward to hearing from our witnesses on all of these important issues.

And with that, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

I now recognize the gentleman from Wisconsin, Mr. Duffy, who has taken a great deal of interest in this issue and who has been very vocal and very supportive in looking at some policy that would make this a better process.

So I recognize the gentleman for 2 minutes.

Mr. DUFFY. Thank you, Mr. Chairman. And I appreciate the witnesses for being here today. Many of you may not know, but Wisconsin is the fourth-largest home to insurance in the United States. I know you are all surprised; a little trivia fact for you. And those insurers, and our State regulators and policyholders, have been contacting me, concerned over some of the proposals coming out of the International Association of Insurance Supervisors. These proposals could force European-style regulation on our State-regulated system that, as we all know, has developed over the past 200 years.

The fact is, unlike Europe, our State insurance regulators seek to protect the policyholder: the family with a homeowner, or the life insurance policy, not the insurance company providing the policy. The Treasury and the Federal Reserve are supposed to represent that philosophy on the IAIS. But I, like many others, don't necessarily think that they are doing that.

They are not listening to the insurers, the policyholders, the State regulators, and the lawmakers who are voicing their concerns and offering expertise because a conduit for these stakeholders doesn't exist. While the Federal Insurance Office has established an advisory committee on insurance, and Wisconsin's own commissioner, Ted Nickel, serves as a member, it doesn't provide advice on international insurance-related matters.

Additionally, I believe Congress should be kept apprised during the entire negotiation process of international insurance agreements just like we are during the Federal Trade Commission negotiations. During that time, the FTC must do economic assessments on the affected industries and consumers, providing that information to all of us here in Congress. I believe Treasury and the Fed should be required to do the same. For these reasons, I have been developing and working on legislation that would require Treasury

and the Fed to report to Congress throughout the negotiation process, while also providing economic assessments just like the FTC does.

And my legislation would strengthen FIO's Federal advisory committee on insurance so that they could influence Treasury and the Fed on all international insurance negotiations, as well as domestic insurance issues. This is an important issue. As Mr. Garrett mentioned, transparency—especially with some recent comments that were made—is key.

And with that, Mr. Chairman, I yield back.

Chairman NEUGEBAUER. I thank the gentleman. And we will now hear from our panel. We again thank the panel for their testimony today, and remind each of you that you will have 5 minutes to summarize your testimony, but your full testimony will be made a part of the record.

Our panel today consists of: Mr. Michael McRaith, Director of the Federal Insurance Office, U.S. Department of the Treasury; Mr. Thomas Sullivan, Senior Adviser, Board of Governors of the Federal Reserve System; the Honorable Michael F. Consedine, Commissioner, Pennsylvania State insurance commission; and the Honorable Neil Breslin, State Senator, New York, and ranking member of the New York State Insurance Committee. Welcome, gentlemen.

And with that, Mr. McRaith, you are recognized for 5 minutes.

STATEMENT OF MICHAEL MCRAITH, DIRECTOR, FEDERAL INSURANCE OFFICE, U.S. DEPARTMENT OF THE TREASURY

Mr. MCRAITH. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for inviting me to testify today. I am Michael McRaith, Director of the Federal Insurance Office at Treasury, or FIO. We released our second annual report on the insurance industry in September. The report cited 2013 data showing that the U.S. industry's reported surplus reached a record level of approximately $990 billion. Non-health insurers collected more than $1.1 trillion in premiums in 2013, or nearly 7 percent of U.S. GDP.

The report also cites data showing that private market volume is increasing dramatically in developing countries. For example, China's private insurance market increased by more than $137 billion in the last 5 years; South Korea by nearly $50 billion in that same period; and Brazil by more than $41 billion in that time period. These facts illustrate globalization of the insurance marketplace, and explain the increased focus on global standards. For this reason, among others, FIO has a statutory role to correct and develop Federal policy on prudential aspects of international insurance matters, including representing the United States at the IAIS.

In this work, we collaborate extensively with our colleagues at the Federal Reserve, and the U.S. State regulators, including my two colleagues on this panel. International insurance standards are not new. The IAIS was formed in 1994, and U.S. State regulators were among the founding members.

International standards reflect best practices based on collective analysis and judgment of the participants. Importantly, nothing about international standards is self-executing in the United States. Federal and State authorities will study, test, and analyze

the potential value and impact of any international standard prior to implementation.

The United States has the most diverse and competitive insurance market in the world, with insurers that operate in one part of one State and insurers that are multinational and engaged in a variety of financial services. With this in mind, we work with our international counterparts to build a global consensus that makes sense for the United States. Simply put, international standards must, when implemented, serve the interests of U.S. consumers and industry and the national economy.

The IAIS is also mid-stream in structural reform. These proposed changes will eliminate the previous pay-for-play dynamic and increase the IAIS' transparency and independence. No longer will the IAIS depend upon the $20,400 annual fee paid by observers. Now, open meetings and the Web site will be accessible to all stakeholders, not just those who can afford to pay the annual fee. Consultation with stakeholders will be more rigorous, including a more rigorous process for publication of materials and requests for comment. Nevertheless, the proposed stakeholder engagement at the IAIS can be improved through a second public consultation process that began just yesterday.

At FIO, building on our experience will increase the number of opportunities for stakeholders to meet in one place with all U.S. IAIS participants. In 2014, we continued the EU–US insurance project. The E.U. and the U.S. are two important insurance jurisdictions both as markets and as homes for insurers. With the collaboration of State regulators, we have worked with our E.U. counterparts to improve compatibility, understanding, and, where appropriate, consistency. One identified objective in the project is a covered agreement. Not a trade agreement, a covered agreement is an agreement between the United States and another country involving prudential insurance measures.

Indeed, the U.S. market and its oversight are unique. Through effective collaboration at home and abroad, U.S. authorities will continue to provide leadership that complements our shared interest in a vibrant, well-regulated market that promotes competition and financial stability and protects consumers. Finally, in all of our work internationally and domestically, Treasury priorities, FIO priorities will remain the best interests of U.S. consumers and industry, the U.S. economy, and jobs for the American people.

Thank you for your attention, and I look forward to your questions.

[The prepared statement of Mr. McRaith can be found on page 61 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Mr. Sullivan, you are recognized for 5 minutes.

STATEMENT OF THOMAS SULLIVAN, SENIOR ADVISER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. SULLIVAN. Chairman Neugebauer, and members of the subcommittee, thank you for inviting me here on behalf of the Federal Reserve. The Federal Reserve welcomes the opportunity to participate in today's hearing, and is pleased to be joined by our colleagues from the U.S. Treasury Federal Insurance Office, the Na-

tional Association of Insurance Commissioners, and the National Conference of Insurance Legislators.

And while we each have our own unique authority and mission to carry out, we remain committed to working collaboratively on a wide range of insurance, supervisory and regulatory issues, including the subject of today's hearing: international insurance regulation.

My written statement provides details about the work of the Federal Reserve with respect to international insurance issues, but I would like to highlight a few key areas for you.

The Federal Reserve assumed responsibility as a consolidated supervisor of certain insurance holding companies as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Insurance holding companies for which the Federal Reserve is the consolidated supervisor hold approximately one-third of U.S. industry assets. The Federal Reserve supervisory teams for the insurance holding companies are a combination of Federal Reserve staff as well as newly-hired insurance experts.

We are committed to tailoring our supervisory framework to specific business lines and risk profiles of the insurance holding companies that we do oversee. Our supervisory efforts to date have focused on strengthening the firm's risk identification, risk measurement and management, internal controls, and corporate governance.

Some of the insurance holding companies subject to Federal Reserve supervision are internationally active firms which compete with other global insurers to provide insurance products to businesses and consumers around the world. Last year, the Federal Reserve joined our State insurance supervisory colleagues and the FIO as a member of the IAIS.

The Federal Reserve has been, and will continue to be, engaged in the development of global standards for regulating and supervising internationally active insurers. As a general proposition, we believe in the utility of having effective global standards for regulation of supervising internationally active financial firms. When implemented consistently across global jurisdictions, such standards help to provide a level playing field for global financial institutions. Further, consistent global regulatory standards can help limit regulatory arbitrage, jurisdiction shopping, and promote broader financial stability.

The IAIS Common Framework Initiative, or ComFrame, includes the development of a global consolidated capital standard for large, complex international insurance companies. For the largest, most active global insurers, the Federal Reserve supports group-wide consolidated capital standards, which are well-tailored. Such standards must be deliberately developed through a transparent process, and properly calibrated. It is important to note that any standards adopted by the IAIS are not binding on the Federal Reserve, the FIO, State insurance regulators, or any U.S. company. During the development of global standards for insurance firms by the IAIS, the Federal Reserve will work to ensure that the standards do not conflict with U.S. law and are appropriate for U.S. insurance markets and U.S. insurers.

Moreover, the Federal Reserve will only adopt IAIS regulatory standards after following the well-established rulemaking protocols under U.S. law, which include a transparent process for proposal issuance, solicitation of public comments, and rule finalization.

The Federal Reserve, along with the FIO and the NAIC, continues to actively engage with U.S. insurance companies on the development of global regulatory standards for U.S. firms. Recently, the FIO hosted a session with the Federal Reserve, the NAIC, and State insurance regulators, along with U.S. firms, to talk about these very issues and understand what their concerns were around some of these developments.

The Federal Reserve is committed to continuing this dialogue and our work with the FIO and State and international insurance regulators to develop standards for global insurance firms that are consistent across countries and appropriate for internationally active U.S. insurers.

Nothing in ComFrame, including the development of a group capital requirement, seeks to lessen the critical role of the individual insurance legal entity supervision conducted by the U.S. States and foreign countries. Rather, group-wide consolidated supervision and consolidated capital requirements supplement this approach with a perspective that considers the risks across the entire firm, including risks that emanate from non-insurance subsidiaries and entities within the group.

The Federal Reserve is a consolidated holding company supervisor that focuses on identifying and evaluating risks, capital and liquidity adequacy, governance and controls across its supervised organization. U.S. insurers with a global footprint or global aspirations stand to benefit considerably from a level global regulatory framework that is strong, but pragmatic. Reasonably consistent global insurance standards for internationally active insurers and international cooperation among global regulators provide the means to that end.

The Federal Reserve has acted on the international insurance stage in an engaged partnership with our colleagues from the FIO, the State insurance commissioners, and the NAIC.

Our multi-party dialogue, while respectful of our individual authorities, strives to develop a central team USA position on these most critical issues. Mr. Chairman, thank you for inviting me here today, and I look forward to an active dialogue with the subcommittee.

[The prepared statement of Mr. Sullivan can be found on page 68 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Consedine, you are recognized for 5 minutes.

STATEMENT OF THE HONORABLE MICHAEL F. CONSEDINE, COMMISSIONER, PENNSYLVANIA STATE INSURANCE DEPARTMENT, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

Mr. CONSEDINE. Thank you, Mr. Chairman, and thank you all for the opportunity to testify today. U.S. insurance consumers benefit from some of the most dynamic and competitive insurance markets in the world. Taken individually, U.S. States make up 24 of the

world's 50 largest insurance markets. Pennsylvania, for example, is the 14th largest insurance jurisdiction worldwide, with over $95 billion in written premium. The NAIC has long been committed to providing leadership on global insurance issues, with a focus on ensuring policyholder protections and maintaining stable and competitive insurance markets.

The NAIC, as mentioned, was a founding member of the IAIS, recognizing that while insurance is a local product, it is a global business. For over 2 decades, U.S. State insurance regulators have been extensively engaged with our international counterparts in developing the elements of a stronger international insurance regulatory framework. All along, our focus has been to ensure that any international standards are adaptable to our markets and benefit our consumers. Standards developed at the FSB and the IAIS are not binding, but can serve as a guide for regulators to encourage a degree of consistency in approach, if not necessarily in structure or execution.

If these standards collectively elevate the quality of insurance regulation around the globe, it is a positive thing for U.S. insurers and consumers. However, any international standards must be flexible enough to deal with existing structural and legal differences to avoid putting U.S. insurers and consumers at a disadvantage in one market relative to another. Where the Federal Reserve and the Treasury Department engage at the IAIS, we are committed to cooperating and sharing our perspectives with them. Recognizing that we each have distinct responsibilities, it is up to each of us to contribute and commit to international standards to the extent we feel is appropriate and have the authority to do so.

However, it is difficult to reach consensus around standards without the input of those most impacted, in particular the consumers we protect and the companies we supervise. Transparency does not require that regulators hand over the power of the pen to those we regulate. It simply requires that the process of standard-setting be done in an inclusive form. That is a fundamental aspect of our democratic system in the United States, and that is why State insurance regulators vigorously opposed efforts at the IAIS to limit stakeholder engagement and why we remain committed to a transparent process here at home.

The NAIC has long provided forums for significant engagement by all stakeholders, while preserving a capacity for regulators to meet confidentiality on sensitive matters. In fact, as I speak, my colleagues are holding meetings with stakeholders right here in D.C. to discuss a host of initiatives being undertaken by the States, including our work at the IAIS.

The IAIS is developing three capital standards targeted for different purposes, including an insurance capital standard for internationally active insurance groups. Although State insurance regulators have concern with the pace of the work, and it is not yet fully understood what benefit these standards will bring to U.S. policyholders, the IAIS is moving forward.

Insurance regulators therefore have an obligation to be at the table on behalf of our consumers and our marketplace to seek an outcome that works for our system and doesn't stagnate growth, jobs, and innovation. If tailored for our system, there is value in

understanding the capital adequacy of insurance groups, particularly when part of a larger conglomerate. But that value only exists if it wraps around our existing legal entity standards. We also remain concerned with the more volatile market valuation accounting approach as an international standard which represents a short-term focus rather than a long-term view.

In our view, taking a homogeneous approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry. The IAIS must also recognize that a system with existing safeguards for the movement of capital within a group may take a different approach than jurisdictions without similar requirements. The IAIS' objectives on capital standards are not easily achievable and will require significant commitment of resources over many years to ensure that they are compatible with the U.S. system of insurance regulation.

In conclusion, as international standard-setting continues, the NAIC will remain directly engaged to determine whether the concepts under discussion make sense and add real benefit for U.S. policyholders. We are committed to working with our Federal colleagues where appropriate and sharing our views with Congress and our State legislatures on these important matters. The NAIC is pleased to work closely with this committee to ensure that the long-standing strengths of our State-based system are preserved, that U.S. policyholders remain well-protected, and that insurance markets remain stable and competitive.

And again, thank you for the opportunity to testify today.

[The prepared statement of Mr. Consedine can be found on page 55 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Senator Breslin, you are recognized for 5 minutes.

STATEMENT OF THE HONORABLE NEIL D. BRESLIN, SENATOR, STATE OF NEW YORK; AND PRESIDENT, NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)

Mr. BRESLIN. Good afternoon, Mr. Chairman, and members of the subcommittee. Thank you for inviting me here today to discuss the regulatory standards and their impacts on the U.S. insurance industry. My name is Neil Breslin. I am a State Senator from New York and also the president of the National Conference of Insurance Legislators.

I think, to all of us, it is clear that regulation of insurance in the United States is under attack. Our more than 150 years of effective oversight, which strikes a balance between the needs of the consumers and those of committed markets, is under fire. Our system, which came through the financial crisis relatively unscathed, is being second-guessed by officials from countries that had a far different experience. My colleagues at NCOIL and I believe strongly that global insurance discussions must be open and allow for broad comment during development of proposed standards; must do no harm to State regulation; and absolutely must include a vehicle for State legislators, as well as regulators, to weigh in.

Transparency and open deliberations are a foundation of U.S. State legislatures and are critical if State lawmakers who enact insurance laws in the United States are to be confident in regula-

tions they are asked to consider, including those that start overseas. We assert that State lawmakers would find it difficult to support proposals that have not benefited from those guiding principles. Failure to allow due process and to require accountability can have negative consequences for insurers large and small and for the consumers who rely on them. We at NCOIL are troubled by discussions outside the United States that do not parallel the tenets or our own United States regulation.

In particular, we have a concern that the International Association of Insurance Supervisors, IAIS, while probably well-meaning in its efforts to develop global standards, has moved to limit the ability of interested parties to access and to comment during its deliberations. The growing urgency of the organization's efforts, particularly related to capital standards, group supervision and corporate government demands a more, not less, open approach.

It is very important that officials who represent the United States overseas understand and stand together when it comes to any initiative affecting U.S. insurers and, ultimately, consumers. There must be clear understanding that insurance companies do not operate like banks, and that bank-centric proposals would make it more difficult for U.S. companies to remain strong, healthy, and competitive.

In other words, regulation that works in the banking industry may be entirely inappropriate for insurance, and probably is. NCOIL, through an international issues task force that I have the honor of chairing, is working with the National Association of Insurance Commissioners and other advocates of State oversight to ensure that Federal entities, particularly those involved at the IAIS and at the Financial Stability Board, the FSB, stand up for the U.S. system and challenge any attempt to disregard its principles. We have reached out to the FIO at the Department of the Treasury, the SEC, the Federal Reserve and the IAIS, the FSB and others. We have pressed for coordination and cooperation, open dialogue, and for a better understanding of the U.S. system.

We are committed to making sure there is a meaningful way for State legislators who are in direct contact with the consumers, who are the ultimate winners and losers in dialogues over insurance, to participate. The absence of a legislative voice may present inadvertent danger to U.S. insurance markets and to consumers and businesses they serve.

There must a formal way for State lawmakers to participate. And though we appreciate statements of interest in working with State legislators, we look for a more official role. In that regard, we are pleased that the FIO recently included, for the first time, a legislator on its Federal advisory committee. And in particular, that individual, George Kaiser, a North Dakota legislator, and a past president of NCOIL, was the legislator chosen for membership.

As some in the room may know, NCOIL has been concerned that as created under the Dodd-Frank Act, the FIO is subject to mission creep, both domestically and internationally. And so with the critical time in insurance regulation, we especially welcome a legislative seat at the table.

I am here to say that while State regulation is not perfect, State legislators and regulators are always working to enhance areas

where reform is needed, and NCOIL and the NAIC have worked strongly together over the years to effect such change. The United States has a long history of protecting consumers, and promoting strong markets in both good and trying financial times. And there is real harm in international insurance discussions that would unravel a U.S. system that may be different from other insurance regulation across the world. But it works.

I and my colleagues at NCOIL are committed to ensuring that State-based regulation is not compromised, and we look forward to working with you to that end.

Thank you again, and I look forward to the questions.

[The prepared statement of Senator Breslin can be found on page 34 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

I now recognize Members for questions, reminding Members they each have 5 minutes. Before I ask my first question, I think in this issue—and we have heard in some of the testimony today—is the statement, don't worry about these standards being talked about, that they have to ultimately be adopted by the States. Now, when you get to the point where your hair is the same color as mine, and you have raised two teenaged sons, and somebody starts saying, don't worry, you know that is the time to start worrying. Because I think there are two points here. One is, why would we be at the table participating in these if we didn't think, in some way, these standards were going to be a part of U.S. policy?

So I think it is disingenuous to say, don't worry about that. I think people are worried about it. And we heard testimony about that today. I think the other part is, is I think there will be some assumption with the people that we are negotiating with across the pond here that we are going to adopt some of these. And that if we don't adopt them, that somehow our domestic companies could be penalized in participating in overseas markets if these standards that are being proposed are not adopted by that.

So I think for some folks to say, don't worry about this, is disingenuous. I think there is concern here, and that is one of the reasons that we are having this hearing today. Because I think there are some concerns about that process.

Mr. Sullivan, I am a little concerned about the Fed's involvement in this IAIS process. Because from the Fed's perspective, you are solvency regulators for SIFIs, savings and loan, holding companies. And so your participation in this process, developing capital standards for these globally significant companies, how are you going to differentiate your thoughts on how we look at these SIFIs? And then how we look at these companies that are not a part, that aren't globally significant? And how do we—you are going to think—thinking for different capital standards for those SIFIs based on different capital standards for these other companies.

But as you are at that table, do your thoughts on the SIFIs spill over into what your thoughts are on what the capital standards should be for the non-SIFIs?

Mr. SULLIVAN. Thank you, Mr. Chairman. There are, as Commissioner Consedine pointed out in his testimony, three capital standards that are being considered by the IAIS. The first was the recently published basic capital requirement, which would then have

a high loss absorbency, or HLA, applied to it. And that is to apply to the GSIIs, the globally systemic insurers. The other thing we talked about was the Insurance Capital Standard, the ICS. That is intended to only apply to internationally active insurance groups. So there is a distinction upon where a particular insurer fits and what capital standard would apply.

Chairman NEUGEBAUER. How do you begin to reconcile that, considering that a lot of these European countries have a different regulatory structure than the U.S. structure? And so when you begin to try to apply those in a global way, how do you reconcile those differences?

Mr. SULLIVAN. Referring again back to my testimony, and you heard from Director McRaith as well, once those standards are set, they would have to be brought back to the United States and adopted through our rulemaking process. It would only mean something if we adopt it through our rulemaking process here within the United States. And we would go through our process of notification, feedback, and then final rule.

Chairman NEUGEBAUER. I think in your testimony you mentioned that at the point where we would accept these consolidated capital standards, we would go through the normal rulemaking process. To me, that, from your testimony, is an assumption that you intend to adopt it at some point in time, or propose these capital standards.

Mr. SULLIVAN. I also pointed out that it would have to first conform with U.S. law. And I also said that it would not have to be disruptive to U.S. markets or U.S. insurers. So it would have to meet those tests before we would consider adopting it here in the United States.

Chairman NEUGEBAUER. Mr. Sullivan, in Mr. Consedine's testimony, he stated that the State regulators are unclear what benefit the international capital standards would bring to the U.S. policyholders. Why would we be participating in this process if we didn't think there was any clear benefit to policyholders in the United States?

Mr. SULLIVAN. We are a consolidated supervisor at the Fed. We do believe in consolidated group capital requirements. We believe that they can have a leveling of the playing field amongst market participants. So we do believe it would have a benefit to the market. And from a regulatory perspective, it allows us to look at the group on a consolidated basis versus what the NAIC is doing in terms of its view of legal entity capital.

Chairman NEUGEBAUER. Some folks point out that during the financial crisis, the insurance industry actually was the bright star in the sky, that with the exception of a company that was operating outside, really, the traditional insurance arena, the rest of the industry fared very well. Given that, what is driving the Fed and others to look at these enhanced capital structures, if our current system seems to be working?

Mr. SULLIVAN. I hear everything is fine—you know, why fix a problem, if nothing is broken. But I would also suggest that markets aren't static, nor should regulation or supervisory intervention be static. We need to constantly evolve. And I think the one case that you cite, Mr. Chairman, actually is a glowing example of what

can happen across the entirety of an enterprise, and the fact that we do need to look at things on a consolidated basis, not necessarily on a legal entity basis.

Chairman NEUGEBAUER. I thank the gentleman.

The gentlewoman from New York, Mrs. McCarthy, is recognized for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. And I thank everybody here for giving this testimony. I think it is something that many of us are certainly interested in. Going back over the last couple of years, especially since Dodd-Frank, myself and Congressman Gary Miller have been working on capital standards and trying to make an adjustment. Because here on the House side, we believe we had the right language. On the Senate side, there was a little bit of confusion and, unfortunately, language was changed. So I guess, Mr. McRaith, and certainly anybody else who wants to jump in, when we talk about the insurance capital standards—we have 221 bipartisan Members of Congress. And the Senate passed it overwhelmingly on unanimous consent.

Unfortunately, right before we went on a break, the bill came up. But it was put together with some other bills—which, by the way, had already passed, but the way it was written the Senate wouldn't have accepted it. So it kind of put us back to square one. But H.R.—and I don't know if you are all familiar with H.R. 4510, the Insurance Capital Standards Clarification Act. The legislation would provide clarity to the capital standards applied to insurance companies under the Federal Reserve supervision. Mr. McRaith, do you think that applying the wrong capital standards, such as bank capital standards, to an insurance company is ineffective?

Are you familiar with this legislation? Is it something that you would support? Could it be something that you would support? And if you do know about the legislation—this goes for everyone—to expand on it. We definitely saw through the hearings going back in those years that the insurance companies really had nothing to do with the collapse of the economy that was going on. So if you could answer that, I would be happy.

Mr. MCRAITH. Congresswoman, to be abundantly clear, insurance firms should be supervised as insurance firms. I think Senator Collins has been on record as saying that Section 165 of the Dodd-Frank Act is intended to provide the opportunity for the Federal Reserve to tailor its supervision to the firms that are subject to its supervision. I don't want to comment on any pending legislation, other than to say that I think the Federal Reserve has been clear on its view. And I would defer to my colleagues at the Federal Reserve on that subject.

Mrs. MCCARTHY OF NEW YORK. Thank you. Mr. Sullivan, do you have anything to say?

Mr. SULLIVAN. Yes, I do. And I would only reiterate what Chair Yellen and Governor Tarullo have said on behalf of the Fed: that we would support the legislation, we seek to tailor how we supervise insurance firms, and we believe the legislation would afford us that opportunity. So we do support it.

Mrs. MCCARTHY OF NEW YORK. Thank you. Do any of you think that if this is delayed until next year, that might hurt the insur-

ance companies, being that they can actually come up with a business model that we have been holding them up on for all this time?

Mr. SULLIVAN. We would stress expedience in addressing—

Mrs. MCCARTHY OF NEW YORK. It could be passed tomorrow on suspension, to be very honest with you. Any other comments?

Mr. CONSEDINE. Congresswoman, we at the State NAIC level fully support the legislation, as well, and share the concerns that if the Federal Reserve doesn't have the ability to tailor capital standards specific to insurance companies, there could be very significant consequences for both the companies involved but, more importantly, the consumer. So we do, indeed, support the legislation.

Mrs. MCCARTHY OF NEW YORK. Thank you. Mr. Sullivan, welcome from New York. I am a New Yorker, too. You could probably tell by the way I talk. But, welcome. I think it is important, and like I said, there are 221 Members, Republicans and Democrats, evenly split working towards this. We noticed, and I am not putting any blame on Senator Collins, there was a mix-up in the understanding of what was going on. She is now the lead sponsor on the Senate side. So I hope that you have some sway with our colleagues to bring it up before the session, the 213th session, leaves.

Because, God knows, when we get back in January, February, it is going to take quite a while to get some votes up there, to get some business going. Thank you, gentlemen.

And thank you again, Mr. Chairman, for holding this hearing.

Chairman NEUGEBAUER. I thank the gentlewoman.

The vice chairman of our Housing and Insurance Subcommittee, Mr. Luetkemeyer from Missouri, is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Mr. McRaith, in your testimony you indicate that we have had record levels of reported capital and surplus this past year, apparently. That is wonderful, fantastic. How do we look, from the balance sheet standpoint, on the liability side? Have we increased our liabilities to where we may have nice capital over here but our liabilities have shot up even higher yet, to the point where we are still in deep trouble? Or are we in good shape as a result of the limited amount of liability that has been taken on? Can you address that?

Mr. MCRAITH. So that element of my testimony refers to the annual report which we released in September, Congressman. And that annual report affirms that the industry shows improved and continued improved resilience following the financial crisis. In short, we are seeing appropriate reserve levels, which measures liabilities relative to assets.

Mr. LUETKEMEYER. Okay. Mr. Sullivan, the chairman talked a little bit about the SIFI situation. And I am kind of curious. There have been three U.S.-based insurance companies that have been designated as SIFIs. Can you tell me, or explain to me how we get an insurance company to be a SIFI? What are the criteria that you think would cause an insurance company, if it went down, to bring our whole economy down? What are the circumstances?

Mr. SULLIVAN. Representative, I have not been part of the deliberations of the Financial Stability Oversight Council (FSOC). They have their own criteria for designation of firms, and I am not part of that process or a member of FSOC.

Mr. LUETKEMEYER. It is in your testimony today.

Mr. SULLIVAN. What is that?

Mr. LUETKEMEYER. It is in your testimony today. You discuss it. You discuss that IAIS has designated some SIFIs, three are U.S.-based, and you can't discuss what your testimony was about?

Mr. SULLIVAN. No, no. Are you talking about GSIIs or FSOC? I'm sorry.

Mr. LUETKEMEYER. Well, I am talking about the GSIIs, but same thing.

Mr. SULLIVAN. Yes. The IAIS has published their criteria for designation, and they have designated three U.S. firms as GSIIs. They have an algorithm that goes through an assessment of each insurer, and—

Mr. LUETKEMEYER. I guess the question is, do you agree with them?

Mr. SULLIVAN. I agree with the three designations, yes.

Mr. LUETKEMEYER. Okay. If you agree with them, on what basis do you agree? That we have three insurance companies in this country that are systemically important enough they could bring down the entire economy? When in 2008, during the most disastrous economic financial debacle since the Great Depression, there were no insurance companies that were a problem.

Mr. SULLIVAN. Right.

Mr. LUETKEMEYER. How does that work?

Mr. SULLIVAN. We are worried about systemic risk. We have an algorithm that assesses systemic risk at the IAIS. And I support the process that the IAIS—

Mr. LUETKEMEYER. That is the same response I got from somebody with regards to the flood of 1993 in my home district. We had a flood in 1993 which was record-breaking, a 500-year flood. The levee around the town saved the town, and yet it was unaccredited and they were going to raise their insurance premiums because the levee didn't work. Makes no sense. I'm sorry, I have a hard time following you on that one, sir.

I guess my question to Mr. Consedine here is, we have the hearing today entitled, "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II." You deal with the State guys all the time. You all have insurance companies in your State, all the folks. How are the FIO and the IAIS affecting your State and your insurance companies' ability to deliver quality, competitive products at this point?

Mr. CONSEDINE. These standards that are being set now in Basil, Switzerland, and other places ultimately could be applied to U.S. companies, large companies, and could ultimately potentially trickle down to some of our smaller companies. So our view is, this is not just a Wall Street issue in Pennsylvania. This is a Main Street issue, too.

And so the concern is, right now, in these discussions, they are being influenced by different viewpoints from both Europe and the United States. And it is very important that we get it right at this stage. Because what happens at this stage ultimately will then be the standards that go out global.

And yes, we will have the ability to accept or reject them. And if we reject them because we don't like them, then we put our market at a competitive disadvantage.

Mr. LUETKEMEYER. Okay. In your discussions, in your testimony, you also talked about some difference of opinion with regards to IAIS and FIO and all of the different folks who are promulgating these regulations. What is your relationship with those folks, at this point?

Mr. CONSEDINE. We are an active participant in the IAIS. The NAIC, as was mentioned, was a founding member. Fifteen, or all of our States, are members. So we are fully engaged in those discussions, along with our counterparts at the Federal Reserve and FIO. Domestically, we have ongoing and regular discussions with our counterparts at FIO and the Federal Reserve on these issues, in part in an effort to put the best team USA game that we can because there is a lot at stake.

Mr. LUETKEMEYER. Okay, one more question. You are involved in the discussions. Are they listening to you?

Mr. CONSEDINE. I think so. And we are seeing—

Mr. LUETKEMEYER. That was a qualified yes, there, not what I am looking for.

Mr. CONSEDINE. We are seeing real progress.

Mr. LUETKEMEYER. Okay.

Mr. CONSEDINE. For example, as was mentioned, we came away from this last meeting with, I think, an important win for the United States on market-based valuation. And that was a result of, I think, active listening and really good teamwork.

Mr. LUETKEMEYER. Fantastic. Thank you.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Wisconsin, Mr. Duffy, is recognized for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman. Just quickly, Mr. McRaith, would you discuss the transparency again of this process, the negotiations? You talked about it being online, is that right, the hearings, the meeting? Is that your testimony?

Mr. MCRAITH. Forgive me. Are you referring to the transparency at the IAIS?

Mr. DUFFY. Yes, I am.

Mr. MCRAITH. Right. So the first priority was eliminating the pay-for-play. And you might not be aware, but eliminating the observer status means that now observers and the public get access to the same information, the same meetings, but don't have to pay $20,000 for it.

Mr. DUFFY. So in regard to the status of the negotiations, what kind of information is disseminated to this institution or to stakeholders?

Mr. MCRAITH. In terms of the international standard development work, which I think is what—when you are referring to negotiations, that is what you mean.

Mr. DUFFY. Right.

Mr. MCRAITH. Look, we are entirely pleased to work with this committee, to report to this committee, and to work with stakeholders. One thing that we are committed to at FIO is to continue

to build opportunities for U.S. stakeholders to engage with all of the U.S. IAIS participants at one time. We have been doing this—

Mr. DUFFY. But there is no process in place right now for consistent reports to come to this committee and this Congress, or to stakeholders. Is that right?

Mr. MCRAITH. We have reported and worked with the—

Mr. DUFFY. I know, but there is no—

Mr. MCRAITH. —staff of this committee on a regular basis, and we would be pleased to continue doing that, of course.

Mr. DUFFY. When a new standard is agreed to at IAIS, is there going to be a comment period for stakeholders and this institution to give feedback on the agreed-to language?

Mr. MCRAITH. Yes, absolutely. And I think that is one reason why we think this is an improvement. Because the process for consultation is now formalized and expanded in a way it did not exist before. And I would say even the consultation process is now subject to public consultation as of yesterday. So it is still in draft form. New ideas are still being received.

Mr. DUFFY. I am going to come out with a bill in the not-too-distant future. And I hate to ask people to comment on bills they haven't seen. I don't do it, so I don't expect you to. But the concept of having some form of an advisory committee of stakeholders that participate—they don't participate, but they give advice to you in the negotiating process. Would you object to that? And would you object to consistent updates to this committee on the status of negotiation?

Mr. MCRAITH. You are right. I don't want to comment on a bill I haven't seen. But I do want to say and emphasize that we absolutely value the opportunity to have this conversation with this committee, with the staff of this committee, and with stakeholders. As we move forward, we welcome the opportunity to build on what we have done to date.

Mr. DUFFY. Would you object to an advisory committee, formalized?

Mr. MCRAITH. We do have an advisory committee right now that includes stakeholders from across the diverse array of the insurance sector.

Mr. DUFFY. And standard updates, continual updates to this committee, you would have no objection to that being formalized?

Mr. MCRAITH. We welcome the chance to work with this committee and work with the staff of this committee.

Mr. DUFFY. Because I think a lot of us have had—and I don't mean any offense to Treasury and the Fed; I think both of you are somewhat new at engaging in the insurance base the way you are right now—some concerns with the timeliness of getting FIO reports. Some of them have been a couple of years late. And so to make sure that a standard that comes out through this negotiation, that I know you will say it is not a rule, it is not binding. But we all know that standard is going to be met by stakeholders and probably by our regulators. We want to have an advisory committee making sure that you have the best information possible and that we stay in constant communication as this process moves forward.

And we think the process should move forward, but we don't want to find ourselves at the end of the negotiation, agreeing to something and the industry and this institution has great reservation about what you have done. And so to put some procedures in place to make sure that there is a constant dialogue and a constant feedback for you, I think is important. And to make sure that there will be a time period for comment to make sure, before we sign off or you sign off on this agreement, that there is a period for comment and there are questions that you might ask to get feedback from the industry on how it is going to impact us.

My time is almost up. In regard to guarantee funds versus capital, how are we doing in the negotiations with our international counterparts? Are we rolling over?

Mr. MCRAITH. I am not entirely sure I understand the question. Is the question whether we are conceding that guarantee funds don't work and instead requiring more capital for the insurance firms?

Mr. DUFFY. Yes.

Mr. MCRAITH. Absolutely not. In fact, I don't remember ever having that discussion once. In fact, I don't think anyone has ever discussed that. I think what we view in the United States is—

Mr. DUFFY. Are you considering—

Mr. MCRAITH. —the guarantee association system works well for the insurance entities.

Mr. DUFFY. My time has expired. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Virginia, Mr. Hurt, is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. I thank you for holding this hearing, and I thank the witnesses for appearing today.

My first question is directed to Commissioner Consedine. The comment that you made during your testimony indicated that capital standards that may be adopted in a—modeled on bank-like standards, designed to minimize risk, could actually instead create more risk for insurance companies. And I was wondering if you could elaborate on that a little bit?

Mr. CONSEDINE. Thank you, Representative. One of our concerns with capital standards, especially if they result in a higher capital requirement for many insurance companies, is both from an economic and policyholder perspective. And requiring companies to hold higher amounts of capital, you severely limit the free flow of capital, and their ability to grow, to hire people, to create jobs, to create new products. I think you see the opportunity for pricing swings, possibly price increases. And ultimately, in some cases, and we have seen this play out in other countries, you limit the availability of products that are based on long-term liabilities and valuation standards; products that could be very critical here in the United States, especially with an aging population, with pension risks that are all—could be dependent on the availability of those types of products. And the absence of those products could have a long-term detrimental impact on our economy.

Mr. HURT. Excellent. Now, Director McRaith, I wanted to ask you, when you have testified before this committee before, you have expressed strong support for State-based insurance regulation. And

I certainly, for one, appreciate it, as I have said to you before. But I was wondering if you could talk a little bit about the proposals that we are seeing overseas, the Financial Stability Board and the E.U.'s Solvency II proposal as well as the ComFrame from—by the FSB. If you could talk about what risks, what dangers do you see? What dangers are you looking for as you represent our interests in this process? What are the things that you are looking for that could hurt the competitiveness of American insurance companies and policyholders?

Mr. MCRAITH. I think Commissioner Consedine identified a legitimate concern, which is having a capital standard that would affect the availability of products or the ability of the industry to compete within the United States. As I said in my testimony, any international standard has to serve the best interests of the U.S. consumers, the U.S. industry, and the U.S. economy. So as we look at capital, that is a priority. As we look at enterprise risk management, that is a priority. As we look at governance standards and expectations, that is a priority. It is also, in our view, consistent with what Tom Sullivan said in his testimony, that it is also appropriate to look at the firms as a consolidated enterprise if they are large, multinational, complex organizations.

And that is what ComFrame intends to do. But I want to be clear, and emphasize—and I say this as a Chicago Bulls fan; Michael Jordan, Scotty Pippin, and Phil Jackson were great in their own right. Together, they won six championships. The Federal Reserve, the State commissioners, and the FIO, working today, we can deliver standards internationally that serve the best interests of the United States.

Mr. HURT. Thank you. My last question is to Commissioner Consedine and Senator Breslin. We heard Director McRaith talk a little bit about his commitment to transparency and a broader participation by the stakeholders, namely insurance commissioners in our 50 States as well as the legislators and legislative organizations. Can you all talk just briefly, in the few minutes we have—few seconds we have remaining about what you think specifically needs to be done in order to bring broader participation?

Mr. BRESLIN. Obviously, in a general sense, just the transparency part is anathema to the States. The States, as was indicated before, six of our States, including Texas, Pennsylvania, and New York are among the top 20 insurance producers in the world. And each of those States has strong transparency regulations and strong State-based—

Mr. HURT. Can you talk about the specifics, though? I think I understand what you mean generally. Are you able to assign any specific remedies?

Mr. BRESLIN. Obviously, with each of those regulatory bodies in the international sense is to have open meetings, open discussion. When they deal with trade agreements, those trade agreements should be shared with the States. The States should have—legislators should have participation so that enhances the transparency issue.

Mr. HURT. Excellent. Thank you.

My time has expired. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Florida, Mr. Ross, is recognized for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman. Having just come off of an election, as all of us have, I doubt any of my colleagues, including myself, campaigned on Basel III or Solvency II or IAIS. And yet the impact of these regulatory schemes have a significant role in the end user, the consumer. And believe me, coming from Florida, I come from a State which 7 years ago decided to affect the markets in a regulatory and statutory form by over-expanding a property insurance company that was run by the State, owned by the State, and backed by taxpayers, only to effect a below market rate.

And what we have here is somewhat the antithesis of that. Director McRaith, I truly appreciate your confidence here about being at the table and using the analogy of the Chicago Bulls. I just don't want us to have the luck of the Chicago Cubs when it comes to having our role at the international table. Now, I think that having the representation of the NAIC is very, very important. Ever since the McCarran-Ferguson Act, what we have in place I think is one of the best things that this world economy has seen in providing consumer protection, solvency, and a good regulatory scheme for domestic insurance.

And yet I still have to question why FSOC decides to want to put into place the designation of three domestic carriers as SIFIs. And my question to you, Mr. McRaith is, is that an indication that the State regulatory scheme is not sufficient if FSOC is putting into play three domestic carriers as SIFIs?

Mr. MCRAITH. Congressman, the council is guided by the statute. The statute establishes the legal standard, which is whether the material financial distress of the firm could pose a threat to—

Mr. ROSS. And I think the lack of transparency there as to what designates a SIFI for the insurance companies is obviously an obstacle or a hurdle we are trying to overcome. But that also goes to the problem that we are having today when we are dealing with international standards. Now, Director McRaith, you said in your testimony that international standards are not themselves self-executing. I agree with that. We don't have to accept them. But by their very nature, are they not self-limiting? In other words, if we don't accept them, aren't our domestic carriers going to suffer at the table?

Mr. MCRAITH. There are three phases in the process: standard-setting; testing before implementation; and implementation. Our view is, right now we are in the early stages of development, Congressman, and the best thing we can do is work together to provide U.S. leadership in the international standard-setting.

Mr. ROSS. I appreciate that. And in that leadership—and, Mr. Sullivan, I will ask you this question. Any increase in the capital standards is going to ultimately lead to an increase in the product. Granted, I know that Commissioner Consedine talked about how that is going to tie up capital and keep from expanding and creating jobs. But ultimately, in order for these carriers to stay in business they are going to have to seek other recourse. Which is going to most likely be, if capital standards increase then the product price is going to have to increase. Wouldn't you agree?

Mr. SULLIVAN. I would agree, but we haven't reached a point to determine whether or not additional capital is required yet.

Mr. ROSS. I think that is important. And I think that is what I am getting at is that we have to be together, we have to deal from a position of strength here. We probably have the largest number of premiums out there, absent health insurance premiums, in the world economy. We have to go into these, and not just one person at the table who has an insurance background. But I think a concerted effort that what we have in place may not be the best system ever designed but it is working very well. And to that end, I would just ask Commissioner Consedine, what do you see as a hurdle in putting us at the table with the IAIS in trying to make sure that we are not just jammed with some capital standards that we are going to be left to take de facto if not by way of the rulemaking process?

Mr. CONSEDINE. Thank you, Representative. I think part of it, again, is putting together the team that we have. But the next step, and I think the more important step, that we are engaged in is putting the ideas together in some form that we can offer an alternative—

Mr. ROSS. I agree.

Mr. CONSEDINE. —to what is already being pushed by different parts of the world. We need a solid U.S.-based proposal. We are working on it. We will get there. But that is, to me, the turning point in this discussion.

Mr. ROSS. And, Senator, I just want to tell you, as a past boardmember of NCSL, and as a past member of NCOIL, I laud you for what you are doing. And I think the best impact we can have is at the State level to make sure that our constituencies understand the significance that when those rates go up—not because of an insurance commissioner, but because of an international standard—our methods of recourse are going to be severely limited.

With that, I will yield back.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Ohio, Mr. Stivers, is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you holding this hearing, and I appreciate all the witnesses for their time. Director McRaith, one of the things you said a minute ago was you talked about team USA and the only group at the table you left out are the legislators at NCOIL that, frankly, help, under the McCarran-Ferguson, set the rules of the road in our 50 States, and I guess I am curious how you are soliciting input from them. Because if we are going to indeed have an American approach here, team USA, we need everybody at the table. So what have you and the others, the Federal Reserve, done to reach out to the members of NCOIL to solicit their input?

Mr. MCRAITH. Let me start with the recognition that—as I think you are aware—before starting this job I was the State commissioner in Illinois. And it was a fantastic opportunity to work with people who cared about their constituents, as you well know, Congressman, from your days in the Ohio general assembly. My appreciation for Senator Breslin and his colleagues I expressed earlier. We have a member—as he repeated in his testimony—of the State

legislature on our advisory committee. We know that the legislators work closely with the NAIC and the State regulators, and we are absolutely open to continuing to build on our engagement with the State legislators.

Mr. STIVERS. Great. There was a recent study done by Robert Shapiro which indicated that there is no evidence that higher capital standards are needed for the solvency and operation of large U.S. insurance companies. In fact, they concluded that compared to banks, insurance companies have neither the size nor the interconnectedness to drive correlated losses that can pose any systemic risk. Is there anybody at the table of witnesses who is not familiar with that study? Have you used that study in your conversations with our international partners to help them understand that anything we would do on capital standards needs to really make sense? I think it is an important study, and there are findings there that can back up what the team USA position should be.

Mr. MCRAITH. Congressman, I think I heard about that study maybe less than an hour ago. And forgive me, I have not had a chance to read it.

Mr. STIVERS. Please review it. I will send it to all four of you. I really appreciate it. Have any of the rest of you had a chance to see it?

Mr. SULLIVAN. I have not.

Mr. STIVERS. Okay. I will get it to all of you, and I think it can be an important study in team USA's approach.

So the U.S. State system has always received high marks in the past in a number of areas, although the last report, which was a peer review done by FSB, suggests that more Federal involvement in insurance is necessary. Is there anybody who led a U.S. response to this last review of our U.S. insurance system, and what was that response?

Mr. CONSEDINE. Congressman, I will speak on behalf of the State insurance regulators, and we are currently going through our most recent FSAP review. But the last one that we did, I believe, about 5 years ago. I think we certainly responded, from a State perspective, that our view is that State insurance regulation doesn't necessarily require additional layers of Federal regulation.

As you said, we have a great track record, especially during the financial crisis. But more importantly, we do take the lessons learned from those reviews and apply them. We have, for the last 5 years, engaged in a modernization initiative to improve our system at a State level, and those improvements continue today.

Mr. STIVERS. Great. Director McRaith, or let me actually ask Mr. Sullivan. Are you familiar with Fed Governor Tarullo's comments during the Senate hearing in September when he said that traditional insurance does not pose a systemic risk?

Mr. SULLIVAN. Yes.

Mr. STIVERS. Okay. And do you agree with those comments?

Mr. SULLIVAN. I support Governor Tarullo's comments, yes.

Mr. STIVERS. If so, how does the Fed justify imposing discriminatory standards against insurance affiliates of U.S. insurance holding companies it regulates if the Dodd-Frank Act, Collins Amendment is fixed along the lines of the House- and Senate-passed legislation, will the Fed use U.S. insurance standards for companies

under your jurisdiction? Or to what extent are you considering applying a version of the international standard that would otherwise be adopted in the United States?

Mr. SULLIVAN. I am not sure on your question. But Governor Tarullo also said we would like relief under Collins and we would like to be able to tailor our standards to the business model of insurance, which I also support.

Mr. STIVERS. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from New Jersey, Mr. Garrett, is recognized for 5 minutes.

Mr. GARRETT. Thank you. Let's just follow up on that really quick, then. Do you have the discretionary authority right now without the passage of that amendment?

Mr. SULLIVAN. Governor Tarullo will talk about very limited authority, or limited flexibility.

Mr. GARRETT. Right.

Mr. SULLIVAN. Outside of Collins.

Mr. GARRETT. Why I asked that is because earlier in your testimony, you seemed to indicate that you were going to be flexible as far as applying them, when the question was with regard to capital standards and other standards regulatory requirements. Earlier, it sounded like you had the flexibility, and now—did I hear wrong before?

Mr. SULLIVAN. I would not say that it is unlimited flexibility, Congressman. I think there are some opportunities to distinguish between the assets held by an insurer versus a bank, but I am not sure how much lift there would be there.

Mr. GARRETT. Right. So going forward, you do not have the authority that you would need to have in order to provide the flexibility to this, correct?

Mr. SULLIVAN. Correct. We would like more flexibility—

Mr. GARRETT. Right. And so making the designations without that authority means that you—and without the passage of the change of the law means you are going to impose standards that are not applicable and not appropriate for them. Is that correct?

Mr. SULLIVAN. We have to abide by the law.

Mr. GARRETT. Right. And you are saying that you don't have the authority to do the correct thing with the correct amount of flexibility. So if it is not the standards that are correct, then they would be incorrect standards that you would be applying. Otherwise, you wouldn't need the flexibility, right?

Mr. SULLIVAN. We would prefer the flexibility.

Mr. GARRETT. So you are going to be imposing standards that are not appropriate.

The whole panel, whole discussion, seems to have been focused on the issue of transparency, or 90 percent of it. And certainly with regard to the Fed, their level of transparency is something that some of you may know I have questioned in the past, in general. I could just run down one. One is when the Fed issues regulations right now, outside of this area, there is no cost-benefit analysis being done, as we have recalled, that is also required over at the SEC, the CFTC, or almost any other Federal agency. And I have always wondered why the Fed doesn't do it there. I guess I will get

back to the question of seeing whether or not cost-benefit analysis is part of the discussion when you engage on the international front.

Second, at the Fed, the fact that it has been tailored down to the rulemaking process and what has been driven by a single Fed Governor, which I think is—and consolidated in a manner that is overly concentrated I think is problematic in transparency.

And third, in the whole area outside of this area in stress testing of the financial institutions and banks and what have you is—a lot of critics have said is highly secretive and gives way too much discretion without going through the normal administrative notice and comment process.

And that is not me making those comments. It was the president of the Federal Reserve Bank in Kansas City who called for more transparency in what has been called an opaque testing process. So we see that the Fed comes into this realm with a questionable and checkered past with regard to transparency. And so that is why I am wondering, Mr. Consedine and Senator Breslin, whether you feel that is an entity that we should be confident in going forward, and relying on transparency considering their past track record. Senator?

Mr. BRESLIN. I have made the general comment throughout that each of the Federal agencies aren't sufficiently transparent to satisfy State legislators in their role of supervising insurance in the States. And unless and until there is that participation by State legislatures, they will continue to make mistakes in doing so without that degree of transparency.

Mr. GARRETT. Mr. Consedine, can you add anything else?

Mr. CONSEDINE. Thank you, Congressman. Again, in the sort of limited context of our world and insurance regulation, I can attest to the Fed's outreach efforts at this point on some of the issues that we have been talking about today. In the area of consolidated supervision, where they, in fact, are the consolidated supervisor for a number of large insurance companies or thrifts—

Mr. GARRETT. Is your State different from—you said you are one of the top 20 in the States. Is your State's and your interests different from the other States? Do we need you there anymore if the Fed is able to do this going forward? Are all 50 States and their departments so similar that there is not something unique about Pennsylvania and New Jersey and elsewhere?

Mr. CONSEDINE. No. I would like to think you absolutely need us. We are—

Mr. GARRETT. Well, not if, at the end of the day, they get your input and they get the input from the other 49 States, and they make a decision that is adverse to your State.

Mr. CONSEDINE. And, again, the Fed only regulates a small segment of the insurance marketplace.

Mr. GARRETT. So for that small a segment, you are willing to abrogate your authority and sovereignty in that area?

Mr. CONSEDINE. Absolutely not, and that is part—

Mr. GARRETT. Okay, so there is something unique and special about Pennsylvania that maybe—that you are there defending.

Mr. CONSEDINE. I am speaking on behalf of Pennsylvania, but also the NAIC. And, again, we work with the Fed. But we have not,

nor will we ever, abrogate our responsibilities to our consumers in our State markets as part of a—

Mr. GARRETT. But then, at the end of the day the law allows them to abrogate that—allows them to supplant that authority, right?

Mr. CONSEDINE. We haven't seen that to date. Again, at a legal entity insurance company level, we are still the regulators.

Mr. GARRETT. Okay. And, Mr. McRaith, you were saying earlier that as far as to the question that SIFI designation, that it is clear as far as the process, as far as that is in statute I think is the word you said, correct?

Mr. MCRAITH. I recited the legal standards in the statute, yes.

Mr. GARRETT. Yes. Is it really that clear? Because it is—I haven't even been able to find that standard in the statute, and I don't think that the players were able to find that in this statute. I thought that there actually is broad discretion and that is the reason that there is not transparency in that area. But you are able to actually cite the statute where it actually says that they make this determination for these SIFIs?

Mr. MCRAITH. I cited—I don't want to cite the entire statute because I can't do that.

Mr. GARRETT. Yes.

Mr. MCRAITH. But I can tell you that the legal standard is what I cited earlier. But remember, the council is governed by the statute and the considerations and factors in the statute. And it also has a rule and guidance that have been published following three public consultation periods. So all of that is clear and based on feedback from interested parties.

Mr. GARRETT. Interesting.

I yield back my time.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Michigan, who has sponsored resolutions on the transparency of the IAIS, Mr. Huizenga, is recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate the opportunity to sit in. And yes, in fact, I have sponsored House Resolution 735, along with my colleague across the aisle, Greg Meeks from New York. And a similar resolution expressing the sense of the Senate being very concerned with this has been introduced by Senators Heller and Tester.

It just seems to me that as we are moving forward, or as I should say IAIS is moving forward with eliminating this observer status, the question is, as I am understanding Mr. Sullivan and others, that somehow being there as observers is going to influence and damage the independence of the IAIS.

Congress is very transparent, we are very transparent. To my colleagues from the States, I served in the State legislature, as well, in Michigan. Extremely transparent. There are cameras here that are all transparent. It doesn't mean we are not independent. It doesn't mean that we somehow are going to bend to the will of the Administration. Talk to our colleagues on the other side. They are very concerned about that sometimes, right? So it seems to me that these are being conflated. And I am especially concerned, Director McRaith, that Roy Woodall—he is the insurance voting

member of FSOC, an insurance position that we created specifically as to matters dealing with systemic risk—asked to be invited to sit in on some recent IAIS systemic risk meetings but was turned down.

You may recall that at the subcommittee's hearing earlier this year there was a bipartisan support for the FSOC's insurance member attending these meetings, IAIS. And I understand you are on the IAIS executive committee. That is correct? Yes, you are—he is nodding. So can you tell us why this FSOC member was turned down, or turned away, and not invited?

Mr. MCRAITH. Congressman, the transparency of the IAIS as proposed eliminates the fee. So that any stakeholder, whether it is Roy Woodall or anybody else, can attend meetings—starting January 1st, will be able to attend meetings, access information on the Web site, and obtain material relating to important matters without having to pay the fee. That is the issue of the pay-to-play that we were looking—

Mr. HUIZENGA. So Mr. Woodall is going to be able to go into all these meetings.

Mr. MCRAITH. The same meetings that he would have been able to attend as an observer.

Mr. HUIZENGA. All right. And as our representative—because it is my understanding that, as a result, the observer members will no longer be able to attend or participate in the meetings unless a specific non-member group is invited to attend as a guest. Am I wrong, then, or is that contrary to what you are saying?

Mr. MCRAITH. It is wrong in the sense—and forgive me for correcting you—that it is a statement of policy that is an improvement over the prior policy. So now, the—

Mr. HUIZENGA. Oh, you may think it is an improvement, but there are a whole bunch of other people who don't think it is an improvement. But continue, please.

Mr. MCRAITH. The problem—the difference now is that individuals who were observers and had to pay $20,000 no longer have to pay that fee. They will have the same access to the same meetings, and more access to other information without paying—

Mr. HUIZENGA. So why are people opposed to this? If they are going to save $20,000, why are they opposed to i? Or is that the question you are asking?

Mr. MCRAITH. I would also add, the process is still under development. So just yesterday, the consultation process was released for a second consultation. So those who are interested in its outcome still have another opportunity to provide ideas.

Mr. HUIZENGA. So why would they put this in place without having this process, that you have cut off the highway before you have built the off ramp? There is no off ramp or on ramp to have these people participating. You have just said they can no longer come in. Mr. Woodall was denied being able to come in to the meetings. But don't worry, we are going to get you back in once we develop this process. That, to me, just flies in the face of the whole idea of transparency. So I am assuming, then, that if you will be making sure that he is able to get into these meetings. If not, will you assure me and the rest of this body that you will be working on making sure he is invited by IAIS?

Mr. MCRAITH. What I have committed to members of the observer community is that we, the Federal Insurance Office, need to ensure that stakeholders are able to engage in a substantive and meaningful way at the IAIS. The current proposal improves upon the prior process, among other things because they don't have to pay a fee. But also, as I mentioned earlier, Congressman, in the United States we need to give opportunities for stakeholders to meet with all of the IAIS participants at one time. And we are committed to doing that, as well.

Mr. HUIZENGA. I still stand by my resolution. But thank you, Mr. Chairman, I appreciate the opportunity.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Thank you. Let me comment that the U.S. system for regulating insurance companies did well in the greatest stress test I could have imagined, which is 2008. The system survived. And even those regulated insurance subsidiaries of AIG, a parent company that was not well-run, those entities that were under State insurance regulation survived quite well and have even returned AIG to something approaching profitability.

I happened to be the lead Democrat on the Policyholder Protection Act, which is designed to make sure that policyholders and the regulated insurance companies are not viewed as cash to be devoured if a related bank or depository institution is in trouble. And specifically, would ensure that Bank Holding Company Act provisions are extended to thrift holding companies to ensure that funds that are dedicated to policyholder claims are not used to support a failing bank.

Mr. Sullivan, what is the Fed doing in its oversight of insurance companies that are also—that are thrift holding companies to ensure that policyholders are protected and their funds are not used as a source to protect the insured depository institution?

Mr. SULLIVAN. Thank you, Representative Sherman. Our role is that of the consolidated supervisor, and we are working in conjunction with our colleagues at the NAIC and the individual States who have dominion over that particular insurer to make sure that our efforts to supervise the entirety of the firm, and look at it across the enterprise, look at its risk management, its governance and the rest of its structure, while complimenting the work that the States are doing from the supervision of the legal entities. And in that work, we look at the safety and the soundness and the source of strength of the entire enterprise and whether or not the parent can support the insured depository institution. So we are not—

Mr. SHERMAN. So are you moving toward a system in which the assets of the insurance corporation, often a subsidiary of a holding company, that those assets are available for the policyholders and cannot be tapped in order to reduce the cost to the FDIC or in other ways—otherwise deal with the problems of a troubled depository institution?

Mr. SULLIVAN. We are not moving in that direction. I doubt Commissioner Consedine or any of his colleagues would allow us to get our hands on those assets. So we are looking, as I—

Mr. SHERMAN. So you are moving in the direction of not—of providing rules so that policyholders could be confident that you are not going to get your hands on those assets.

Mr. SULLIVAN. That is correct. We are looking at the totality of the enterprise.

Mr. SHERMAN. Thank you. I have also cosponsored legislation designed to make sure that when we look at the capital standards of insurance companies that we clarify that we are using capital standards measures appropriate to insurance companies, not just graft on bank standards.

How certain are we that when we—that we will continue to use insurance standards for evaluating insurance companies? I will ask Mr. Sullivan, but also others on the panel to comment.

Mr. SULLIVAN. I guess I would say, Representative, is I am living proof of that by virtue what the Fed has done in terms of bringing me on board and the rest of the insurance talent that we continue to add to the Federal Reserve. We continue to build our knowledge base and our expertise around supervising insurance companies.

As you may or may not know, I was previously an insurance commissioner and a member of the NAIC. And I have nearly 30 years in this industry. So I think that should be a comforting sign to you and to others that the Fed is serious about understanding the business of insurance, making sure—I used the word earlier—"tailoring" our approach to how we supervise these institutions.

Mr. SHERMAN. Does any other panelist have a comment?

Mr. CONSEDINE. Congressman, I would just add I think we have heard already today though that when it comes to the issue of giving the Fed the additional flexibility it needs to design capital standards that are tailored, truly, to insurance company we do need the action of this Congress. And we support that.

Mr. SHERMAN. Thank you.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman. Without objection, I would like to submit for the record testimony from the American Academy of Actuaries, the National Association of Mutual Insurance Companies, the Property Casualty Insurers Associations of America, and a study by Robert Shapiro and Aparna Mathur that was referred to by one of the other Members.

Without objection, it is so ordered.

I would like to thank each member of the panel for being here today. I would say that I hope what you heard from both sides of the aisle here is, we want transparency. I think the American people deserve that transparency, and I think the industry deserves that transparency. We want you to be working together and representing a team USA, and a unified voice is you bringing forth your perspective on that.

I think one of the things that is a hope also that you heard is that we are pretty proud of the regulatory structure that was already in place today, and which I think has proven to be very resilient. As Commissioner Sherman mentioned, it went through, I think, what would be the ultimate stress test and did quite well.

And so we are not ready to give up a lot of ground. Why this is important, it is not necessarily—we are not talking about the companies and policies, but what we are really talking about is the pol-

icyholders. American families all across this country enjoy some of the best insurance products in the world. And they enjoy them at a nice price. Now, some people think they may be a little bit overpriced. But what we don't want to do is inject regulation where regulation is not needed, which ultimately drives up the cost of those products or even limits the availability of some of those products because of actions that were taken.

So it is a delicate balance. But I think what you heard from everybody is, we are watching and we want to see some action. We heard a lot of talk today, but we would like to see some action.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, thank you for coming, and this committee is adjourned.

[Whereupon, at 3:41 p.m., the hearing was adjourned.]

A P P E N D I X

November 18, 2014

WRITTEN STATEMENT OF
THE HONORABLE NEIL BRESLIN, NEW YORK STATE SENATE

Ranking Member, NYS Senate Insurance Committee
President, National Conference of Insurance Legislators (NCOIL)
Chair, NCOIL International Issues Task Force

"THE IMPACT OF INTERNATIONAL REGULATORY STANDARDS
ON THE COMPETITIVENESS OF U.S. INSURERS, PART II"

SUBCOMMITTEE ON HOUSING AND INSURANCE,
COMMITTEE ON FINANCIAL SERVICES,
U.S. HOUSE OF REPRESENTATIVES

NOVEMBER 18, 2014

Good afternoon Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee. Thank you for inviting me to testify regarding international regulatory standards and their impacts on U.S. insurance regulation. My name is Neil Breslin, NYS Senator and President of the National Conference of Insurance Legislators (NCOIL).

It is clear that U.S. insurance regulation is confronting historic challenges. Our more than 150 years of effective oversight—which strikes a balance between the needs of consumers and the importance of healthy and competitive markets—is under pressure from international officials whom NCOIL believes may not understand or appreciate what state regulation does so well. Our system, which came through the financial crisis well, is being second-guessed by officials from countries that had a far different experience.

My colleagues at NCOIL and I believe strongly that global insurance discussions must be open and allow for broad comment during development of proposed standards, must "do no harm" to state regulation, and absolutely must include a vehicle for state legislators, as well as regulators, to weigh in.

Transparency and Accountability

Transparency and open deliberations are a foundation of the U.S. state legislative process and likewise are critical if state lawmakers, who enact the laws regulating insurance in this country, are to have confidence in the regulation they are asked to consider—including rules that emanate from overseas. It is a fundamental NCOIL belief that openness and transparency are critical in any and all international dialogues affecting the U.S. system—and we assert that state legislators should not be asked to accept, and would be hard-pressed to support, proposals that have not been developed based on those standards. Failure to allow for due process and to require accountability can have negative consequences for insurers large and small and for the consumers who rely on them.

We are dismayed by discussions outside the U.S. that do not parallel our guiding principles. In particular, we have expressed concern that the International Association of Insurance Supervisors (IAIS), while most likely well-meaning in its efforts to develop global insurance standards, has pursued a path that limits access to IAIS deliberations and makes it more difficult for interested parties to comment. The growing urgency of IAIS initiatives—particularly regarding capital standards, group supervision, and corporate governance—demands a more, not less open approach.

Cooperation and Coordination

It is critically important that those who represent the U.S. overseas stand together when it comes to any proposal affecting U.S. insurers and ultimately consumers, and there must be clear understanding that insurance companies do not operate like banks and that bank-centric proposals would make it more difficult for U.S. companies. Regulation that works in the banking industry may be entirely inappropriate for insurance.

NCOIL, through an NCOIL International Issues Task Force that I have the honor of chairing, is working with the National Association of Insurance Commissioners (NAIC) and with other advocates of state oversight to ensure that federal entities—particularly those involved at the IAIS and at the Financial Stability Board (FSB)—stand up for the U.S. system and challenge any attempt to disregard its principles. As you can see by our numerous appendices, we have reached out to the FIO, the Department of Treasury, the SEC, and the Federal Reserve—as well as to the IAIS, the FSB, and others. We have pressed for coordination and cooperation, for open dialogue, and for a better understanding of the U.S. system. We also are committed to ensuring that there is a meaningful mechanism for state legislators—who are in direct contact with the consumers who are the ultimate winners and losers in dialogues over insurance regulation—to share the legislative perspective.

Role of State Legislators

The absence of a legislative voice in international discussions may present an inadvertent danger to effective U.S. insurance markets, which represent one-third of the global insurance industry, and to the consumers and businesses they serve. There needs to be a formal way for state lawmakers to participate and, though we appreciate expressions of interest in working with state legislators, we look for a more official role.

In that regard, we are pleased that the FIO recently included, for the first time, a legislator on its Federal Advisory Committee on Insurance (FACI)—a decision that NCOIL urged in 2011 when FACI first came into being—and in particular that Rep. George Keiser, a North Dakota state legislator and past NCOIL president—was the legislator chosen for membership. As some in this room may know, NCOIL has been concerned that as created under the Dodd-Frank Act, the FIO is subject to "mission creep" both domestically and internationally, and so at this unprecedented time in insurance regulation, we especially welcome a legislative seat at the table.

Conclusion

I am here to say that while state regulation is not perfect, state legislators and regulators are always working to enhance areas where reform is needed, and NCOIL and the NAIC have worked together over the years to effect such change. The U.S. has a long history of protecting consumers and promoting strong markets—in both good and trying financial times—and there is real harm in international insurance discussions that would unravel a U.S. system that may be different from other insurance regulation around the world—but that works. My colleagues and I at NCOIL are committed to ensuring that state-based regulatory mechanisms are not compromised, and we look forward to working with you toward that end.

Thank you again for the opportunity to speak.

APPENDICES FOLLOWING:

1. NCOIL *Resolution Regarding Guiding Principles for U.S. and International Insurance Regulatory Discussions* (July 13, 2014)
2. NCOIL *Resolution Regarding the States' Response to International Proposals for Insurer Solvency Regulation & a Global Insurance Capital Standard (ICS)* (July 13, 2014)
3. NCOIL *Resolution Concerning Principles of State Sovereignty in International Trade* (July 13, 2014)
4. NCOIL letters to federal and international officials regarding need for a legislative voice in international insurance discussions (July 21, 2014)
5. NCOIL letter to U.S. House Financial Services Committee in support of H.R. 4510, the *Insurance Capital Standards Clarification Act* (July 29, 2014)
6. NCOIL comments to IAIS regarding IAIS proposal to close meetings, limit interested-party input (September 2, 2014)
7. NCOIL letters to Congress in support of H. Res. 735/S. Res. 561 regarding IAIS openness and transparency (October 14/16, 2014)

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NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)

Resolution Regarding Guiding Principles for U.S. and International Insurance Regulatory Discussions

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Adopted by the NCOIL Executive Committee on July 13, 2014, and by the NCOIL International Insurance Issues Task Force on July 10, 2014. Sponsored by Sen. Jason Rapert (AR), chair of the Task Force's Coordination & Transparency Working Group

WHEREAS, U.S. federal entities, including the Department of Treasury, Federal Insurance Office (FIO), and Federal Reserve Board are pursuing initiatives, individually and/or through interactions with key international organizations, that could affect how U.S. insurers operate in this country and elsewhere; and

WHEREAS, developments at the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) have the potential to directly impact U.S. insurance regulation and insurers and, as a result, U.S. consumers; and

WHEREAS, state regulation successfully has fostered robust, competitive markets that have served consumers well for more than 150 years, in both good and trying financial times, and represents one-third of the insurance market worldwide; and

WHEREAS, the state insurance regulatory system in the U.S. is transparent and open to all stakeholders, is accountable to the public, and is governed by the rule of law; and

WHEREAS, the National Conference of Insurance Legislators (NCOIL), an organization of state legislators dedicated to the proper regulation of U.S. insurance markets, recognizes the importance of transparent dialogue and cooperation between stakeholders involved in and affected by the oversight of insurance in the states and internationally; and

WHEREAS, transparency and open deliberations are a foundation of the U.S. state legislative process and likewise are critical if state lawmakers, who enact the laws regulating insurance in this country, are to have confidence in the proposed insurance regulation they are asked to consider, including regulation that emanates from international initiatives; and

WHEREAS, working with state insurance regulators and other state officials, as well as with consumer and industry representatives, NCOIL legislators through their International Issues Task Force are moving to ensure that efforts here and abroad, though well-meaning, do not endanger protections afforded under state-based insurance regulation; and

WHEREAS, there currently is no meaningful avenue in current international dialogues for state legislators to weigh in.

WHEREAS, failure to include and respect the voice of state legislators and regulators in development of federal and global proposals regarding insurance could have far-reaching, troubling consequences for U.S. markets; and

NOW, THEREFORE, BE IT RESOLVED that NCOIL calls for creation of a meaningful mechanism so that state legislators and insurance regulators can effectively participate in international discussions affecting insurance.

BE IT RESOLVED that NCOIL strongly believes that any international initiatives impacting state insurance regulation should be guided by a need for due process and transparency.

BE IT RESOLVED that NCOIL is committed to engaging with federal and global officials in the months and years to come and will further its collaborations at the state level and with other key parties.

BE IT FINALLY RESOLVED that a copy of this resolution be sent to state legislators and regulators, to Congressional leadership, to the Financial Stability Board and the International Association of Insurance Supervisors, and to the Consumer Financial Protection Bureau, Department of Treasury, Federal Insurance Office, and Federal Reserve Board.

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NATIONAL CONFERENCE OF INSURANCE LEGISLATORS

Resolution Regarding the States' Response to International Proposals for Insurer Solvency Regulation and a Global Insurance Capital Standard (ICS)

Adopted by the NCOIL Executive Committee on July 13, 2014, and by the International Issues Task Force on July 10, 2014, and amended on July 11, 2014. Sponsored by Sen. James Seward (NY), chair of the Task Force's Capital Standards Working Group

Whereas, the Financial Stability Board (FSB) has directed the International Association of Insurance Supervisors (IAIS) to establish a quantitative insurance capital standard (ICS) for Internationally Active Insurance Groups (IAIGs), including a number of U.S. companies, and

Whereas, the FSB also issued a "peer review" critical of the U.S. insurance regulatory system (specifically focusing on group-wide supervision) despite the fact that our system aligns with the insurance business model and has well served markets and consumers for over a century, and proved resilient during the global financial crisis, and

Whereas, the IAIS has agreed to follow the FSB instructions to develop the ICS according to an unrealistic timeframe, and

Whereas, the IAIS and the FSB are private associations of financial service regulators without legal authority beyond their individual, respective jurisdictions, and

Whereas, those private associations lack independent accountability to elected legislatures, and

Whereas, the original FSB mandate and development of international insurance regulatory standards are being conducted in a manner that does not provide the level of opportunity for open public comment and deliberation that are due process hallmarks of law and rulemaking in the United States, and

Whereas, some global standards for solvency regulation and accounting may conflict with existing regulation and standards within the United States and the individual states, and

Whereas, the National Association of Insurance Commissioners (NAIC) Model Holding Company Act allows state insurance regulators to participate in and even lead global supervisory colleges without surrendering the domestic regulator's authority, and

Whereas, a group capital requirement may erode policyholder protection, and

Whereas, the U.S. state insurance legislatures and regulators responsible for establishing, implementing and overseeing standards for solvency regulation and policyholder protection may find that the IAIS ICS requirements, once identified, are misplaced, unnecessary and duplicative, and

Whereas, as systemic risk to the financial system and solvency risk to insurers arises from causes other than insufficient capital, the ICS focus on capital requirements is only a partial approach to preventing financial crises and prudential regulation of insurers, and

Whereas, a one-size-fits-all global ICS would fail to adequately recognize jurisdictional differences such as different accounting standards throughout the world, specifically in the United States the effective and state-required use of Statutory Accounting Principles, or significant and complex differences in risk and capital needs from one insurance group to another, and

Whereas, unlike the other approaches to solvency regulation, the United States system of solvency regulation and insurance regulatory principles are focused on policyholder protection, including guaranty funds, not on investors, creditors or other stakeholders.

THEREFORE, BE IT RESOLVED the National Conference of Insurance Legislators calls upon the NAIC, the U.S. representatives to the Financial Stability Board (FSB), and the Federal Insurance Office (FIO) to oppose the creation of any additional set of international solvency standards, including a global ICS, that fails to adequately and appropriately accommodate the proven US approach to insurer solvency regulation;

AND, BE IT RESOLVED the National Conference of Insurance Legislators opposes mandating the Fair Value measurements and market consistent valuation methodologies favored by the IAIS and encourages the NAIC, the FSB, and the FIO to likewise oppose;

AND, BE IT ALSO RESOLVED the National Conference of Insurance Legislators coordinate with U.S. state insurance regulators and federal agencies to formulate a unified U.S. position that is consistent with the policies and laws of the states on global insurance capital standards for the benefit of policyholder protection and to further the competitiveness of the U.S. insurance industry;

AND, BE IT ALSO RESOLVED the National Conference of Insurance Legislators encourages all state legislatures to support our state-based system of insurance regulation by enacting resolutions similar to this one;

AND, BE IT ALSO RESOLVED the National Conference of Insurance Legislators urges the states' governors and Congressional delegations to write letters and to otherwise communicate these concerns to US representatives on the FSB, including the Secretary of the Treasury, the chair of the Board of Directors of the Federal Reserve and the chair of the Securities and Exchange Commission;

AND, BE IT FURTHER RESOLVED that a copy of this Resolution be sent to each state legislature, each state insurance regulator, the NAIC, the FIO, the FSB, the IAIS, the US Department of the Treasury, the Board of Governors of the Federal Reserve System, the SEC, and to members of Congress to encourage coordination among these parties in the formulation and articulation of U.S. policy on global insurance capital standards.

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NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)

Resolution Concerning Principles of State Sovereignty in International Trade

Adopted by the NCOIL Executive Committee on July 13, 2014, and by the International Issues Task Force on July 10, 2014. Sponsored by Rep. Kathleen Keenan (VT), chair of the Trade Agreement Working Group

WHEREAS, a history of free trade agreements, including the North American Free Trade Agreement (NAFTA), the Central American Free Trade Agreement (CAFTA), and numerous bilateral free trade agreements have resulted in enormous economic and legal impacts on the states; and

WHEREAS, the United States, through the U.S. Trade Representative (USTR), is currently in the process of negotiating two broad multilateral agreements, the Trans-Atlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP), as well as a Trade in Services Agreement (TISA); and

WHEREAS, ongoing negotiations regarding TTIP, TPP, and TISA need more transparency, accountability to elected officials and regulators, and mechanisms for serious consultation with the states; and

WHEREAS, conflict resolution provisions of international trade agreements have significant implications for state sovereignty and raise concerns regarding open debate and potential cost burdens for the states; and

WHEREAS, these negotiations are being conducted in a manner that does not provide the opportunity for an appropriate degree of public debate and deliberation in relation to the size and importance of the proposed agreements; and

WHEREAS, extreme caution is needed in international trade negotiations to avoid preempting state-level decisions with regard to the regulation of insurance and reinsurance; and

WHEREAS, it is appropriate and necessary that state legislators make clear the principles for which they stand on matters of sovereignty, transparency, due process, and the preservation of an historically effective system of regulation that has endured numerous challenges including the 2008 financial crisis.

WHEREAS, the voice of state legislators is largely unheard in the context of international trade despite the consequences borne by states as a result of previous international trade agreements; and

WHEREAS, NCOIL has, on a number of occasions, urged the USTR to expand state legislative participation on the Intergovernmental Policy Advisory Committee (IGPAC), but to date the USTR has not done so;

WHEREAS, the National Association of Insurance Commissioners, representing state insurance regulators, and the Federal Insurance Office (FIO) have venues through which they can input into international trade activity; and

NOW, THEREFORE, BE IT RESOLVED that the National Conference of Insurance Legislators supports expanded and continuous involvement by the states, through their elected legislative and other representatives, in all ongoing and future international trade agreement negotiations.

AND, BE IT RESOLVED that federal-state consultation should include the timely and comprehensive sharing of information on the substance and likely impact of trade agreements on state laws and regulations; appropriate use of state single points of contact (SPOCs); and a reasonable opportunity for meaningful input by the states;

AND, BE IT ALSO RESOLVED that the National Conference of Insurance Legislators opposes preemption of non-discriminatory state laws and regulations adopted for a public purpose and with due process by "no more burdensome than necessary" and similar standards.

AND, BE IT ALSO RESOLVED that the National Conference of Insurance Legislators supports according state regulations presumptive validity under any international trade agreement;

AND, BE IT ALSO RESOLVED that the National Conference of Insurance Legislators opposes any provision of an international trade agreement that grants greater substantive or procedural rights to foreign investors than to citizens and domestic businesses;

AND, BE IT ALSO RESOLVED that the National Conference of Insurance Legislators supports international trade conflict resolution proceedings that apply due process principles to affected states, including open hearings, state access to documents, and an opportunity for state governments to participate in the proceedings;

AND, BE IT FURTHER RESOLVED that a copy of this resolution will be sent to each state legislature, each state insurance regulator, the National Association of Insurance Commissioners, the U.S. Trade Representative, the U.S. Department of Commerce, the U.S. Department of State, and members of Congress.

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PRESIDENT: Sen. Neil Breslin, NY
PRESIDENT-ELECT: *Vacant*
VICE PRESIDENT: Sen. Travis Holdman, IN
SECRETARY: Rep. Steve Riggs, KY
TREASURER: Sen. Jason Rapert, AR

(LETTER SENT TO THE FIO, U.S. DEPT. OF TREASURY, SEC, AND FEDERAL RESERVE SYSTEM BOARD OF GOVERNORS)

VIA E-MAIL

July 21, 2014

Honorable Michael T. McRaith
Director, Federal Insurance Office
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220-0002

Dear Director McRaith:

I write as President of the National Conference of Insurance Legislators (NCOIL), an organization of state lawmakers dedicated to the proper regulation of U.S. insurance markets, to express NCOIL's strong interest in working with you in the months and years to come, in light of the critical role that state legislators can and should play in international efforts affecting insurance.

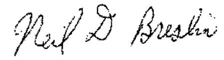
As we move forward in a smaller, increasingly interconnected world, we believe it is incumbent upon federal agencies to recognize the importance of state-based insurance regulation and the legislative voice that NCOIL provides. State legislators who debate and enact the insurance laws in this country—including those emanating from overseas initiatives—must have a part in international efforts in order to be confident that the proposals legislators are asked to adopt are in the best interests of their constituents. The absence of a legislative voice in international discussions may present an inadvertent danger to effective U.S. insurance markets, which represent one-third of the global insurance industry, and to the consumers and businesses they serve.

As insurance legislators we work with regulators constantly to shape our markets so they best respond to today's complex insurance environment. The recent financial crisis was a further cause to step back and reevaluate what works well and what might be enhanced in insurance regulation both here and around the world. We are looking today to make certain that current international endeavors are not a solution in search of a problem and do not negatively impact the successful U.S. approach.

Through a recently created NCOIL International Issues Task Force, NCOIL is strengthening its collaborations with state insurance regulators and other officials as well as with consumer and insurer representatives to ensure that U.S. consumers remain well-protected. We look forward to dialoging—through more formalized channels than now exist—with you also.

Should you have questions or wish to discuss future outreach, please feel free to contact Susan Nolan, NCOIL Executive Director, in the NCOIL National Office at snolan@ncoil.org or 518-687-0178.

Sincerely,



Sen. Neil Breslin (NY)
NCOIL President

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PRESIDENT: Sen. Neil Breslin, NY
PRESIDENT-ELECT: *Vacant*
VICE PRESIDENT: Sen. Travis Holdman, IN
SECRETARY: Rep. Steve Riggs, KY
TREASURER: Sen. Jason Rapert, AR

(LETTER SENT TO THE IAIS AND THE FINANCIAL STABILITY BOARD)

VIA E-MAIL

July 21, 2014

The Honorable Yoshihiro Kawai
Secretary General
International Association of Insurance Supervisors
c/o Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Secretary General:

I write as President of the National Conference of Insurance Legislators (NCOIL), an organization of state lawmakers dedicated to the proper regulation of U.S. insurance markets, to express NCOIL's strong interest in working with you in the months and years to come, in light of the critical role that state legislators can and should play in international efforts affecting insurance.

As we move forward in a smaller, increasingly interconnected world, we believe it is incumbent upon international organizations to recognize the importance of state-based insurance regulation and the legislative voice that NCOIL provides. State legislators who debate and enact the insurance laws in this country—including those emanating from overseas initiatives—must have a part in international efforts in order to be confident that the proposals legislators are asked to adopt are in the best interests of their constituents. The absence of a legislative voice in international discussions may present an inadvertent danger to effective U.S. insurance markets, which represent one-third of the global insurance industry, and to the consumers and businesses they serve.

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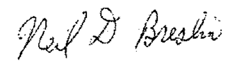

Sen. Neil Breslin (NY)
NCOIL President

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PRESIDENT: Sen. Neil Breslin, NY
PRESIDENT-ELECT: *Vacant*
VICE PRESIDENT: Sen. Travis Holdman, IN
SECRETARY: Rep. Steve Riggs, KY
TREASURER: Sen. Jason Rapert, AR

VIA E-MAIL

July 29, 2014

The Honorable Jeb Hensarling
Chair, Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling:

As President of the National Conference of Insurance Legislators (NCOIL), I write to express NCOIL support for H.R. 4510, the *Insurance Capital Standards Clarification Act*, legislation that seeks to ensure that capital standards that insurers are required to meet are appropriate for the industry.

As an organization of state lawmakers dedicated to the proper regulation of U.S. insurance markets, we have expressed our concerns through resolution and letters to Congress and others that application of bank-like capital standards to insurance companies would harm policyholders and businesses alike. H.R. 4510 would address this concern and mitigate the imposition of "one size fits all" bank-centric standards to insurers. It would make clear in current law that insurers should be held to capital rules that acknowledge the inherent, critical differences between how insurers and banks operate.

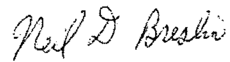
H.R. 4510 would not relax capital standards for any insurer or bank. Insurance companies under H.R. 4510 would still abide by the strict capital rules mandated under state insurance regulation, which have protected insurance consumers and businesses for more than 150 years. State regulation recognizes that insurers have long-term liabilities, while banks have short-term liabilities and need to cover a depositor run.

The legislation is a commonsense approach that would remove any confusion regarding the original intent of Section 171 of Dodd-Frank. Senator Susan Collins (ME) has testified that imposing bank capital rules on insurers had not been her intent when writing Section 171. Senator Collins has introduced Senate companion legislation that easily passed that chamber. H.R. 4510 also enjoys broad support among both Republicans and Democrats in the House and Senate, and insurance regulators and industry experts.

NCOIL believes that regulation of insurance companies should be strong and fair. We continue to urge Congress, as well as federal and state entities in international dialogues, to acknowledge the success of state-based insurance regulation. H.R. 4510 would accomplish that
goal by allowing the Federal Reserve the flexibility to apply capital standards that are appropriate to the insurance industry.

Please feel free to contact Susan Nolan, NCOIL Executive Director, in the NCOIL National Office at snolan@ncoil.org or 518-687-0178 should you have any questions. Thank you for your attention.

Sincerely,



Sen. Neil Breslin (NY), NCOIL President

cc: The Honorable John Boehner
Members of the Financial Services Committee

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NCOIL Comments to International Association of Insurance Supervisors (IAIS) on Proposal re: IAIS Meeting Participation & Consultation with Stakeholders

(submitted on September 2, 2014)

The National Conference of Insurance Legislators (NCOIL)—an organization of state legislators who chair and are guiding forces in the committees responsible for introducing, debating, and endorsing insurance laws in each U.S. statehouse—appreciates the opportunity to comment on the IAIS *Draft Procedures on Meeting Participation and the Development of Supervisory and Supporting Material and Draft Policy for Consultation of Stakeholders*. While we recognize the increasing role that the IAIS is playing in international discussions and understand IAIS interest in promoting efficiency, we would like to stress certain practices that need to be observed regarding the approach that IAIS may take.

NCOIL believes that openness and transparency are a requirement in any and all international dialogues that would impact the successful U.S. regulatory system and continue to encourage such methods of due process, most recently in resolutions adopted on July 13 relating to capital standards and to guiding principles for insurance regulatory discussions. We called for a meaningful mechanism for state insurance legislators to weigh in and highlighted the importance of coordination and cooperation among legislators, regulators, and interested parties.

Though the draft IAIS procedures express support for a more open and transparent process, NCOIL is unclear as to how closing IAIS meetings would advance that goal. In the U.S., discussions regarding proposed legislation and other matters must, with very limited exceptions, be open to all who may be interested—to help ensure that policymakers are held accountable for their decisions and that the product of those deliberations are given credence. We respect the integrity and dedication of regulators active in the IAIS, and so we caution that closing meetings could call IAIS decision-making into question.

The growing importance of IAIS initiatives, particularly regarding capital standards and corporate governance, demands a more, not less open approach. That means, we believe, that a range of interested parties should continue to have a say throughout development of IAIS work products. Limiting stakeholder input will actually endanger the efficiency that IAIS is seeking, as it would be difficult for state legislators in the U.S. to support a proposal affecting U.S. insurance oversight without a full understanding of its impacts and without a belief that the proposal reflects open and balanced discussion. Global standards, though well-intentioned, will fail to meet their objectives without approval at home.

While choosing a small group of interested parties to offer comments in closed IAIS meetings may be thought of as a way to encourage efficiency while retaining transparency, NCOIL urges you to reconsider, as this approach could create an unlevel playing field and the appearance of favoritism. It also could lead to work products that pose inadvertent harm to certain segments of the industry, such as small and medium-sized companies that lack significant resources to participate in international discussions.

NCOIL again thanks you for the opportunity to comment. In addition to our submission, we strongly encourage you to consider carefully the comments submitted by the National Association of Insurance Commissioners (NAIC) on behalf of state insurance regulation and in support of an IAIS process that is transparent and accountable.

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PRESIDENT: Sen. Neil Breslin, NY
PRESIDENT-ELECT: *Vacant*
VICE PRESIDENT: Sen. Travis Holdman, IN
SECRETARY: Rep. Steve Riggs, KY
TREASURER: Sen. Jason Rapert, AR

October 16, 2014

The Honorable Edward R. Royce, Chair
The Honorable Eliot L. Engel, Ranking Member
Committee on Foreign Affairs
2170 Rayburn House Office Building
Washington, DC 20515

Dear Representatives Royce and Engel:

As President of the National Conference of Insurance Legislators (NCOIL), I write to express NCOIL support for House Resolution 735, which calls for transparency and broad interested-party involvement in International Association of Insurance Supervisors (IAIS) efforts. NCOIL—as an organization of state legislators who chair and are instrumental in the committees that develop and adopt insurance laws in each U.S. statehouse—recently stressed to the IAIS those same guiding principles and urged the organization to rethink its proposal to close meetings and curtail input.

In line with H. Res. 735, our September 2, 2014, comments to IAIS reassert our fundamental belief that openness and transparency are critical in any and all international dialogues affecting U.S. regulation. In the comments, we noted our specific efforts to ensure due process—including July 13 resolutions regarding global capital standards, meaningful ways for state legislators to weigh in, and the need for coordination and cooperation.

H. Res. 735 makes a critical point to which we wholeheartedly agree: The growing importance of IAIS initiatives, particularly related to capital standards and corporate governance, demands a more, not less open approach. State legislators in the U.S. should not be asked to accept, and would be hard-pressed to support, IAIS-inspired proposals that have not benefited from the transparency and inclusiveness that are hallmarks of U.S. policymaking. We cannot fully appreciate the impacts of an IAIS standard if all parties have not had a chance to comment on what such impacts are.

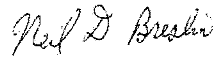
We are concerned as well that pursuing IAIS efficiency by limiting who can access IAIS discussions could result in an unlevel playing field and an appearance of favoritism. While perhaps a well-intentioned way to streamline IAIS activity, the proposal could create inadvertent harm to small and medium-sized insurers without resources to engage internationally.

We agree with H. Res. 735 that the IAIS should take into account the concerns of the National Association of Insurance Commissioners (NAIC). NCOIL, through an NCOIL International Issues Task Force, is working with the NAIC and with other advocates of state oversight to ensure that federal entities—particularly those involved at the IAIS and at the Financial Stability Board (FSB)—stand up for the U.S. system and challenge any attempt to disregard its principles. We welcome dialoging with you toward this shared goal.

The issues raised in House Resolution 735 are critical in protecting an insurance regulatory system that, unlike counterparts around the world, came through the financial crisis well. We encourage enactment of the resolution.

Please feel free to contact Susan Nolan, NCOIL Executive Director, in the NCOIL National Office at snolan@ncoil.org or 518-687-0178 should you have any questions.

Sincerely,



Sen. Neil Breslin (NY)
NCOIL President

cc: The Honorable John Boehner
Members of the Committee on Foreign Affairs
Members of the Committee on Financial Services

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PRESIDENT: Sen. Neil Breslin, NY
PRESIDENT-ELECT: *Vacant*
VICE PRESIDENT: Sen. Travis Holdman, IN
SECRETARY: Rep. Steve Riggs, KY
TREASURER: Sen. Jason Rapert, AR

October 14, 2014

The Honorable Tim Johnson, Chair
The Honorable Mike Crapo, Ranking Member
Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senators Johnson and Crapo:

As President of the National Conference of Insurance Legislators (NCOIL), I write to express NCOIL support for Senate Resolution 561, which calls for transparency and broad interested-party involvement in International Association of Insurance Supervisors (IAIS) efforts. NCOIL—as an organization of state legislators who chair and are instrumental in the committees that develop and adopt insurance laws in each U.S. statehouse—recently stressed to the IAIS those same guiding principles and urged the organization to rethink its proposal to close meetings and curtail input.

In line with S. Res. 561, our September 2, 2014, comments to IAIS reasserted our fundamental belief that openness and transparency are critical in any and all international dialogues affecting U.S. regulation. In the comments, we noted our specific efforts to ensure due process—including July 13 resolutions regarding global capital standards, meaningful ways for state legislators to weigh in, and the need for coordination and cooperation.

S. Res. 561 makes a critical point to which we wholeheartedly agree: The growing importance of IAIS initiatives, particularly related to capital standards and corporate governance, demands a more, not less open approach. State legislators in the U.S. should not be asked to accept, and would be hard-pressed to support, IAIS-inspired proposals that have not benefited from the transparency and inclusiveness that are hallmarks of U.S. policymaking. We cannot fully appreciate the impacts of an IAIS standard if all parties have not had a chance to comment on what such impacts are.

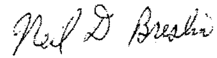
We are concerned as well that pursuing IAIS efficiency by limiting who can access IAIS discussions could result in an unlevel playing field and an appearance of favoritism. While perhaps a well-intentioned way to streamline IAIS activity, the proposal could create inadvertent harm to small and medium-sized insurers without resources to engage internationally.

We agree with S. Res. 561 that the IAIS should heed the concerns of the National Association of Insurance Commissioners (NAIC). NCOIL, through an NCOIL International Issues Task Force, is working with the NAIC and with other advocates of state oversight to ensure that federal entities—particularly those involved at the IAIS and at the Financial Stability Board (FSB)—stand up for the U.S. system and challenge any attempt to disregard its principles. We welcome dialoging with you toward this shared goal.

The issues raised in Senate Resolution 561 are critical in protecting an insurance regulatory system that, unlike counterparts around the world, came through the financial crisis well. We encourage enactment of the resolution.

Please feel free to contact Susan Nolan, NCOIL Executive Director, in the NCOIL National Office at snolan@ncoil.org or 518-687-0178 should you have any questions.

Sincerely,



Sen. Neil Breslin (NY)
NCOIL President

cc: The Honorable Harry Reid
Members of the Committee on Banking, Housing & Urban Affairs

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Testimony of

Michael F. Consedine

Commissioner

Pennsylvania Insurance Department

On Behalf of the National Association of Insurance Commissioners

Before the

Subcommittee on Housing and Insurance

Committee on Financial Services

United States House of Representatives

Regarding:

The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers

November 18, 2014

Introductory Remarks

Chairman Neugebauer, Ranking Member Capuano, and members of the Committee, thank you for the opportunity to testify today. My name is Michael Consedine. I serve as the Commissioner of the Insurance Department for the Commonwealth of Pennsylvania and I am also here on behalf of the National Association of Insurance Commissioners (NAIC).

It is truly my good fortune to lead an outstanding team in Pennsylvania of more than 200 regulators in overseeing one of the largest insurance industries in the U.S., with over $95 billion in written premium and deposits. I also serve as the NAIC's Vice-President, and Chair of the NAIC's International Insurance Relations (G) Committee.

On behalf of my fellow state insurance regulators, I appreciate the opportunity to offer our views and perspective today on the international regulatory standards being proposed by the Financial Stability Board (FSB), the International Association of Insurance Supervisor (IAIS), and other international bodies.

The NAIC and the States have an Important Role in International Insurance Matters

The NAIC and its members have long been committed to providing leadership on a wide range of global insurance issues and activities, with a focus on ensuring policyholder protections and maintaining stable and competitive insurance markets. The NAIC was a founding member of the IAIS as an international standard setter, and provided it with start-up resources more than 20 years ago, recognizing that while insurance is local product, it is a global business. For over two decades, U.S state insurance regulators have been and remain extensively engaged with our international counterparts in developing the elements of a stronger international insurance regulatory framework. Our focus has been and continues to be to ensure that such standards are adaptable to our markets and benefit our consumers.

The relevance of international standards and multijurisdictional cooperation within the U.S. have been elevated since the 2008 financial crisis. International developments at the FSB and IAIS are not binding at the state or federal level, but serve as guidance for regulators to ensure a degree of consistency in approach, if not necessarily in structure or execution. To the extent that these standards collectively elevate the quality of insurance regulation around the globe, it is a positive thing for U.S. insurers who seek to do business abroad, and for U.S. consumers who benefit from the products and competition offered by foreign participation in our market. But equally important, the development of international standards must be flexible enough to deal with structural and legal differences that exist to avoid putting insurers, and by extension consumers, at a disadvantage in one market relative to another.

Where the Federal Reserve and Treasury Department engage at the IAIS, we are committed to collaborating and sharing our perspective with them, recognizing that we each have important, yet separate and distinct responsibilities. We also respect that it is for each party to contribute to and commit to international standards to the extent they feel appropriate and to the extent they have authority to do so.

The U.S. Market Represents a Major Portion of the Global Insurance Market

U.S. insurance consumers benefit from some of the largest and most competitive insurance markets in the world with $1.8 trillion in premium volume and thousands of insurers writing policies. State insurance regulators supervise nearly a third of all global premium, and even taken individually, U.S. states make up more than 24 of the world's 50 largest insurance markets. My home state of Pennsylvania, for example, is the 14th largest insurance jurisdiction worldwide by premium volume. Our domestic insurance industry employs over 117,000 individuals that contribute over $20 billion to Pennsylvania's GDP.

The U.S. is viewed by foreign insurers as an attractive market in which to do business. This increase in competition and capacity has been good for consumers, and it has also necessitated a long history of extensive coordination with foreign supervisors. In addition to direct exchanges of information and data, state regulators have convened and led supervisory colleges (gatherings of all key regulators regardless of sector or jurisdiction) for all U.S.-based internationally active insurance groups. We have also participated in colleges hosted by foreign regulators for firms of mutual interest. This extensive interaction also informs our work. State regulators, through the NAIC, continue to take international and regional developments into account as we make enhancements to our own regulatory system through ongoing efforts like the NAIC's Solvency Modernization Initiative. We have taken great strides to enhance our group supervision framework, implement enterprise risk management reporting, improve corporate governance, and reduce collateral requirements for foreign reinsurers. All of this work has been influenced by our direct and sustained interactions with foreign regulators and standard setters. But as we consider these changes, and review international standards, we are always mindful to balance the cost with the benefit, and careful to avoid undermining a solvency system that has served policyholders, the financial system, and the economy at large extremely well.

Transparency is a Key Element of Effective Regulation

When it comes to global collaboration on insurance oversight, the IAIS is a forum intended to build consensus around best practices, much like the role of the NAIC here at home. As the largest member of the IAIS by far, the NAIC and state insurance commissioners remain committed to that important mission.

However, it is difficult to achieve optimum regulatory outcomes or reach broad consensus around international standards without the input of those most impacted, in particular the consumers we protect and the industry we regulate. That is why state regulators vigorously opposed efforts at the IAIS to limit stakeholder engagement, and why we remain committed to transparent processes here at home. The NAIC has long provided forums for significant engagement by insurance consumers, industry representatives, and other stakeholders, while preserving a capacity for regulators to meet confidentially on sensitive regulatory matters. In fact, as we sit here today, my colleagues are holding public meetings and engaging stakeholders here in D.C. to discuss a variety of issues and initiatives being undertaken by the states, including our work at the IAIS and consideration of regulatory enhancements to our state-based system.

We have provided funding for consumer representatives to participate directly in the work of the NAIC, as well as at the IAIS. We also supported expanding participation at the IAIS to include

Roy Woodall, the Financial Stability Oversight Council's voting insurance expert, and helped develop the IAIS by-law change necessary to add the Federal Insurance Office to the IAIS membership. This history of inclusiveness has benefited our work, and we believe improved the quality of IAIS's work as well. Transparency does not require that regulators hand over the power of the pen to those we regulate but simply requires that the process of standard setting be done in an open and inclusive forum. This is a fundamental aspect of our democratic system in the United States. Therefore, the IAIS's recent decision to limit direct stakeholder participation is a step back for the openness and transparency necessary to give IAIS work credibility and legitimacy, particularly if and when legislative bodies are expected to consider IAIS proposals.

Global Capital Standards for Insurers Should be Compatible with the U.S. System

Let me turn now to specific standards under discussion at the IAIS. The IAIS is simultaneously developing three new capital standards targeted for different purposes. As part of the policy measures recommended for application to globally systemically important insurers (G-SIIs), the IAIS has moved rapidly, under specific direction and pressure from the FSB, to develop international standards for a basic capital requirement (BCR) and higher loss absorbency (HLA) capital measures (capital buffers). In addition, the IAIS is developing a risk-based global insurance capital standard (ICS) as part of a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame).

State regulators have concerns with the rapid pace of the work, and it is unclear what benefit these standards will bring to U.S. policyholders. However, the IAIS is moving forward. State insurance regulators therefore have an obligation to be at the table on behalf of our consumers and markets to seek an outcome that works for our system, should we choose to implement it. The NAIC's objective is to ensure that the capital proposals developed at the IAIS are reasonable and compatible with our system. We must also ensure they don't inadvertently lead to unintended consequences such as limiting insurance products or stagnating growth in the insurance sector, including jobs and innovation. If tailored for our regulatory system, there is value in understanding the capital adequacy of insurance groups, particularly when part of a larger conglomerate or affiliated with other entities. But that value only exists if it wraps around our existing legal entity standards. We also remain concerned with the more volatile market valuation accounting approach favored by Europe as an international standard because it represents a short-term focus rather than a longer-term view and could have a negative impact on the U.S. market to the detriment of American insurance consumers.

In our view, taking a more homogenous regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry. The NAIC is also concerned that if new standards are excessive or too inflexible, then they could increase costs on U.S. insurers and consumers and undermine the U.S. state-based insurance regulatory system, which is based on protecting policyholders and has a strong track record of effective solvency supervision and stable, competitive insurance markets. The IAIS must recognize that a system that has existing safeguards and controls to supervise the movement of capital within a group may take a different approach to capital adequacy at the group level than jurisdictions that do not have similar requirements.

We are committed to collaborating where we can, and the NAIC has long-standing procedures and ongoing responsibilities to seek input from policyholders and other interested parties, and we

will continue working on these issues in a transparent manner through our NAIC process. The NAIC ComFrame Development and Analysis (G) Working Group (CDAWG) has met several times to discuss these issues, most recently on Sunday, November 16, and further meetings are planned. We also have participated in ongoing discussion with our federal colleagues at the Federal Reserve and the Federal Insurance Office. The IAIS objectives on capital standards are not easily achievable and will require a significant commitment of resources over many years to ensure that they are compatible with the U.S. system of insurance regulation.

A Global Framework for Insurance Group Supervision Should Include the U.S. System

As I mentioned earlier, the IAIS has been working for several years to develop a Common Framework (ComFrame) to enhance the cross-border supervision of Internationally Active Insurance Groups (IAIGs). ComFrame was intended to build on the foundation established by the IAIS Insurance Core Principles (ICPs), which were revised in 2011 and form the basis of best practices recommended for use by supervisors around the world. The IAIS completed a three-year ComFrame development phase in 2013, and this year it commenced a four-year field-testing phase with a target adoption date of 2018 and implementation date of 2019.

At the IAIS, the focus of the NAIC's efforts at every step has been to emphasize cooperation in supervisory practices while avoiding overly prescriptive measures, extra layers of unnecessary regulation, or new one-size-fits-all requirements for insurers who operate globally. ComFrame should promote a flexible collaborative process to achieve shared regulatory objectives and more consistent outcomes, rather than a top-down approach to group supervision that could undermine the strengths of our system. The NAIC remains concerned about the potential direction of ComFrame and will continue to evaluate the proposal to determine the extent to which its provisions might be compatible with the regulatory system here in the U.S.

The EU-U.S. Insurance Project Has Potential to Enhance Transatlantic Insurance Markets

Building on a regular series of transatlantic insurance dialogues over the past decade, the EU-U.S. Insurance Project was initiated in 2012 by the FIO, the NAIC, the European Commission, and the European Insurance and Occupational Pensions Authority. The original purpose of the project was to develop a deeper understanding of our different approaches to solvency oversight and explore ways to increase cooperation and collaboration where possible.

In December of 2012, the U.S. and EU teams issued a joint report along with a Way Forward document outlining common objectives and initiatives to be pursued over the next five years on various aspects of transatlantic group supervision such as ways to enhance the effectiveness of international supervisory colleges. In December of 2013, a joint EU-U.S. public forum was convened on international insurance group supervision and supervisory colleges in conjunction with the NAIC Fall National Meeting in Washington D.C. The Way Forward initiative was updated in July of 2014, based on recent developments and progress achieved to advance mutual understanding and recognition. Another public forum on group supervision was held in October 2014 in conjunction with the IAIS Annual General Meeting in Amsterdam.

While there has been progress toward achieving a better mutual understanding of the regulatory tools and approaches used by the U.S. and Europe, there are still many questions going forward about how the EU will treat U.S. firms under its new Solvency II oversight regime when it

becomes effective in 2016. In addition, questions remain about the rationale for pursuing collateral reduction through the Treasury's Covered Agreement authority and, depending on its scope and content, what might its potential pre-emptive impact be on U.S. consumers and companies. In the meantime, U.S. state insurance regulators continue to achieve progress with enhancements to our system, including reductions in collateral requirements for foreign reinsurers that are on track to address nearly 80% of the U.S. insurance market by the end of 2015.

Conclusion

As international standard setting continues, the NAIC will remain directly engaged to determine whether the concepts under discussion at the FSB and IAIS make sense and add real benefit for U.S. policyholders. We are committed to collaborating with our federal colleagues where appropriate, and sharing our views with Congress on these important issues. NAIC is pleased to work closely with this committee to ensure that the long-standing strengths of our state-based system are preserved, that U.S. policyholders remain well protected, and that insurance markets remain stable and competitive.

Again, thank you for the opportunity to testify today.

*****EMBARGOED FOR DELIVERY*****

Testimony of Michael McRaith
Director of the Federal Insurance Office, U.S. Department of the Treasury
Hearing entitled "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II"

House Financial Services Subcommittee on Housing and Insurance
November 18, 2014

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for inviting me to testify today on the impact of international regulatory standards on the competitiveness of U.S. insurers.

My name is Michael McRaith, and I am the Director of the Federal Insurance Office (FIO) in the U.S. Department of the Treasury.

This past September, FIO published its second Annual Report on the Insurance Industry.[1] The 2014 Annual Report includes sections describing (1) a financial overview of the U.S. insurance industry, (2) developments and issues with respect to consumer protection and access to insurance, (3) regulatory developments, and (4) international developments.

Among the highlights, the 2014 Annual Report analyzes data demonstrating that insurers operating in the United States continue to show resilience in the aftermath of the financial crisis, including record levels of reported capital and surplus. On the subject of access to insurance, FIO is statutorily authorized to monitor the affordability of non-health insurance products for traditionally underserved communities, minorities, and low- and moderate-income consumers. Accordingly, the 2014 Annual Report describes FIO's request for public comment on an appropriate definition and metric for assessing the affordability of personal auto insurance.

With respect to U.S. regulatory developments, the 2014 Annual Report discusses matters at the state and federal levels, including activities of the Financial Stability Oversight Council and the pending National Association of Registered Agents and Brokers Reform Act of 2013 (NARAB II). Internationally, standard-setting activities have continued at the International Association of Insurance Supervisors (IAIS) and work to promote cooperation between insurance supervisors in the United States and the European Union (EU) has continued through the EU – U.S. Insurance Project. These international work streams form the basis for this hearing and are the focus of my testimony.

The insurance sector, both nationally and globally, is evolving dramatically, and we appreciate the opportunity to reflect with you upon where it is now and where it is going.

International insurance standard-setting activities are not new. In fact, the National Association of Insurance Commissioners (NAIC) was among the founding members of the IAIS in 1994. Since that time, the U.S. state regulators have worked to set and meet international standards.

[1] FIO's 2014 Annual Report can be found at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2014_Annual_Report.pdf.

Each of the 56 members of the NAIC is also a member of the IAIS, and state regulators have more votes in the IAIS plenary session (15) than any other jurisdiction.

More recently, since it became a full member of the IAIS in 2012, and consistent with its statutory role, FIO has represented the United States on prudential aspects of international insurance matters, including representing the United States at the IAIS.

At the 2014 IAIS Annual Meeting in October, the U.S. Federal Reserve Board System (Federal Reserve) became a full member of the IAIS. With the participation of state regulators, the Federal Reserve, and FIO, all aspects of the unique U.S. insurance oversight system are engaged at the IAIS.

In addressing the standard-setting work of the IAIS, FIO, the Federal Reserve, and state insurance regulators work together extensively and coordinate frequently. With frequent calls, and meetings, the leadership and staff of all three groups are in close and meaningful engagement. We continue to build and improve upon the mechanisms for consultation and collaboration.

An essential predicate to any discussion of the U.S. insurance sector and its regulation is the recognition that the United States has the most diverse and competitive insurance market in the world. Thousands of insurance companies operate in the United States, ranging from small mutual companies operating in a few rural counties to massive global firms engaged in a variety of financial services. While serving as the Illinois Director of Insurance, I learned firsthand about the importance of small and mid-size companies to the marketplace and to local and regional economies. Despite significant consolidation pressures in the small insurer segment for many years, we work to preserve the important contributions of small- and mid-size insurers to the consumers and communities served by those firms.

The U.S. insurance sector, including the internationally active insurance groups which have generated global interest at the IAIS, has an important role in the national economy. Indeed, in the United States, insurance is both local and global. Insurers compete in markets throughout the country, underwrite risk on a local and personal basis, and consumers have the benefit of local support from state insurance regulators.

Supporting this local and global activity is the global reinsurance industry—a market with many important participants based outside the United States. In fact, based on gross premiums ceded, more than 90 percent of the unaffiliated reinsurance of U.S. property and casualty insurers is placed with a non-U.S. reinsurer or a U.S. reinsurer with a non-U.S. holding company parent.

In fulfilling the statutory role to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, FIO engagement is guided by three priorities: (1) to promote and enhance a competitive U.S. insurance market through effective, efficient supervision; (2) to establish prudentially sound, equal footing for U.S.-based insurers to operate in new and developing global markets; and (3) to safeguard financial stability.

Competition in the United States means more affordable products tailored to meet the evolving needs of individuals, families, and businesses. At the same time, with an increasingly international insurance marketplace, FIO strongly supports the development of international prudential standards that promote consistent oversight.

In fact, U.S.-based insurers are extending operations in emerging markets around the world, and a growing number expect in the coming years to generate 40 percent or more of revenue from outside the United States. In addition, many well-known insurers in the United States are subsidiaries of non-U.S. holding companies.

Following the development of other financial services by several decades, the insurance marketplace is increasingly global. Private market premium volume increases in countries around the world illustrate that insurers are committed to international growth. Measuring global market share by aggregate premium volume, from 2008 to 2013, the United States' share of the world market declined from 29.06 percent to 27.13 percent despite an increase in real dollars of more than $32 billion. For the same period, China's share increased in real dollars by more than $137 billion and as a percentage of the global market from 3.30 percent to 6 percent. As reported in the 2014 Annual Report, similar proportional increases were seen for that same period in South Korea, South Africa, and Brazil.

These numbers reiterate the message that global demographics have delivered in other ways: developing markets present important growth opportunities for U.S.-based firms and that growth will continue at an increasing rate in the years to come.

As a result, many jurisdictions—including both developing and well-established markets—are modernizing insurance supervisory regimes. For example, in North America, both Mexico and Canada have undertaken sweeping insurance regulatory reforms, as have Australia, China, and South Africa.

With the concurrent forces of increased market globalization and regulatory modernization, international standard-setting activities aim to reduce the breadth of differences among the participating supervisors. By reducing the number of regulatory approaches, reporting requirements, and capital assessment practices, over time the compliance burden for insurers engaged in multinational operations should also decline.

As the insurance sector evolves globally, the United States will continue to contribute constructively in support of that change, and work in support of international standards that, when implemented, will benefit U.S. consumers and U.S. insurers. Working together, U.S. participants are already leading developments in international standard-setting activities. Absent the participation and leadership of U.S. participants, international standard-setting activities would continue without reflecting the unique features of the U.S. market and regulatory structure.

IAIS Capital Standard Development

The development of capital standards at the IAIS dates back to at least 2009, with the commencement of a common framework for the supervision of internationally active insurance groups, or ComFrame. More broadly, and in response to the global financial crisis, G-20 Leaders at recent Summits asked the Financial Stability Board (FSB) to develop a policy framework to address the systemic and moral hazard risks associated with systemically important financial institutions (SIFIs). In response, the FSB, which coordinates G-20 financial regulatory initiatives, developed a framework and called on the relevant international standard-setting bodies to, among other things, develop methodologies for identifying G-SIFIs in each financial services industry.

In July 2013, the FSB called upon the IAIS to develop by 2014 backstop capital requirements (now known as Basic Capital Requirements, or BCR) for global systemically important insurers (GSIIs) and to develop in 2015 an approach to higher loss absorbency (HLA) for GSIIs. These policy measures conform with the G-20 endorsed FSB SIFI framework, which calls for HLA for identified G-SIFIs. In addition, the FSB not only called upon the IAIS to continue development of ComFrame, but also to include in ComFrame a quantitative insurance capital standard applicable to all internationally active insurance groups (IAIGs). This comprehensive work plan and deliverables (including ComFrame, BCR, and HLA) were welcomed most recently by G-20 Leaders last year in St. Petersburg.

At its 2014 Annual Meeting in October, after more than 12 months of data analysis, testing and consultation, the IAIS adopted an approach to the BCR. The BCR is a basic, factor-based approach to measuring capital within an insurance group and across jurisdictions. While it represents a significant milestone as the first global group capital standard for the insurance sector, the BCR constitutes only a baseline, does not assess certain key aspects of risk, and fails to integrate essential features of any long-term capital regime. For example, by virtue of the compressed schedule for its development, the BCR does not measure a GSII's matching of assets and liabilities, an essential consideration when assessing the adequacy of an insurer's capital and risk management practices. However, the BCR serves as a starting point for the development of both the HLA and the Insurance Capital Standard (ICS), the latter of which will likely supersede the BCR as the future basis for HLA for GSIIs.

The HLA represents a significant technical challenge for the IAIS because of the heterogeneity of insurance firms and the variety and complexity of products sold by insurers across the world. The various structures and business models of firms potentially identified as GSIIs and subject to the HLA present a spectrum of considerations before the HLA standard can be designed. For this reason, IAIS members agreed to move the drafting and publication of an HLA consultation paper until the spring of 2015. With the benefit of additional study and outreach to technical experts, the spring release date of the HLA consultation paper will allow for more constructive and insightful feedback from stakeholders.

The IAIS plans to release an ICS consultation paper in December 2014 for a 60-day period. The ICS will be the capital standard applied to IAIGs and will presumably serve as the basis for HLA

and GSIIs. The paper will include inquiries and questions relating to the many small and large technical aspects of an insurance capital standard. Notably from the U.S. perspective, the consultation paper will be a meaningful trigger for constructive feedback but is not a definitive statement of policy direction with respect to the ICS. Although technical experts from around the world, including representatives of all U.S. participants, have been involved in various aspects of the data analysis and testing leading to elements of the consultation paper, the IAIS membership has not considered or endorsed any specific approach to the ICS. Importantly, none of the IAIS-developed capital standards will be implemented until 2019, at the earliest.

For purposes of the ICS, U.S. representatives from FIO, the Federal Reserve, and state insurance regulators have been developing a U.S. approach to insurance group capital. This unprecedented undertaking represents a significant step in the ability of the U.S. participants to advocate for a national view on insurance group capital. The participating authorities have repeatedly expressed support for the effort and a continuing commitment to its success.

International standard-setting activities—with regard to capital in particular—remain in the early stages of development. Importantly, international standards are not self-executing and are entirely without legal effect in the United States until implemented through a federal or state process. While under development and prior to final adoption, the IAIS standards will be tested for accuracy, value, and impact both on the U.S. insurance market and on individual firms. In our view, consistent with past practice, implementation at either the state or federal level of an international standard should occur in a manner tailored to the unique features of the U.S. insurance sector, promote competition and consumer choice, and safeguard policyholder protection and financial stability.

IAIS Organizational Reform

The IAIS has recently undertaken organizational reform that improves the independence and transparency of its standard-setting activities. Formerly, the IAIS charged stakeholders as much as $20,400 annually in order to receive the designation of "observer" and thereby receive access to certain meetings and information. The IAIS received approximately 40 percent of its funding from industry and other stakeholders, thereby creating the appearance of a pay-to-play or *quid pro quo* arrangement that detracted from the credibility of IAIS members and stakeholders. Effective January 1, 2015, the IAIS will no longer collect or be dependent upon observer fees, a move which will promote the efficiency and independence of the organization.

Eliminating the observer status and concomitant annual fee has the additional, essential benefit of increasing IAIS transparency. First, open meetings on important topics, previously known as "observer sessions" and available only to those who paid the fee, will now be accessible for all interested stakeholders. Second, the revised consultation process formalizes and will require a written consultation processes that incorporates a publication and comment period so that all stakeholders can offer views. Third, technical experts will be included in and consulted throughout the standard-setting and drafting exercises. For example, as the IAIS recently developed an application paper on market conduct practices, a representative of a U.S. trade association was directly included in and throughout the drafting process. Fourth, access to materials on the IAIS web site will now be available to all stakeholders, not just those who can

afford to pay the annual fee. Finally, as in the past, stakeholders will continue to be included in those work streams in which such direct intervention supports the progress and development of the standards.

The IAIS organizational reform is not finalized. A second draft of the consultation process with stakeholders was released yesterday (November 17, 2014) for public comment.

The current draft proposal for stakeholder engagement can be improved. Specifically, we support a requirement that stakeholders who submit comments to the IAIS through a consultation process should receive the benefit of a substantive reply similar to the U.S. administrative law that requires an agency to address comments submitted when adopting a regulation. In addition, stakeholders should have the opportunity to meet directly with the international supervisory community in a manner akin to that which has occurred during IAIS annual meetings. Finally, U.S. stakeholders should have the opportunity to meet and present to all U.S. participants at the IAIS in advance of or after an IAIS meeting. With experience, these opportunities have been increasing and will continue to grow in number and substance.

EU and U.S. Insurance Project

The U.S. and the EU are both significant insurance markets. In terms of premium volume, the EU ranks first and the U.S. second as consolidated markets. The U.S. and EU are home to many of the world's most prominent global insurers—large multinational insurance groups pushing more aggressively into new markets around the world. The EU is also modernizing its approach to insurance regulation through Solvency II.

With these facts in mind, FIO convened the insurance leadership of both jurisdictions at Treasury in January 2012. At this initial meeting, participants included FIO, state regulators, the European Commission, the European Insurance and Occupational Pension Authority, and the United Kingdom regulatory authority. We call this the EU – U.S. Insurance Project (Project). For the last three years, several state insurance commissioners, including Commissioners Voss, McCarty, Consedine, and Urias, among others, have contributed to this effort. With a goal of improved compatibility and consistency, the process recognizes that the U.S. and EU have different regulatory processes and systems, and different markets. Topics being addressed include group supervision, confidentiality or professional secrecy, and reinsurance, as well as reporting, on-site examinations, and actuarial standards.

The Project has been a demonstrably successful collaboration among all involved authorities and individuals. In September 2012, the Project released a report that identified similarities and differences between the regulatory approaches of the two jurisdictions, and in December 2012 the Project released an initial *Way Forward*, which outlined several common policy objectives and milestones for the next five years. Following adoption of Solvency II in the EU in late 2013, the December 2013 release of FIO's report entitled "*How To Modernize And Improve The System Of Insurance Regulation In The United States*," further developments at the IAIS, and continued modernization at the state level, the Project released a revised *Way Forward* in August

2014 which updated the common objectives and milestones.[2] Of course, as with all international developments, implementation will occur in the United States only through federal and state authorities.

A central issue being addressed by the Project is that of a covered agreement for reinsurance and reinsurance collateral requirements. Reinsurance is a risk-sharing tool which effectively provides global risk diversification. The authority to enter into a covered agreement, unlike a comprehensive free trade agreement, is a unique authority given to FIO and the office of the United States Trade Representative (USTR) to negotiate an agreement between the United States and one or more foreign jurisdictions. The terms of a covered agreement as authorized by statute involve prudential insurance measures and could preempt contrary state laws.

The 2014 *Way Forward* reiterates Treasury's support for USTR and Treasury to pursue a covered agreement with respect to state-based reinsurance collateral requirements. The reinsurance business model is global, and the regulation of reinsurance should reflect and integrate that business model. In our view, collateral requirements for reinsurers should be risk-based, not geography-based. The 2014 *Way Forward* also identifies both group supervision and confidentiality/professional secrecy as areas for which the possibility of a covered agreement should be explored. Importantly, a covered agreement must provide tangible benefits for U.S. stakeholders. While the mechanics of the covered agreement process remain under development, FIO welcomes robust engagement with Congress, state regulators, and other stakeholders on the opportunity presented by a covered agreement.

Conclusion

Through effective collaboration at home and abroad, U.S. insurance authorities are positioned to provide U.S. leadership that complements the shared interest in a well-regulated insurance market that fosters competition, promotes financial stability, and protects consumers.

Importantly, it bears repeating that, in all of our work, both internationally and domestically, Treasury priorities will remain the best interests of U.S. consumers, U.S. insurers, the U.S. economy, and jobs for the American people.

We welcome the chance to work with this Committee and its excellent staff, and look forward to more discussions on these important topics.

Thank you for your attention. I look forward to your questions.

[2] FIO's report on *How To Modernize And Improve The System Of Insurance Regulation In The United States* is available at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf.

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Statement by

Thomas Sullivan

Senior Adviser

Board of Governors of the Federal Reserve System

before the

Subcommittee on Housing and Insurance

of the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

November 18, 2014

Chairman Neugebauer, Ranking Member Capuano, and other members of the subcommittee, thank you for inviting me to testify on behalf of the Federal Reserve.

The Federal Reserve welcomes the opportunity to participate in today's hearing and is pleased to be joined by our partners from the Federal Insurance Office (FIO) of the U.S. Treasury, the National Association of Insurance Commissioners (NAIC), and the National Conference of Insurance Legislators. While we each have our own unique authority and mission to carry out, we remain committed to working collaboratively on a wide range of insurance supervisory and regulatory issues, including the subject of today's hearing, international insurance regulation.

The Federal Reserve's Role in the Supervision of Certain Insurance Holding Companies

The Federal Reserve assumed responsibility as the consolidated supervisor of certain insurance holding companies as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). Under the Dodd-Frank Act, the Federal Reserve is responsible for the consolidated supervision of insurance holding companies that own federally chartered thrifts or banks, as well as insurance holding companies designated by the FSOC. The insurance holding companies for which the Federal Reserve is the consolidated supervisor hold approximately one-third of industry assets and vary greatly in terms of size and the types of products they offer.

After the passage of the Dodd-Frank Act, the Federal Reserve moved quickly to develop a supervisory framework that is appropriate for insurance holding companies that own depository institutions and promptly assigned supervisory teams to handle day-to-day supervision of those insurance holding companies. While doing so, we have reached out to our colleagues in the state insurance departments. The Federal Reserve supervisory teams for insurance holding companies

are a combination of experienced Federal Reserve staff as well as newly hired staff with insurance expertise. The Federal Reserve is investing significant time and effort into enhancing our understanding of the industry and the firms we supervise, and we are committed to tailoring our supervisory framework to the specific business lines and risk profiles of the insurance holding companies we oversee. Our supervisory efforts to date have focused on strengthening firms' risk identification, measurement and management, internal controls, and corporate governance. Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions while mitigating any risks to financial stability.[1] We conduct our consolidated supervision efforts in coordination with state insurance regulators, who continue their established oversight of insurance legal entities.

The Federal Reserve's Participation in the International Association of Insurance Supervisors (IAIS)

Some of the insurance holding companies subject to Federal Reserve supervision are internationally active firms that compete with other global insurers to provide insurance products to businesses and consumers around the world. Our supervisory activities for these firms include collaborating with our regulatory counterparts internationally. As part of this role, last year, the Federal Reserve joined our state insurance supervisory colleagues from the NAIC and the FIO as members of the International Association of Insurance Supervisors (IAIS). Accordingly, the Federal Reserve has been and will continue to be engaged in the development of global standards

[1] Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2014), "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program," Supervision and Regulations Letter SR 14-9 (November 7), www.federalreserve.gov/bankinforeg/srletters/sr1409.htm.

for regulating and supervising internationally active insurers. Global standard setting is not new to the Federal Reserve, as we have for decades participated in standard setting for global banks through our membership in the Basel Committee on Banking Supervision. As a general proposition, we believe in the utility of having effective global standards for regulation and supervision of internationally active financial firms. When implemented consistently across global jurisdictions, such standards help provide a level playing field for global financial institutions. Further, consistent global regulatory standards can help limit regulatory arbitrage and jurisdiction shopping and can promote financial stability.

Since joining the IAIS in late 2013, the Federal Reserve has been an active participant in several key committees, working groups, and work streams. We currently hold a seat on the Financial Stability Committee and the Technical Committee. Throughout our first year as a member of the organization, and consistent with our statutory mandate, the Federal Reserve has been particularly focused on the financial stability and consolidated supervision work of the IAIS.

IAIS Strategic Priorities

At the heart of the IAIS' strategic priorities is the development of its Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). Among other things, ComFrame includes the development of a global consolidated capital standard for large, complex international insurance companies. A group capital requirement for insurers with significant international operations is a new concept for U.S. insurance companies. State law includes entity capital requirements but does not include a group or consolidated capital requirement. For the largest and most active global insurers, the Federal Reserve

supports group-wide consolidated capital standards that are well tailored to insurance risks. Such standards must be deliberately developed through transparent processes and properly calibrated.

A second key focus of the IAIS involves the identification of global systemically important insurers (G-SIIs) and the design of an enhanced regulatory and supervisory framework for G-SIIs. In 2013, the Financial Stability Board, in consultation with the IAIS and using a methodology developed by the IAIS, designated a set of nine global insurance firms (including three U.S.-based insurers) as G-SIIs. In addition to developing enhanced supervision standards and resolution planning requirements for G-SIIs, the IAIS continues to refine its G-SIIs designation methodology and to work diligently to design loss absorbency requirements for G-SIIs.

The IAIS recently released the Basic Capital Requirement (BCR) for G-SIIs. It is the first international consolidated capital requirement for the insurance industry. The IAIS developed the BCR to help provide a level playing field for the capital adequacy of the largest, most complex insurance companies in the world. The IAIS intends to supplement the BCR with a Higher Loss Absorbency (HLA) capital requirement for G-SIIs that present the greatest risk to financial stability.

In time, the IAIS expects that the BCR will be replaced by the more detailed and comprehensive Insurance Capital Standard (ICS), which is currently under development. Although the ICS likely will apply to a broader range of internationally active insurance groups, the IAIS expects that the ICS ultimately will also serve as the basis upon which HLA capital requirements are applied for G-SIIs. IAIS work on the ICS began last year and will continue for at least the next few years. This work includes the active participation of many volunteer

insurance companies, including U.S. insurance companies, through field testing of various approaches and options.

It is important to note that any standards adopted by the IAIS are not binding on the Federal Reserve, the FIO, state insurance regulators, or any U.S. insurance company. During the development of global standards for insurance firms by the IAIS, the Federal Reserve will work to ensure that the standards do not conflict with U.S. law and are appropriate for U.S. insurance markets and U.S. insurers. Moreover, the Federal Reserve would only adopt IAIS regulatory standards after following the well-established rulemaking protocols under U.S. law, which include a transparent process for proposal issuance, solicitation of public comments, and rule finalization.

Cooperation and Coordination among U.S. Supervisors, Regulators, and the Industry

The Federal Reserve, along with the FIO and the NAIC, continues to actively engage with U.S. insurance companies on the development of global regulatory standards for insurance firms. Recently, the FIO hosted a session with the Federal Reserve, the NAIC, state insurance regulators, and industry stakeholders to discuss the ICS project and solicit feedback. The Federal Reserve is committed to continuing this dialogue and to continuing our work with the FIO and state and international insurance regulators to develop a set of standards for global insurance firms that is consistent across countries and appropriate for internationally active U.S. insurers.

Nothing in ComFrame, including the group capital requirement, seeks to lessen the critical role of individual insurance legal entity supervision conducted by the U.S. states and foreign countries. Rather, group-wide consolidated supervision and consolidated capital

requirements supplement this approach with a perspective that considers the risks across the entire firm, including risks that emanate from non-insurance subsidiaries and entities within the group. The Federal Reserve is a consolidated holding company supervisor that focuses on identifying and evaluating risks, capital and liquidity adequacy, governance, and controls across its supervised organizations. U.S. insurers with a global footprint or global aspirations stand to benefit considerably from a level global regulatory framework that is strong but pragmatic. Reasonably consistent global insurance standards for internationally active insurers and international cooperation among global regulators provide the means to that end.

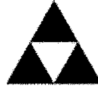
The Federal Reserve has acted on the international insurance stage in an engaged partnership with our colleagues from the FIO, the state insurance commissioners, and the NAIC. Our multiparty dialogue, while respectful of each of our individual authorities, strives to develop a central "Team USA" position on the most critical matters of global insurance regulatory policy.

IAIS Process and Transparency

While the Federal Reserve has been a member of the IAIS for only a short time, the work of the IAIS has been underway for many years. The IAIS recently celebrated its 20th anniversary and continues to evolve as an organization. The IAIS, as an international standard-setting body, should be independent from industry. The IAIS recently voted to revise its approach for industry participation in standard setting. Under the new processes, industry will no longer provide financial support to the IAIS or be day-to-day participants in the development of international supervisory standards for insurance. The result will be a more transparent rulemaking process that will allow for input by the industry and the public more generally through the ability to provide public comments on rulemaking proposals. The Federal Reserve

supports transparency in rulemaking and policy development and believes that it is critical that standard-setting bodies be fully independent of the regulated.

Mr. Chairman, thank you for inviting me here today. I look forward to an active dialogue with you and other members of the subcommittee.



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Testimony of Elizabeth Brill, MAAA, FSA
Chairperson, Solvency Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

Submitted for the Record

U.S. House Financial Services Subcommittee on Housing and Insurance Hearing
Entitled "The Impact of International Regulatory Standards
on the Competitiveness of U.S. Insurers, Part II"
November 18, 2014

Chairman Neugebauer, Ranking Member Capuano, and distinguished Members of the Subcommittee:

On behalf of the American Academy of Actuaries'[1] Solvency Committee, I appreciate the opportunity to provide this written testimony for your Subcommittee's November 18 hearing: "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II." I would like to provide you and the members of the Housing and Insurance Subcommittee with input on certain key priorities and principles that the American Academy of Actuaries believes should be contemplated when considering and developing insurance group solvency and capital standards. We hope these principles will be helpful to the Subcommittee as it engages with state, federal, and global insurance regulators and legislators on these issues.

Any international group solvency or capital standards developed by entities such as the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS) likely would have a profound effect on many domestic and international insurers. That is why proposed international standards from the IAIS must be created in a careful, transparent, and meaningful manner. Failure to do so would risk undermining the ability of U.S. insurers to operate effectively and efficiently, and could negatively impact the financial stability of U.S. insurance regulation and the insurance industry.

As U.S. legislators and regulators continue to discuss and develop insurance group capital and solvency standards, the American Academy of Actuaries offers its support in engaging and

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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shaping this challenging area of public policy. To this end, we offer the following principles for consideration as the House Financial Services Housing and Insurance Subcommittee develops its perspectives concerning the elements of U.S. insurance group capital and solvency proposals:

1. A group solvency regime should be clear regarding its regulatory purpose and goals. For example, the purpose could be to protect policyholders, enhance financial stability, ensure a competitive marketplace, provide a level playing field, identify weakly capitalized companies, rank well-capitalized insurers, improve risk management practices and procedures, or some combination of the above. The regulatory purpose and goals will aid in the development of a standard itself, as well as the associated regulatory actions and priorities.

2. Any metrics, information, or other output of a group solvency standard should be useful to all relevant parties, including regulators, management, shareholders, and rating agencies.

3. A group solvency regime should promote responsible risk management in the regulated group and encourage risk-based regulation. For example, a solvency regime should recognize risk-mitigation activities, such as asset/liability matching, hedging, and reinsurance. The actuarial functions are critical in the risk management process and their role should be clearly defined, as it is in the U.S. reserving and solvency framework. Actuaries can and should identify where factor-based systems may miss key emerging risks, set reasonable boundaries around more subjective estimates and modeling and, as appropriate, render actuarial opinions.

4. Methods should recognize and take into consideration the local jurisdictional environments under which members of an insurer group operates, including the local regulatory regime, product market, and economic, legal, political, and tax conditions.

5. A group solvency standard should be compatible across accounting regimes, given the political uncertainties in achieving uniform standards.

6. A group solvency standard should minimize pro-cyclical volatility so as to avoid unintended and harmful consequences on regulated insurance groups, insurance markets, and the broader financial markets.

7. A group solvency standard should present a realistic view of an insurance group's financial position and exposures to risk over an agreed-upon time frame.

8. All assumptions used in any capital or solvency model should be internally consistent.

9. It is more important to focus on the total asset requirement than the level of required reserves or capital on a separate basis. The focus should be on holding adequate total assets to meet obligations as they come due. Whether a jurisdictional standard requires the allocation of these assets to liabilities versus capital/surplus should be irrelevant to the overall solvency regime.

10. It must be demonstrated that the capital held is accessible, including in times of stress, to the entity facing the risk for which the capital is required.

The Academy has made similar recommendations to the Federal Insurance Office within the Department of Treasury, the Federal Reserve Board, and state legislators and regulators.

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Thank you for this opportunity to provide our views on the key principles that should help in the development of insurance group solvency and capital standards. Actuaries have worked for decades with insurance and other financial sector regulators to develop prudent rules that address insurer solvency, including capital requirements. Actuaries' involvement has been critical in the development and evaluation of U.S. insurance regulations, and we believe that actuarial expertise will contribute greatly to the creation of international insurance standards. The American Academy of Actuaries looks forward to assisting the Subcommittee as it reviews global insurance standards and their potential implications for domestically active insurers. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Statement

of the

National Association of Mutual Insurance Companies

to the

United States House of Representatives

Committee on Financial Services

Hearing on

The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II

November 18, 2014

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the House Financial Services Committee on international insurance regulatory issues and the impact on U.S. insurers.

NAMIC is the largest property/casualty insurance trade association in the U.S.A., serving regional and local mutual insurance companies on main streets across America as well as many of the country's largest national insurers. NAMIC's 1,400 member companies serve more than 135 million auto, home and business policyholders, and write more than $196 billion in annual premiums.

Introduction

NAMIC believes the current U.S. state-based insurance regulatory system is robust and well-positioned to meet the needs of the nation's insurance marketplace. While most of our members do business exclusively in the United States, we also believe that American insurers should be well-positioned to compete in the international insurance market as well. However, NAMIC has serious concerns about recent efforts to set international regulatory standards, being justified by the globalization of insurance markets. *All of our members, domestically and internationally active,* have the potential to feel the impact of international standards being imported to the U.S.

International decisions influence regulation in the United States, influence the assessment of U.S. regulation, and impact the reinsurance market. While a small number of our members meet the definition of internationally active insurance groups, over 650 of our members are part of registered holding companies. Global insurance regulatory standards, such as a new group capital standard, would have significant impacts on many of these holding companies if it were ever adopted under state insurance laws in the United States.

The International Association of Insurance Supervisors (IAIS) is the organization at the center of many of these discussions. It is charged with establishing Insurance Core Principles (ICPs) that represent the international standards for insurance regulation. After the financial crisis the IAIS began work on a Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs), also known as ComFrame. This new framework, which started as new standards for cooperation and coordination among insurance supervisors, became a series of new requirements for these IAIGS, including a planned global capital standard.

NAMIC believes the chief mission of the IAIS ought to be to facilitate a stronger global insurance regulatory environment through cooperation and coordination rather than attempting to create one-size-fits-all requirements for every country in the world. If it is determined that the development of a capital standard should proceed, the various representatives of the U.S. that engage in these international fora, must speak with one voice. And that voice must speak in defense of the U.S. market, existing regulatory

structure, insurers, and especially policyholders. Finally, in order to ensure that state regulators, the insurance industry, and Congress all have an appropriate say in this debate, a transparent process should at all times be considered of paramount importance.

The Development of an International Capital Standard

A current and powerful example of the issues at stake when discussing international standards for insurance, is the development of a global capital standard by the IAIS. On October 9, 2013, the IAIS announced it would develop a risk-based International Capital Standard (ICS) by the end of 2016 for all IAIGs. Since its inception, ComFrame has included a capital component – this will be the starting point for the ICS (when complete the ICS will act as the ComFrame capital component). The ICS is scheduled to be implemented beginning in 2019. NAMIC remains concerned both with the timeframe of this project as well as some of the inherent assumptions about global uniformity that inform the project.

The application of the same capital standard to unique companies that come from very different regulatory environments with very different economic and political goals will not produce comparable conclusions about capital or solvency. Every country has a unique regulatory system with unique features that influence the solvency of the companies doing business in that regulatory environment.

For instance, U.S. companies are subject to rate regulation, legal entity risk-based capital requirements, financial statement filing requirements, regulatory financial analysis, periodic risk-focused financial examinations, market conduct examinations, guaranty fund assessments, Enterprise Risk Reports, Own Risk Solvency Assessment filings, and a highly litigious environment. This system is based upon an economic and political philosophy that supports limited barriers to entry and exit, and a competitive insurance market with protection of policyholders the primary role of the regulator. Many of these features of the U.S. system result in higher levels of solvency, a stronger more competitive system, and earlier identification of hazardous conditions that are not provided in all regulatory systems. At a minimum the features of the U.S. system are different from those of other countries.

The U.S. environment differs from that of Europe or China for example. The proliferation of state-based insurance entities in China, monthly financial reporting requirements and the percentage of companies below 100% solvency reported in their 2011 FSAP are features of the unique Chinese environment. In the EU the future implementation of Solvency II with its very high capital requirements and desired protection of creditors and investors poses another unique regulatory and political environment. None of these systems are right or wrong, they are just different. The level of supervision of insurers is sound and while the means are different, they have all found effective ways to supervise their insurance industry. But it is important to recognize that these are not comparable systems – the companies from these countries do not have comparable regulatory oversight. Any effort to create one capital standard should be principle-based,

outcomes-focused and fluid enough to recognize these very major differences in approach.

In addition to regulatory environment and economic/political philosophy, unique characteristics from company to company will also affect any effort at comparability as all differing characteristics cannot be measured fully in a single capital formula. Companies could have the same level of "written premium" but very different levels of volatility due to differing concentrations of catastrophe risk or terrorism risk, for example. Companies could have the same amount invested in "derivatives" with one engaged only in simple interest rate swaps and the other invested in highly complex, multiple level derivatives similar to those that were related to the financial crisis. Companies could have the same Enterprise Risk Management framework, but the incorporation of an ERM risk and capital analysis throughout the enterprise in all decision-making could be quite varied. These are just a few of the examples of the very significant differences between different insurance groups that are not "comparable." These variations will result in very different solvency concerns and capital needs.

The specific direction that the IAIS has taken is generally too prescriptive and formulaic and has some specific features of concern:

- ***Legal Entity Regulation*** – The U.S. system of insurance regulation operates under the assumption that a legal entity capital system is stronger and more protective of policyholders who rely on contractual commitments from the individual legal entity. The idea that group supervision and a capital requirement at the group level will create more sound regulatory protections ignores the impact on policyholders who rely on the legal entity from whom they decided to purchase insurance. The group level contagion risk from one troubled legal entity to a sound legal entity is not what that policyholder bargained for. While the legal contractual implications may vary between jurisdictions, this is a very important concept in the U.S. The recognition of the need for legal entity capital protection is critical and is something the IAIS seems to lack in its deliberations over the ICS.

- ***Fungibility of capital*** – The movement away from the focus on supervision and capital requirements at the legal entity level raises questions about a supervisor requiring movement of capital between legal entities, also known as "'fungibility" of capital. This is of considerable concern for companies that operate with a business model based on legal entities. One need go no further than imagining what might have happened in the case of AIG if regulators or the subsidiary entities with all of the contagion risk had been allowed to simply raid the healthy subsidiaries to try and address the problem. Legal entity supervision obviates the need for fungible capital at the group level, a fact that supporters of an ICS seem to simply ignore.

- ***Accounting Standards*** – NAMIC has advocated for a flexible, principle-based approach that considers the regulatory outcomes of each jurisdiction. The IAIS

seems to be committed to producing a prescriptive capital formula based on the same accounting information. U.S. companies rely on Statutory Accounting and U.S. GAAP, which is not consistent globally. Changes in accounting standards would be very disruptive. If the U.S. supervisory, corporate law, and accounting systems are required to change significantly to accommodate the new group capital requirements that are more consistent with existing European standards, this will create a significant competitive disadvantage for U.S. insurers.

A successful global effort would not create unnecessary competitive issues for companies domiciled in one well-supervised jurisdiction over companies from another. Instead, a flexible and dynamic capital assessment that would recognize and improve understanding of diverse, successful approaches to solvency regulation and would create a principle-based, outcomes-focused approach is needed. Using this approach would help supervisors achieve the desired goals of policyholder protection and insurer solvency. In short we favor a dynamic solvency assessment process that will continuously improve.

Unfortunately, the IAIS does not seem to be heading in this direction and implementation may require adopting different accounting standards and the global capital requirement may favor the local approach of one jurisdiction over another creating further disproportionate costs between companies similarly situated. The potential market disruptions could be unintended, but very significant. Additionally, it appears that the IAIS is moving forward without a full assessment of the impact on U.S. consumers and insurance markets.

One Voice – Team U.S.A.

If the U.S. regulatory system, risks, and legal environment are not the same as many of the other jurisdictions pushing prescriptive capital calculations in the case of the ICS, it stands to reason that the U.S. would want to advocate on behalf of its own system in these discussions. At the very least, the U.S. should be pursuing an outcomes-based approach, which would ultimately serve the global economy better than a presumption that all companies can be compared on an equal footing. As this is the case, the U.S. is in need of a clear and coherent position from which to negotiate internationally on insurance regulation and congressional leadership and oversight in helping develop that may be necessary.

Currently, many decisions on international financial services are being made by the G-20 entity known as the Financial Stability Board (FSB). It was the FSB that tasked the IAIS with developing the capital standards for both Global Systemically Important Insurers as well as IAIGs. The U.S. is represented on the FSB by the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission (there are no U.S. state insurance regulators or legislators on or represented at the FSB). At the IAIS, the U.S. is represented by the Treasury Department through the Federal Insurance Office, the Federal Reserve, and state insurance commissioners. NAMIC believes it is important to ensure that our federal agencies representing the U.S. at the

IAIS are advancing policy positions that represent the best interests of U.S. insurance consumers, the insurance markets, the insurance regulators, and the U.S. economy in general. It is important that "Team U.S.A." speak with one voice.

To the extent that any of the U.S. representatives are pushing, or even simply acquiescing to, these new standards, it seems clear they would be working in direct contravention of the direction of Congress to support the existing state-based insurance regulatory system in international negotiations. The various policymakers engaged in these discussions have been taking clear steps to coordinate the industry and U.S. regulators on policy positions. This is all to the good and must continue. However, NAMIC believes Congress must continue to play a key role in helping to ensure that our Federal representatives and state regulators are communicating and uniting to advocate on behalf of the U.S. insurance market and the regulatory system that protects its policyholders.

Transparency

At the same time they are moving down a path with significant ramifications, the IAIS is moving toward a less transparent deliberative process – the exact opposite of what should be taking place. Until this year, IAIS allowed participation in its meetings by interested parties known as "Observers." Observers paid significant fees to participate in the policy discussions, draft reviews and to have access to the materials produced by the IAIS. The organization was primarily funded through these fees.

As a result of questions about this industry funding mechanism as well as a concern that allowing observers complicated deliberations, the decision was made in 2014 to eliminate the "Observer" status. Beginning in 2015 all IAIS materials will be public and all stakeholders will have the same access to consultation drafts. However, as part of the elimination of Observers, additional changes were proposed that would essentially close most IAIS committee meetings to all interested parties/stakeholders. They have also proposed that they will invite select stakeholders to attend committee meetings when they want to hear their perspective. The National Association of Insurance Commissioners, the National Association of Insurance Legislators, the insurance industry, and consumer groups strongly oppose the closed process, and both the House and Senate have resolutions introduced in opposition to the change in transparency.

NAMIC believes that the growing importance of the IAIS and the need for "efficiency" require more, not less transparency. The importance of the issues requires the meaningful input of interested parties now more than ever. The proposed changes would ensure that the IAIS hear from only selected portions of the industry which may unintentionally create unworkable policies for many market players or unlevel playing fields with potentially disastrous results. The benefits of broad public participation include: learning from the expertise of impacted companies, balancing opposing views, identifying unintended consequences and practicalities, providing a cost/benefit analyses and identifying overlapping and interactive regulations. Transparency and

meaningful participation will also ensure that any proposed international standards are properly vetted.

NAMIC opposes efforts to reduce access to negotiations for outside stakeholders at the IAIS and supports efforts to encourage the U.S. representatives to fight to increase transparency and provide for full stakeholder participation.

Conclusion

It is NAMIC's view that the chief mission of the IAIS ought to be to facilitate a stronger global insurance regulatory environment through cooperation and coordination rather than attempting to create one-size-fits-all requirements for every country in the world. The development of the ICS points to many concerns including an over-reliance on uniformity, disregard for fundamentally different regulatory and legal systems, and a lack of a true consideration of potential costs. Meanwhile, the IAIS is moving away from an open deliberative process and while the various U.S. representatives are attempting to coordinate, a demonstrated track record of a coherent and consistent position and message is needed.

Congress has a critically important role to play as these international discussions continue. Through oversight and awareness, along with the possibility of legislation to address a needed course correction if and when the time comes, lawmakers can help protect the robustly competitive insurance market in this country.

Testimony of the

Property Casualty Insurers Association of America (PCI)

Subcommittee on Housing and Insurance

Committee on Financial Services

United States House of Representatives

November 18, 2014

The Property and Casualty Insurers Association of America (PCI) commends Chairman Neugebauer, Ranking Member Capuano and the Subcommittee on Housing and Insurance for holding this important hearing on "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II". The Property Casualty Insurers Association of America (PCI) represents more than 1000 insurers that account for 40% of the total U.S. home, auto and business insurance market. PCI members write insurance and reinsurance throughout the world. Among our members are companies designated as systemically important and globally systemically important as well some that potentially would be subject to enhanced supervision as internationally active insurance groups.

Since enactment of the Dodd-Frank Act, many in the U.S. industry, consumer groups, state legislatures and insurance regulators have expressed deep concerns and objections about the increasingly pervasive dominance in domestic and international insurance standard discussions of the Treasury and Federal Reserve Board and the banking regulatory culture they are accustomed to. The attempt to graft centralized bank holding company regulation designed to supervise too-big-to-fail international banks onto state regulated insurance is having the unfortunate and Congressionally-unintended consequence of sublimating a focus on consumer protection and marketplace competitiveness to a one-size-fits-all globalization and homogenization of regulatory standards.

Further Congressional engagement is necessary to reiterate the intent of Congress with respect to federal efforts to redirect insurance regulatory goals and to make appropriate clarifications to the Dodd-Frank Act. In particular, the House currently has before it bipartisan and bicameral legislation to stop the application of bank holding company standards to insurance holding companies with depository institution affiliates (the Insurance Capital Standards Clarification Act of 2014), legislation to prevent federal bank regulators from using insurance assets held for consumer policyholders as a source of strength to bail out banks (Policyholder Protection Act of 2014), and House Appropriations report language (H. Rept. 113-508) that "remind the Federal agencies involved in international financial standard setting discussions to avoid advocating for or facilitating international capital standards (or demands for standards) that run contrary to the objectives of state insurance regulators." Finally, there has been Congressional push back in the form of bipartisan and bicameral resolutions against efforts to close international meetings to U.S. consumers and companies.

Background

The state-based insurance regulatory system was largely reaffirmed by the Congress in Dodd-Frank, because of its strong record of performance in consumer protection. That regulatory system has evolved

numerous tools to protect consumers, including a comprehensive solvency regime, financial reporting and market conduct rules that protected consumers during the financial crisis and in the years since. Indeed, despite years of recession, investment market volatility and unprecedented natural catastrophes, the U.S. property and casualty insurance industry has had very few recent failures and is maintaining near record levels of surplus to premium. The industry continues to be highly diverse, competitive and solvent. States in the U.S. make up more than 24 of the world's 50 largest insurance markets with nearly a third of the global premium market share.

Subsequent to the recent global financial crisis, Congress passed the Dodd-Frank Act creating new federal supervisory authority over firms designated as systemically important financial institutions (SIFIs) and creating a new Federal Insurance Office (FIO) for certain international representation and federal coordination efforts, although leaving insurance regulatory power with the U.S. states. The Fed is now seeking to regulate a very significant percentage of the insurance market, with Governor Tarullo recently reported as stating that the Fed's purpose is "assuring on a consolidated basis the safety and soundness of large financial institutions" (apparently not just systemically important financial institutions) while the Treasury has suggested "hybrid" federal-state regulation for insurance.

The Administration has also assumed leadership and control over financial standards, in particular helping to create the Financial Stability Board (FSB) to set internationally agreed policies and minimum standards that its members commit to implement at a national level. The FSB in Basel, Switzerland, is chaired by the Bank of England, and includes 70 financial government members – primarily finance ministers and central banks with only one entity specifically representing insurance. The FSB decides which insurers are globally systemically important, and increasingly directs entities like the International Association of Insurance Supervisors (IAIS) to develop global insurance standards such as capital standards (ICS) that apply broadly, even to companies that do not pose a systemic risk.

The FSB is extremely opaque, particularly for U.S. insurers who are largely unrepresented but subject to FSB direction. The FSB has been dictating directions on insurance accounting and capital standards. While the Financial Accounting Standards Board (FASB) largely rejected adoption of international accounting standards for the U.S., the standards are now being considered for requirements as part of global insurance capital standards (and the FSB is continuing to press for implementation consistency of the separate U.S. and international models). The IAIS has recently decided to become similarly opaque. While the Committee has encouraged our U.S. and state officials who have attended IAIS meetings to coordinate and work together, there have been mixed results, with some coordination on logistics and capital standards (for example), but lack of agreement on end goals, transparency, and inclusion of all parties.

Closing Meetings to U.S. Consumers and Insurers

Treasury's FIO joined the International Association of Insurance Supervisors (IAIS) several years ago and the Federal Reserve Board recently joined as well. Shortly thereafter, the IAIS voted, over the opposition of the NAIC and state regulators, to eliminate observer participation in most stages of policy development. The ban, which has now been adopted, includes both industry and U.S. consumer groups, although it allows Committee Chairs to call on persons with technical expertise as desired. While some members had questioned the role of observer fees in helping fund IAIS expenses, notably the consumer groups were not required to pay to participate, nor were other alternatives formally considered. Regulators operating behind closed doors may be common in banking circles but it is highly unusual in

U.S. insurance regulation. Potential federal support for reducing public participation in the international standard development process is in direct contravention of directions from this Committee leadership, including an October 22, 2014 letter from Representative Capuano to the Fed, FIO and NAIC taking the position that the ability of U.S. policyholders, U.S. companies, and the American public to contribute substantively via a transparent process is important to meaningful U.S. participation in the IAIS process. The House Appropriations report language accompanying H.R. 5016 (the Financial Services and General Government Appropriations Act, 2015) noted that "many of the proceedings between U.S. regulators and their foreign counterparts are opaque and not subject to the Sunshine Act (P.L. 94-409). In order to maintain the ability of U.S. businesses to compete in an expanding global economy, dialog between international and U.S. regulators must be much more transparent." And there have been bipartisan and bicameral resolutions introduced opposing the IAIS moves to reduce transparency and access by our consumers and companies. However, the U.S. federal representatives to the IAIS apparently diverged from the U.S. state insurance regulators who opposed reducing IAIS transparency to public observers.

Failing to Coordinate Thereby Reducing U.S. Influence

Dodd-Frank intended to enhance the U.S. presence and strengthen the U.S. voice in international insurance regulatory discussions by creating Treasury's FIO and giving it the authority to participate in those discussions as a consistent coordinating presence. However, Treasury and the states have significantly different policy goals, in particular the future federal role of insurance regulation and the desirability of regulating insurance groups or holding companies for group capital, supervision and corporate governance. As a result, FIO and the state regulators do not always provide the U.S. with a definitive and united voice. For example, FIO and state regulators have run against each other for IAIS office and the U.S. independent insurance expert appointed under the Dodd-Frank Act has had difficulty getting federal support to be allowed to observe IAIS discussions related to insurance systemic risk analysis. The House Appropriations report language accompanying H.R. 5016 (the Financial Services and General Government Appropriations Act, 2015) admonished that neither the Department of Treasury nor FIO have regulatory authority over insurance companies and "recent negotiations by the Department and FIO involving international capital standards for all internationally active insurance groups, not just those insurers that are considered systemically important, necessitates the Committee to remind the Federal agencies involved in international financial standard setting discussions to avoid advocating for or facilitating international capital standards (or demands for standards) that run contrary to the objectives of state insurance regulators."

Opaque International Insurance Agreements on G-SIIs are Executed Domestically despite a Fundamental Misunderstanding of Insurance by Bank-dominated Regulators

The Treasury and Federal Reserve Board are both leaders of the Financial Stability Board (FSB). The FSB does not have any direct regulatory authority nor any Congressional delegation of power. It is also extremely bank-regulator dominated with only one insurance-specific member out of 70. And yet the FSB is currently directing global financial regulatory developments including for insurance. Last year, the FSB designated nine insurance firms as global systemically important insurers (G-SIIs). Neither the FSB nor the Treasury or Fed have indicated whether there were any standards used in this process. Nor does there appear to be any due process internationally accorded to the designated companies, or any guidance informing companies how to adjust their businesses if desired to avoid or remove such designation. The three U.S. domiciled insurers designated had not been determined by the U.S. FSOC to

be SIFIs under U.S. law, but after the international agreement were subsequently designated (or in one case subject to a preliminary designation that FSOC is still considering). Peter Wallison of the American Enterprise Institute testified to this Committee in May that at the very least, both the Treasury and Fed had to acquiesce in the FSB designation despite any domestic due process, and noted that Representatives of this Committee had been unsuccessful in getting a response from Treasury whether it had concurred in FSB actions. Wallison suggested that a designation decision "seems to have been baked in the cake" at the international level by Treasury and the Fed before it was made by the FSOC.

Both the insurance regulator and independent insurance expert on FSOC strongly dissented to at least one of the designations. Insurance voting member Roy Woodall's dissent to the designation of Prudential indicated that FSOC's designation of Prudential "does not contain any analysis that presents any findings as to... severe impairment of the functioning of U.S. and global financial markets.... No empirical evidence is presented; no data is reviewed; no models are put forward." Woodall indicated that FSOC's "underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented... the grounds for the Final Determination are simply not reasonable or defensible...."

The sole insurance regulator on FSOC, Director Huff, similarly dissented, suggesting that "there appears to be a lack of recognition given to the nature of the insurance business and the authorities and tools available to insurance regulators. Insurance is not the same as a banking product yet the [designation] inappropriately applies bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient, and unsupportable."

Edward DeMarco of the Federal Housing Finance Agency also objected to the same FSOC designation, suggesting that the FSOC concerns about potential for an insurance run did not have supportive evidence and such concerns would be better addressed by tools other than designation. DeMarco in particular noted that the insurer had offered to undertake additional actions to avoid designation, including a resolution plan, which was rejected by FSOC.

Subsequent to significant criticism by Congress, the marketplace, insurance regulators and numerous academics, FSOC has opened a dialogue about its designation process to consider improvements. PCI strongly encourages the Congress to continue its involvement in addressing concerns about this additional area of federal agency intrusion and additional layers of regulation of insurers, and in particular the engagement of our federal agencies in opaque international bodies to impose international standards or designations increasing federal regulatory authority over insurance.

Bank Capital Standards are Inappropriate for Insurers

Federal Reserve Board Governor Tarullo testified before the Senate in September that "there isn't systemic risk in traditional insurance activities" and recognized the critical differences between the insurance and banking models. Unfortunately, the Fed believes that the Dodd-Frank Act's Collins amendment requires the imposition of bank capital standards on insurance holding companies with depository affiliates. Both the House and Senate have passed legislation, the Insurance Capital Standards Clarification Act of 2014, to clarify the original legislative intent of Congress in the Dodd-Frank Act that in regulating insurance holding companies with banks or thrift affiliates, the Federal Reserve Board should apply bank capital standards to the banking portion and insurance capital standards to the

insurance operations. PCI has previously testified in favor of this legislation and it is critical that Congress get this bill enacted this year. It would additionally be helpful for Congress to provide direction regarding the application of appropriate U.S. insurance capital standards to U.S. insurance companies, since the Fed has indicated that it is reviewing not only U.S. state insurance standards but also the Basic Capital Requirement (BCR) and Insurance Capital Standard (ICS) being developed internationally for insurers.

The Burden of Imposing International Financial Reporting Standards on the U.S. Insurance Market

The NAIC CEO, Senator Ben Nelson, has stated that state insurance regulators believe that "the push for market valuation accounting as an international standard will most certainly have a negative impact on the U.S. market to the detriment of American insurance consumers. This kind of homogenous approach of treating insurers like banks may actually encourage new risk-taking in the insurance industry." The U.S. Financial Accounting Standards Board (FASB) has rejected for now convergence to international financial regulatory standards (IFRS) for insurance in the U.S. However, IFRS accounting standards are now being mandated through the backdoor of international capital standards, as the IAIS proposals for a global capital standard could require U.S. application of the key components of IFRS such as mark-to-market volatile accounting for insurance assets and expensive reserving probability weighting and discounting, which FASB has indicated is not helpful to investors or analysts. Robert Litan, The Brookings Institutions Nonresident Senior Fellow, notes in his August 2014 paper "Worrisome Trends in Solvency Regulation of Insurance Groups in a Post-Crisis World (p. 13) that requiring large U.S. insurers to convert either from Statutory Accounting Principles (SAP) used by U.S. insurers to Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) "could entail hundreds of millions of dollars of expense. Smaller insurers are likely to find any forced conversion expensive in relation to their total expenses, and because they do not have the economies of scale of larger insurers, could suffer a disproportionately negative impact. Indeed, the Financial Accounting Standards Board in the United States earlier this year pulled back from a new approach to property-casualty insurance accounting because its costs far outweighed any perceived benefits."

Imposing Bank Type Global Capital Standards without Any Showing of Need or Consumer Benefit

NAIC CEO, Senator Ben Nelson, has indicated that unnecessary capital costs will disrupt our vibrant and innovative U.S. market for insurance and that the homogenous approach of treating insurers like banks may actually encourage new risk-taking in the insurance industry. Connecticut Insurance Commissioner Thomas Leonardi, who has been an international insurance leader for the U.S, has often questioned the need for a one-size-fits-all insurance capital standard (ICS). Leonardi has asked "What's the problem we are trying to solve" and noted the impossibility of having a global capital standard without a global accounting standard. Leonardi has suggested that the timetable for an international capital standard bordered on "reckless", which has been echoed by other state regulatory leaders. Leonardi noted that EU leader Gabriel Bernardino has suggested that there must be one single insurance capital standard worldwide and that Solvency II should be that de facto international standard.

A recent study by Robert Shapiro and Aparna Mathur ("Unnecessary Injury: The Economic Costs of Imposing New Global Capital Requirements on Large U.S. Property and Casualty Insurers") states that "researchers have consistently found that the P&C industry poses no systemic risk" and that international insurance capital standards such as those being considered by the IAIS could increase

domestic homeowner's insurance from affected companies by $34 to $109 for each consumer as well as creating potential availability issues. Michaela Koller, General Director of Insurance Europe said that Solvency II type standards require insurers "to hold inappropriately high amounts of capital", which in particular will "make it more expensive for insurers to invest in long-term government and corporate bonds, as well as growth-stimulating activities, such as infrastructure projects."

In a study on "Worrisome Trends in Solvency Regulation of Insurance Groups in a Post-Crisis World", Brookings' Litan points out that U.S. state insurance regulation has focused on a consumer-centric approach to ring-fence the capital of individual, legal insurance entities to pay insurance contractual promises and not be drawn upon to bail out a failing affiliate. Litan notes that "Since the financial crisis, however, international financial bodies, including the EU, have been pressing U.S. policy makers to adopt the EU's very different approach toward insurance regulation... borrowing from the banking industry the notion of 'group capital' regulation.... In effect, group capital regulation is creditor-centric..." Litan further notes that "if the history of international bank capital standards established by the Basel Committee is any guide – as it should be – the rules applied to a limited number of institutions (Basel initially only applied to internationally-active banks) tends to become a template for a much larger number.... In the insurance arena in particular, the International Association of Insurance Supervisors (IAIS) is currently working on a global solvency standard initially meant to apply by the end of this year only to Globally Systemically Important Insurers (GSIIs), but plans appear to be in place to use that template for a much larger group of insurers, including those in the United States.... there is a key difference between the way in which [insurance is] regulated in the United States and in Europe, as well as in a fundamental difference in regulatory philosophy: while Europe tends to put primary emphasis on preserving insurers and protecting their creditors, the U.S. historically has focused its primary attention on protecting insurance policyholders.... All this means that while group capital regulation may be appropriate for banks, it clearly is not generally appropriate for insurance." (p.1-2). *"In sum, the critical issue is whether we want customer-centric or creditor-centric regulation of insurance, especially of non-systemically important insurers."* (p.13 – emphasis in the original).

The Financial Stability Board, led by the U.S. Treasury, Federal Reserve Board and numerous other central banks, finance ministers and standard setting agencies (but only one specific insurance member) directed the IAIS to come up with a global capital standard for large internationally active insurance companies. It did so without providing a scintilla of objective evidence that such a standard was necessary or desirable. Indeed, the wrong global capital standard could actually create systemic risk in the insurance sector where it is absent in connection with traditional insurance activities. The FSB also recently stated in its October update to guidance on the Key Attributes of Effective Resolution Regimes for Financial Institutions that regulators need to have the power to restructure insurance contracts and allocate losses to creditors and policyholders. This will fundamentally transform the U.S. industry from consumer-centric to increasingly creditor-centric – a transformation that Congress may wish to weigh-in rather than allow a fait accompli through international agreements.

Judging U.S. Insurance Regulation by Foreign Standards

The FSB, which includes the Treasury and the Fed but only one insurance-specific international member, issued a "peer review" of the U.S. state based insurance regulatory system that shockingly called for more U.S. federal involvement and insurance regulatory resources. Shortly thereafter, Treasury's FIO issued a report that called for a hybrid federal-state regulatory system. A more extensive international

analysis is currently being completed under FSB's direction by the International Monetary Fund, with FIO designated by Treasury to lead the U.S. defense of the analysis of the U.S. state insurance system. The former Assistant Secretary of the Treasury for Financial Institutions, Wayne Abernathy, in a September 4, 2013 American Banker article suggested that the FSB "really dislike[s] the American system of insurance regulation... which they write disapprovingly as being 'characterized by the multiplicity of state regulators' and 'the absence of federal regulatory powers.'" Abernathy noted that he was "unable to find the record of Congressional authorization or even discussion of the merits of submitting the entire U.S. financial system to a formal review by employees of European and Asian bank regulators.... Given the recent fiasco with efforts to apply the Basel III capital structure to all U.S. banks, large, small and everything in between, these are not idle questions." Ironically, any legitimate comparison of the performance of the financial systems during the recent global financial crisis would demonstrate that the state-based insurance regulatory system of insurance activities performed far better than many U.S. federal and international banking regulatory systems.

Demanding U.S. Insurance Regulation Change and Apply for Equivalency to Untried Solvency II

European insurance regulators, many of which are part of central banks, are insisting that the U.S. make dramatic changes in its regulatory system to mimic Solvency II, in order that U.S. companies will be treated in the future equally with European companies. The irony is that Solvency II hasn't even been implemented compared to the U.S. system which has evolved over 150 years and has demonstrated its success and benefits in the toughest of circumstances. In its June 6, 2014 letter to FIO and the NAIC, the European Commission stated that "the US authorities agreed in the context of the Financial Markets Regulatory Dialogue that both parties would work towards the start of discussions for a 'covered agreement' (as foreseen by the Dodd-Frank Act), with a view to removing all reinsurance collateral requirements on both sides. We therefore consider that negotiations of a bilateral (or 'covered') agreement to remove all collateral requirements would be a necessary starting point for a temporary equivalence decision in reinsurance for 5 years (during that period, the US solvency regime would need to continue to evolve towards a more risk-based approach, which is a requisite under Solvency II for granting temporary equivalence in reinsurance)." The NAIC responded on July 11, 2014 that "There are clear structural and legal differences between our two supervisory systems, but we continue to believe that the US regulatory system results in outcomes for insurers and policyholders that we hope Solvency II will achieve once it is fully implemented." FIO has recently indicated that it plans on negotiating a covered agreement with Europe, potentially next year, which is likely to include reinsurance collateral and perhaps additional regulatory issues.

Conclusion

A large number of significant unintended consequences have resulted from the limited authority relating to insurance regulation granted in Dodd-Frank to the Treasury and the Federal Reserve Board, especially ironic in view of the Act's repeated affirmation of state-based insurance regulation Discussions in international standard directing and setting bodies are increasingly nontransparent and increasingly transformative in moving insurance regulation from consumer-focused to creditor-focused bank-like regulation. While traditional insurance is widely recognized to not be systemically risky, U.S. federal and international regulators are in negotiations to create global one-size-fits-all bank-like rules necessitating additional layers of centralized/federalized oversight. Many of these standard setting agreements are already being implemented in the U.S. While PCI, like most U.S. state insurance

regulators and marketplace stakeholders supports greater regulatory coordination and communication and cooperation as well as mutual recognition, much of the transformation is occurring beyond the bounds of the Dodd-Frank Act and without specific Congressional authority. On the eve of the Act's fifth anniversary, it is appropriate for Congress to consider providing additional specific direction.

Unnecessary Injury:

The Economic Costs of Imposing New Global Capital Requirements On Large U.S. Property and Casualty Insurers

Robert J. Shapiro and Aparna Mathur

November 2014

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The Economic Costs of Imposing New Global Capital Requirements on Large U.S. Property and Casualty Insurers

Robert J. Shapiro and Aparna Mathur[1]

I. Introduction

In the wake of the global financial crisis of 2008-2009, governments in every developed country applied new forms of financial regulation, and now their attention has shifted to international regulation. One of those trans-national efforts involves applying a new layer of global capital requirements to "Global Systemically Important Insurers (G-SIIs), whose failure could trigger a new financial crisis. In addition, talks are underway to also impose new global capital requirements on large insurance companies with significant foreign operations, but which do not present a systemic risk to their own economies or the global financial system. This study examines the rationale for this new regulatory approach and the costs associated with applying it to large U.S. property and casualty (P&C) insurers. We find, first, that such additional capital requirements are unnecessary: Even the largest U.S. P&C insurers pose no systemic risk to the U.S. or global financial systems, and current state-based capital requirements are sufficient to ensure that they can handle the claims arising from even the most extraordinary losses. Second, we find that imposing additional capital requirements on large U.S. P&C insurers with substantial foreign business, all other factors being equal, would likely force them to slow the growth of new P&C coverage, increase the cost of that coverage, and reduce their investments.

For nearly two centuries, American insurance companies have been regulated almost exclusively by U.S. state governments. Even today, as Congress and the Executive Branch claim expansive authority over most financial institutions, virtually all insurance regulation still takes place in the states. The persistence of this state-based approach reflects, as a legal matter, the McCarran-Ferguson Act enacted in 1945, which authorizes federal regulation of insurers only on matters which states fail to address and Congress specifically declares that the federal government will oversee. The generally hands-off approach of the federal government also reflects basic features of the insurance business, especially for property and casualty insurers. People insure their homes, automobiles, businesses and other property for losses arising from unpredictable events such as thefts, fires, hurricanes and earthquakes; and these events do not occur randomly across the country. Thefts and automobile accidents, for example, are more common in urban areas where populations and auto travel are more concentrated. Major natural disasters such as hurricanes, tornadoes and wild fires, which can produce tens of thousands of claims from a single event, are concentrated even more in certain states and regions. The state insurance commissions which license and oversee the operations of U.S. insurers are properly seen to be closer than a single federal agency to the local circumstances which require coverage and the ability of local populations to secure that coverage.

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At the same time, insurance regulators in every state face many of the same challenges, and the regulation of insurers across the 50 states and the District of Columbia has substantially converged through the broad adoption of model laws and regulations developed by the National Association of Insurance Commissioners (NAIC). State legislatures and insurance commissions can ignore the NAIC's recommendations; in practice, they almost always adopt or adapt NAIC model laws and regulations. One area of broad agreement involves the capital requirements or capital standards for insurers, matters widely seen as the heart of insurance regulation. These standards are intended to ensure that insurers can meet the claims of their customers under extraordinary as well as normal circumstances and continue to provide reliable coverage following disasters that produce many billions of dollars in claims.

Capital standards involve costs for insurers. Consequently, their levels and the rules that determine them affect both the price of coverage and the extent to which people and businesses can access that coverage. Since the mid-1990s, insurance regulators in every state have moved from fixed capital standards to risk-based capital (RBC) requirements. These RBC standards use a series of NAIC formulas to evaluate and assess a broad range of asset risks, insurance risks, affiliate risks and off-balance risks, in order to determine the capital reserves that each insurer needs to take account of those risks and remain financially sound. In recent years, the European Union (EU) also has adopted RBC standards. Unlike U.S. regulators, Europeans favor a more uniform RBC standard based on applying a series of financial models to insurers, including the subsidiaries of U.S. insurers doing business in their countries.

The convergence of the EU's ongoing process of adopting RBC standards with the recent financial crisis and the role played in that crisis by the insurer American International Group (AIG) produced calls for a new, global RBC standard for large insurers with substantial foreign business. For U.S. insurers, this global capital requirement would come on top of state-based regulation and likely would be based on an EU approach to those standards. If adopted on those terms, this initiative will substantially increase the capital requirements for those U.S. insurers.

As we will see, there is no evidence that higher capital requirements are needed to ensure the solvency and operations of large U.S. insurers. Higher requirements cannot be justified as "insurance" against a systemic financial crisis triggered or exacerbated by the failure of a major P&C insurer: Applying a range of measures and standards, researchers have consistently found that the P&C industry poses no systemic risk to the larger financial system or the overall economy. Furthermore, under current state-based RBC standards, the U.S. P&C industry has dealt with enormous claims arising from recent disasters without threatening their current or future coverage, much less their solvency -- from the Northridge earthquake, the 9-11 attacks and Super-storm Sandy, to the terrible 2005 hurricane season encompassing Katrina, Rita, Wilma and Dennis. By a series of measures, the P&C industry also weathered the financial and economic upheavals of 2008 and 2009 with little if any damage and no adverse effects for their policyholders.

We also have analyzed the P&C industry's capacity to deal with larger disasters – events judged to be likely to occur once in a century, once every 250 years, and once every 500 years. We will show that the current resources set aside by the industry for great catastrophes would clearly cover a once-in-a century event with claims more than twice those of the 2005 hurricane season, including Katrina. Assuming current reinsurance practices, the industry's present catastrophe resources also could handle disasters thought likely to occur once every 250 years

and even once every 500 years. In our judgment, a new, uniform and higher global capital requirement for large U.S. P&C companies with international business is unwarranted.

Higher capital requirements also would impose new costs on those insurers, particularly if companies maintain their existing capital margins (the excess of actual capital over required capital). Based on comparative analyses of European and U.S. capital requirements, we estimate that such a global capital standard would at least double the effective capital requirements for U.S. P&C insurers subject to the standard. In principle, the new requirements should raise the price of coverage and/or reduce its availability for millions of American households and businesses, all other factors being equal. In principle, much higher capital standards also would reduce future investments by P&C insurers and dampen the industry's efficiency and offerings by creating an uneven playing field for the affected companies. The extent of those consequences will depend on the level of the new capital requirements.

The impact on the cost of coverage, premium volumes and industry investment will depend on how many P&C insurers are affected and the market share they represent. In this regard, we assume that the new requirements would affect P&C companies with at least $10 billion in annual gross written premiums or $50 billion or more in assets, which operate in least three countries, and derive at least 10 percent of gross premiums from foreign operations. By these criteria, drawn from the current U.S.-EU dialogue on new global capital standards for "Internationally Active Insurance Groups" or IAIGs, the new requirements would cover seven major U.S. insurers with 26.6 percent of the current U.S. P&C market: Liberty Mutual, American International Group, Travelers' Companies, Inc., Berkshire Hathaway, Inc., Chubb Group, ACE Group, and CNA Insurance Services. Using this scenario, we project the potential costs arising from higher, European-style capital standards.

Many researchers have examined and analyzed the economic costs and effects of higher capital requirements for commercial banks. For example, every ten percentage-point increase in bank capital requirements has resulted in an increase of 25-to-45 basis points on the interest rate charged on loans. On this basis, the contemplated increase in capital requirements for large U.S. P&C insurers would lead to increases in the annual premiums charged by the affected companies for automobile and homeowner's coverage of at least 37.5 basis-points and as much as 75 basis-points. Such a large increase would shock insurance and investment markets, so we assume the increase would be phased-in gradually: We limit our estimates to the short-run and project two increases in capital standards, of 15 percentage points and then to 30 percentage points.

To project how these increases would affect premiums for P&C insurance, we also analyzed the impact of a 15 percentage-point and 30 percentage-point increases in capital requirements on the mortgage market, and found that those increases would raise mortgage rates by 4.3 percent and 8.7 percent, respectively. To confirm the applicability, we also investigated the impact of the higher capital requirements on the historic return on equity (ROE) of the P&C industry, which is about 15 percent, and the premium rate increases necessary to maintain that ROE. We estimate that those increases would be about 4 percent and 7 percent, very close to the projected increases based on the mortgage market. Therefore, we adopt here estimates of premium rate increases of 4 percent following a 15 percentage-point increase in capital requirements for IAIGs and 8 percent following a 30 percentage point increase. On this basis, and assuming that all other factor are equal,

- We estimate that the annual premiums charged by those companies for homeowner's coverage would increase by $45-to-$55 if capital requirements rise by 15 percentage-points, and by $90-to-$109 if they rise 30 percentage-points. Similarly, the average annual cost of homeowner's insurance from an affected company could rise by about $34 if capital standards increase 15 percentage-points and by $68 if those standards increase 30 percentage-points.

Higher capital standards are also expected to affect the extent of coverage or volume of premiums. When premium rates increase, some policyholders will reduce their coverage. In addition, if competition and state regulation prevent IAIGs from raising their rates in some places, the affected companies could reduce their offerings or even withdraw their business. When Florida's state insurance commission blocked rate increases proposed by P&C insurers following the 2005 hurricane season, for example, some major insurers withdrew from that market. The volume response to higher capital standards can take a number of forms; but, in all cases, the result would be less competition and fewer choices for businesses and households.

- We estimate that if new global regulation of IAIGs increases their capital requirements by 15 percentage-points, and other factors remain unchanged, it could slow the growth of new premiums by an average of $2.9 billion per-year. Similarly, a 30 percentage-point increase in those standards for those insurers would slow the growth of new premiums by an average of $7.3 billion per-year.

Higher capital requirements are expected to modestly affect the level and composition of new investment by the affected insurers, since the slowdown in the growth of new premiums would reduce the resources available for new investments by the affected insurers.

- We estimate that, other factor remaining equal, a 15 percentage-point increase in capital requirements for IAIGs would reduce the growth of investments by those insurers by $726 million over the next five years (2014-2018), and a 30 percentage-point increase would reduce the growth of their investment by $1.8 billion over the same period.

In response to the higher capital requirements, some IAIGs will likely shift some resources from investments in relatively risky assets (such as equities and real estate) to relatively safer investments (such as Treasury bills and bonds). If all IAIGs respond in this way – the upper bound of such an effect – there would be a modest realignment of their investment portfolios.

- We estimate that a 15 percentage-point increase in capital requirements for IAIGs could result in their shifting about $1.9 billion per-year in investment assets from equities and real estate to high-grade bonds or Treasury bills, for a total of $9.4 billion over five years, other factors remaining equal. A 30 percentage-point increase in those capital standards would result in a generally comparable shift in their investment assets. These shifts in the IAIGs' investment portfolios also would reduce their investment income by between $28.9 million and $54.5 million over five years.

In addition to these costs, the IAIGs would face substantial transition costs associated with converting to the new system's valuation models for the new capital requirements, and the ongoing costs of maintain financial information for multiple accounting platforms. In addition, there are significant differences in the current U.S. system and the contemplated approach to the treatment of P&C insurers and legal entities versus groups, which would entail additional costs. While this analysis does not analyze those costs, they also could be very substantial.

We conclude that the current international discussions around establishing a new, global capital standard for U.S. P&C insurers with substantial foreign business, based on the ICS and European approach to capital requirements, are unwarranted and potentially costly to the United States. Given the recent global financial crisis, financial regulators have legitimate concerns about those aspects and operations of globally-systemic financial institutions that can adversely affect the economies of other nations. But all of the evidence demonstrates that U.S. P&C companies pose no systemic risk to the U.S. and global financial systems and economies. Furthermore, current RBC requirements for U.S. P&C insurers are more than adequate to ensure the solvency and continuing operations of the industry and its major companies under virtually any eventuality, including extraordinarily costly disasters. Finally, higher capital requirements based on the EU approach is projected to increase the cost of automobile and homeowners' coverage for many households and businesses, slow the growth and availability of P&C coverage by the affected companies, and reduce the investments and investment income of those insurers. But globalization does not demand global harmonization of financial regulation, any more than it depends upon uniform fiscal and monetary policies across nations.

II. The Terms for Regulating the Insurance Industry

The regulation of insurers should reflect the character and importance of insurance itself. Insurance is not simply a product designed to satisfy consumer desires, such as a sports car or designer sneakers. Reliable insurance is essential for the efficient planning and functioning of millions of households and businesses, and therefore for the overall economy and society. Governments regulate insurance, along with most products and services, to protect households and businesses from fraud, misrepresentation and injury. But the regulation of insurance also should recognize its character as a private good that produces broad social and economic benefits. Insurance regulation, therefore, should promote the conditions for a strong and healthy insurance industry, so people and businesses can secure coverage under reasonable terms. Insurance regulators, in short, have an implicit duty to do no harm to the industry's larger purpose by not imposing burdens that could impair its capacity to provide broad coverage for the benefit of the consuming public.

Given the insurance industry's larger social and economic purposes, much of its regulation involves the regular review and analysis of the financial conditions of insurance companies, to ensure that they have the resources to pay the claims of those they insure. Their capital reserves should be adequate to meet those claims under a variety of conditions without impairing the industry's capacity to provide and maintain continuing coverage. Researchers have found that capital standards or requirements provide a cushion to help insurers survive their own inevitable mistakes and accidents. At the same time, capital requirements increase the cost

of coverage at the margin, making it harder for individuals and businesses to obtain coverage.[2] These higher costs also raise an insurer's "hurdle rate" for its investments, discouraging lower-return transactions and contracts.[3]

In theory, if regulators could correctly quantify all of these effects for each insurer, they could set capital requirements at an optimal level that makes payments of claims secure while minimizing increases in the cost of coverage. In practice, deriving optimal capital requirements has proven to be elusive.[4] In addition to the technical challenges involved in measuring all of the factors under normal conditions, the 2008-2009 financial crisis demonstrates that no one can anticipate every circumstance that could raise serious problems for insurers. The only recent instance of huge, unanticipated claims crippling a major insurer was AIG's crisis in 2008-2009, and that involved transactions in financial derivatives wholly unrelated to AIG's P&C business. In any case, transactions in financial derivatives by all institutions are now regulated under the 2010 Dodd-Frank financial system reforms, and derivatives today account for less than *one-tenth of one percent* of the assets of P&C insurers.

Nevertheless, some regulators, especially in Europe, see the recent financial crisis as sufficient reason to raise capital requirements for American as well as European P&C insurers—despite the fact that the U.S. P&C industry came through that crisis with no adverse effects. Raising those requirements could entail significant, additional costs for U.S. P&C insurers and their customers; and as the International Monetary Fund has noted, wider safety margins intended to provide greater security during extraordinary crises provide no benefits in the absence of such a crisis.[5] Researchers also have found that reforms that impose new costs on financial institutions can induce them to shift some operations to "shadow" arrangements that may be entirely unregulated.[6] In such cases, the ultimate result is less effective regulation and an uneven playing field which can "generate a variety of damaging unintended consequences." [7]

These challenges suggest that in setting capital standards, regulators should favor an experience-based, pragmatic approach in which the results of current requirements are reviewed regularly. When existing requirements are accompanied by expanding coverage and the prompt payments of claims by financially-sound insurers under both normal and extraordinary circumstances, proposals to raise or otherwise change those requirements should bear a very high burden of proof that they will produce better outcomes.

Proposals for New Capital Requirements on Large U.S. Property and Casualty Insurers

Despite these grounds for caution, American and foreign regulators are currently considering a proposal to apply new, quantitative global capital standards for major international insurers, under the aegis of the Financial Stability Board (FSB). The FSB was created by the G-

[2] Baker and Wurgler (2013).
[3] Elliott (2014). Capital standards also create a reserve protected from the risks that some insurers may be tempted to assume in seeking higher returns. These effects should offset any moral hazard arising from state guaranty associations: These associations honor claims based on coverage by insurers that become insolvent, creating a government backstop that may induce some insurers to take greater risks than otherwise. Van den Heuvel (2007).
[4] See, for example, BIS assessment of the long-term economic impact of stronger capital and liquidity requirements; also, Kashyap, Stein and Hanson (May 2010).
[5] Elliot and Santos (Estimating the Costs of Financial Regulation)
[6] Hanson, Kashyap and Stein (2010).
[7] *Ibid.*

20 nations in April 2009, in the midst of the global financial crisis, to monitor the global economy and, when necessary, recommend measures to avert future financial disruptions and crises. The Board is comprised of representatives from the G-20 countries, the European Commission, and various international financial organizations and standard-setting bodies; and the U.S. delegation is led by senior representatives from the Board of Governors of the Federal Reserve System, the Treasury Department, and the Securities Exchange Commission (SEC).

Under its mandate, the FSB directed the International Association of Insurance Supervisors (IAIS) to develop a new "Basic Capital Requirement" (BCR) for "global systemically important insurers" (G-SIIs), as additional protection against the failure of an insurer which could trigger serious pressures and failures in other financial institutions. The IAIS issued its draft BCR for G-SIIs in October 2014.[8] Moreover, the FSB also directed the IAIS to develop "a comprehensive, group-wide supervisory and regulatory framework" for "Internationally Active Insurance Groups" (IAIGs), including a new, quantitative global Insurance Capital Standard (ICS). In contrast to G-SIIs, IAIGs are simply large insurance groups operating in at least three countries. Unless they are also G-SIIs, their own possible failures carry no perceived risk of triggering national or international systemic problems.

Finally, the IAIS has said that a simple, factor-based model will provide the basis for the Basic Capital Requirement for G-SIIs, and its approach to G-SIIs "will inform development of the ICS" for IAIGs. The contemplated ICS for IAIGs is expected to follow the European Union's uniform, financial model-based approach to capital requirements for P&C insurers, rather than the American alternative of risk-based quantitative and qualitative assessments and risk management techniques attuned to the particular conditions applicable to each insurer.

Capital Requirements in the European Union and the United States

At a general level, capital regulation of insurers in the European Union follows a set of fixed principles which drive the application of a uniform set of financial models, in contrast to the application of multiple quantitative and qualitative rules in the United States. State regulators here begin by applying two types of capital requirements to insurers in their states. The first is a fixed, minimum requirement much like Europe's, although lower than the EU standard. The second requirement is set by risk-based capital standards based on formulas developed by NAIC.[9] Insurers are required to meet the higher of the capital standards determined by the two requirements.[10] For P&C insurers, the risk-based capital requirements (RBC) cover an evaluation and assessment of a broad range of asset risks, insurance risks, affiliate risks, and off-balance sheet risks. Each insurer's RBC amount is compared to the company's actual, total risk-adjusted capital, and regulatory actions are indicated if the total adjusted capital falls below certain levels of its RBC.[11] The RBC formula is as follows:

> *RBC = 0.5 [investments in affiliates and off balance sheet liabilities, such as derivative instruments and contingent liabilities + (fixed income assets + equity assets + credit risk associated with reinsurance recoverables) + (loss reserves + premium or underwriting risks)]*

[8] IAIS (2014-A).
[9] Eling, Klein and Schmitt (2009).
[10] *Ibid.*
[11] For an excellent overview, see Klein (2012)

Since insurers often shift a substantial share of their risks to reinsurers, U.S. reinsurers are subject to comparable requirements; and, non-U.S.-based reinsurers are required to post collateral scaled to an insurer's financial strength rating before that insurer can claim accounting credit for risks transferred to those reinsurers. Beyond RBC standards, each state also monitors the financial condition of its insurers using detailed rules that govern their financial organization and transactions, through regular financial reporting requirements and audits.[12] The Financial Analysis Solvency Tools (FAST) system is one of the main mechanisms for these monitoring tasks, applying an array of solvency monitoring tools and a computerized analytical routine comprised of 20 financial ratios. In a series of studies, the FAST system predicted as much as 91 percent of P&C insolvencies and as few as 40 percent, depending on the data used.[13]

By contrast, the current EU system for capital requirements and regulation is built on two master agreements. The first, called Solvency I, focuses mainly on coordination issues across EU member states; but, it also sets solvency capital requirements based on an insurer's premiums and claims, rather than its risks. These requirements were widely criticized as rigid and unrealistic;[14] as a result, a second agreement, Solvency II, seeks to adapt the American risk-based approach to European principles and produce RBC standards for the EU. Its quantitative standards set a minimum capital requirement as well as a "target capital" standard, which is the economic capital an insurer is deemed to need, according to the system's financial models, to operate within a safe range given its underwriting risk, market risk, credit risk, and default risk.[15] The RBC for P&C insurers in the EU also takes account of operational risks and the prospect that an insurer's liabilities will increase based on the timing, frequency and severity of insured events and the associated claims settlements.

While the American and European approaches to RBC standards consider many of the same factors, important differences persist. The U.S. standard is organized around detailed rules, while the ICS and EU standard are organized around more general principles and financial models. The result is that EU capital regulation is more costly and inconsistent in its application across jurisdictions. In general, the ICS and EU approach also lead to much higher capital requirements, even though an EU study found that the main source of insurer insolvencies in EU nations was management errors, not under-capitalization.[16]

III. Assessing the Case for a New Global Capital Requirement for U.S. IAIGs

There are two reasons why international regulators might consider applying an additional global capital requirement to large U.S. insurers with substantial business overseas. First, the regulators' lack confidence in the classifications which distinguish between IAIGs and G-SIIs, the "systemically important" insurers whose failure could produce serious financial stresses in other financial institutions and possibly cascading failures that could damage the economy and drive up unemployment. If this were so, increasing their capital requirements, as is now underway for G-SIIs, could make their failures less likely. The first issue, therefore, is whether

[12] Eling *et al., op. cit*
[13] *Ibid.*
[14] For example, under Solvency I, an insurer could lower its capital requirements by reducing its premiums, even if doing so increased its risks.
[15] Eling *et al., op cit.*
[16] European Commission (2007).

there is any basis to believe that the failure of a large IAIG could produce systemic costs. The answer, as we will see, is no.

Alternatively, foreign regulators may have little confidence in current U.S. risk-based capital requirements and fear that the failure of an IAIG would require a government bailout and undermine public confidence in insurance. The second issue, therefore, is whether there is any significant likelihood that an IAIG facing huge claims from some catastrophe could fail with such adverse effects. Again, the answer, we will see, is clearly no.[17]

Systemic Risks Associated with the Failure of a Large U.S. Property and Casualty Insurer

The issue of systemic risk mainly involves size and interconnectedness, and in some cases, non-traditional activities that involve unknown risk. The issue here is whether an event could produce such large losses by a major P&C insurer or group of insurers that the losses would impair other parts of the financial system and the overall economy. To begin, the Dodd-Frank financial reforms address these concerns. The Financial Stability Oversight Council (FSOC) created by that legislation is charged with identifying financial institutions that could present such risks to the financial system. Once identified as "systemically important financial institutions" (SIFIs), they are subject to special supervision by the Federal Reserve Board, enhanced capital requirements, higher liquidity requirements, and limits on their short-term debts.

Most experts in finance have concluded that compared to banks, insurers have neither the size nor the interconnectedness that drive the correlated losses that can pose systemic risks, especially when the country experiences severe economic and financial stresses. To begin, the insurance industry is much less concentrated than banking. The largest U.S. P&C insurer is the Berkshire Hathaway Group with assets of $252.8 billion, as compared to the largest U.S. banking institution, J.P. Morgan Chase, with assets of $2.3 trillion. The P&C industry is also less concentrated than banking: The top five P&C insurers account for less than 31 percent of all P&C assets, as compared to the top five banks with nearly 60 percent of all banking assets.[18] Accordingly, two scholars concluded recently that, "in terms of their core activities, insurers are not large enough to be systemically important," and that P&C companies were the *least* likely segment of the industry to have that status.[19]

Insurers also are unlikely to be caught up in the cascading failures which can be triggered by the failure of large bank, and create a systemic crisis, because insurers are not very exposed to bank failures: Bank bonds represent 5.4 percent of P&C bond portfolios, and the bonds of all financial institutions represent 11.4 percent of P&C insurers' equity.[20] In addition, the insurance industry is more highly capitalized than banking: Its capital-to-assets ratio of 39.6 percent (2011) is nearly four times the 11.4 percent ratio for banking.[21] As a result, it is generally recognized that the failure of another financial institution would not expose P&C insurers to losses

[17] A third possibility is that European regulators seek to reduce the competitiveness of large U.S. insurers by imposing the higher capital requirements that European insurers already bear.
[18] Bank Market Share By Deposits and Assets, http://www.cardhub.com/edu/bank-market-share-by-deposits/; NAIC (2013-C).
[19] Cummins and Weiss (2009).
[20] *Ibid.*
[21] *Ibid.*

sufficiently large to threaten their solvency, as Lehman Brothers' failure did for other major banking institutions in 2008. With the exception of AIG, insurers did not suffer greatly in the 2008-2009 crisis -- and AIG's problems did not arise from normal insurance-related transactions. As one long-time analyst of the industry has observed, "[a]part from AIG, the insurance sector as a whole was largely on the periphery of the crisis. The AIG crisis was heavily influenced by its CDS portfolio, sold by a non-insurance entity, AIG Financial Products (AIGFP), which was not subject to insurance regulation."[22]

More generally, a recent analysis tested the impact on the insurance sector of a serious economic crisis in which the broad market gradually fell by 40 percent: The authors found that P&C insurers were *negatively* related to systemic risk under those conditions, concluding that "writing property-casualty lines may act as a stabilizing factor during systemic crises."[23] Another study also modeled the impact of a collapse in stock prices and found that even under those conditions, the insurance industry would not be a source of systemic risk.[24] These findings were confirmed in the recent Great Recession, when the value of the S&P 500 fell from 1,515.96 on December 10, 2007 to 683.38 on March 6, 2009, or 54.9 percent over 15 months. The U.S. P&C industry continued to both operate normally and expand. The "Annual Report on the Insurance Industry" issued by the Federal Insurance Office of the U.S. Department of the Treasury provides extensive evidence of the industry's resilience in this period.[25] From 2007 to 2009, direct premiums written for personal P&C coverage remained stable, and direct premiums for commercial P&C coverage fell less than 10 percent. Similarly, the net investment income of the P&C industry declined just 12.5 percent, from $56.5 billion in 2007 to $48.4 billion in 2009. Moreover, the industry's net yield on its invested assets of 4.2 percent in 2008 and 3.93 percent in 2009 was greater than the net yield recorded for any year since 2009, and fewer P&C companies became insolvent in 2008 and 2009 than in any year since 2009.

Some observers have questioned the exposure of large P&C insurers to serious problems in the reinsurance market, but those concerns also have little foundation. A 2011 analysis found that the failure of one of the three top reinsurers (Swiss Re, Munich Re, or Berkshire Hathaway) would threaten just one percent of P&C insurers, insufficient to trigger or sustain a systemic crisis.[26] A similar analysis was conducted in 2006 by the Group of 30, an international organization comprised of senior personnel from the private and public sectors and academia.[27] The report from the Group of 30 found that if 20 percent of the global reinsurance market failed – that is, if several major reinsurers failed at once – it still would not produce widespread insolvencies among insurers sufficient to affect the real economy.[28]

A series of other academic analyses also have concluded that insurance companies do not pose systemic risks. One recent study found that core insurance activities pose no systemic risk, because no insurer is sufficiently large or interconnected; and a 2010 study by the Geneva

[22] Harrington (2009).
[23] Harrington (2009).
[24] Grace (2010).
[25] U.S. Department of the Treasury (2013).
[26] Park and Xie (2011).
[27] The Group of 30 was then chaired by JP Morgan Chase chairman Jacob Frankel and Jean Claude Trichet, former head of the European Central Bank
[28] Group of 30 (2006).

Association, an international think tank for insurance issues, concurred.[29] Another recent analysis found that problems with insurers do not lead to serious problems for banks and other financial institutions,[30] while other researchers applied a number of alternative measures of systemic risk to the range of financial institutions and found that "insurance firms are overall the least systemically risky" in the financial system.[31] And Daniel Tarullo, a Governor of the Federal Reserve Board, confirmed recently that the Fed, the institution with primary responsibility for the stability of the U.S. financial system and the overall U.S. economy, does not see the P&C industry as a source of systemic risk. In testimony before the Senate Committee on Banking, Housing and Urban Affairs in October 2014, Tarullo said, "[m]y pretty strong presumption is that there isn't any systemic risk in traditional insurance activities."[32]

Other Risks to the Solvency of Large Property and Casualty Insurers

If the failure of a U.S.-based IAIG could not and would not trigger systemic costs for the financial system and economy, the question for those who would impose higher capital requirements on IAIGs becomes this: Is there any prospect that IAIGs facing huge claims from a major disaster will require public bailouts that would undermine confidence in the insurance industry? The capacity of P&C insurers to cover huge, unpredicted losses from super-storms, earthquakes, major terrorist events or other causes depends on their profits and reserves or, stated differently, their premiums, expenses, investment income and surplus. The Treasury Department reports that the 2,700 P&C insurers active in 2012 collected $460 billion in net premiums, with the ten largest insurance groups accounting for nearly half of that total premium volume.[33] The profitability of these insurers is based on those premiums, plus their investment income, underwriting gains or losses, and overall operating performance.[34]

One traditional way for state regulators to measure a P&C insurer's capacity to meet its obligations is the ratio of its premiums to its surplus, using as a threshold for adequate resources represented by a ratio of less than three-to-one. The surplus here refers to an insurer's excess capital after meeting all of the payable claims of its policyholders, or the "policyholders' surplus."[35] The data show that these surpluses have increased every year since 2009, thereby driving down the industry's premium-to-surplus ratio. The ratio in 2013 hit a record-low of 0.73 or one-quarter of the threshold and half the average 1.45 ratio for the 55 years from 1959 to 2013.[36]

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[29] Bell and Keller (2009).
[30] Chen *et al.* (2012)
[31] Acharya *et al* (2010).
[32] LifeHealthpro (2014).
[33] U.S. Department of the Treasury (2013). By 2012, net commercial written premiums exceeded pre-crisis levels.
[34] Kearney (2010).
[35] Beckman and Tremelling (1972).
[36] Property Casualty Insurers Association of America (2014). Another rough and less reliable way of evaluating an insurer's profitability is "combined ratio," or an insurer's losses, loss adjustment expenses (costs associated with investigating, administering, defending or paying claims) and underwriting expenses, as a percentage of its premiums. A combined ratio of more than 100 is said to signal that an insurer's premiums may not be sufficient to cover its losses and expenses over a given period. By this measure, the aggregate, combined ratio for all P&C insurers has exceeded 100 since 2008, while declining from 108 in 2011 to 103 in 2012. However, the combined ratio is not considered to be very accurate, because it does not include an insurer's investment income. As of December 2012, P&C insurers held about $1.4 trillion in invested assets and earned more than $50 billion of net

As noted at length already, the central feature of the regulators' strategy to ensure that P&C insurers remain solvent even under the stress of huge unexpected claims, is their risk-based capital (RBC) requirements.[37] Under this strategy, a complex set of formulas establish a minimum level of capital that can be compared to an insurer's actual capital level,[38] and state regulators are authorized to take certain actions based on an insurer's RBC-level of impairment.[39] In this way, the RBC system alerts regulators to undercapitalized insurers while they have time to intervene and prevent or reduce the costs of an insurer's insolvency. The RBC formula for P&C insurers starts with asset risks and underwriting risks.[40] Asset risks include the risk of default of policies held by the affiliates of a parent insurance company, as well as the risk of default on the principal and interest on an insurer's fixed income assets, or declining value for other short-term and long-term invested assets. The RBC formula for P&C insurers also includes underwriting risks for its reserves and premiums, which include pricing and reserving errors.

The Society of Actuaries (2010) describes the RBC calculation as follows:
Total RBC after Covariance $= R0 + \mathrm{sqrt}\,(R1^2 + R2^2 + R3^2 + R4^2 + R5^2)$, *where*
R0: Asset Risk-Subsidiary Insurance Companies; R1: Asset Risk-Fixed Income; R2: Asset Risk-Equity; R3: Asset/Credit Risk- (Recoverables, Reinsurance); R4: Underwriting Risk-Reserves; and R5: Underwriting Risk-Net Written Premium.
Authorized Control Level RBC (ACL RBC) = 0.5 x Total RBC after Covariance.

If the ratio of insurer's Total Adjusted Capital (TAC) to its ACL RBC falls below one of five defined levels, an action level is triggered. Some 2,601 P&C insurers filed RBC assessments with the NAIC for 2012.[41] Using these and earlier data, we have calculated the aggregate, industry-wide RBC ratio for the years 2008 to 2012. (Table 1, below.) Under the RBC system, regulatory action is required when an insurer's Total Adjusted Capital (TAC) is less than twice its Authorized Control Level (ACL) RBC. Our results show that the TAC for all P&C insurers, taken together, has been *five-to-six times* the ACL. From 2009 through 2012, the industry's RBC ratio has averaged more than 600 percent.

regular investment income, plus another $8.6 billion in realized capital gains. Including investment income, the industry's adjusted combined ratio falls below 100.

[37] NAIC (2014-B). RBC replaced fixed capital standards as the primary means of monitoring the prospective financial solvency of insurers. Under fixed capital standards, insurers were required to hold the same amount of capital -- ranging from $500,000 to $6 million depending on the state and an insurer's lines of business, and regardless of an insurer's financial conditions.

[38] NAIC (2014-B).

[39] Each of the four types of action -- called company action, regulatory action, authorized control, and mandatory control – requires particular responses from the insurer as well as the regulator.

[40] NAIC (2009).

[41] NAIC (2014-A).

Table 1: RBC Ratio for All Property and Casualty Insurers, NAIC, 2008-2012 ($ 000)

	2008	2009	2010	2011	2012
Number of Companies	2,650	2,568	2,606	2,600	2,601
R0 - ***Asset Risk – Affiliates***	41,956,539	44,229,308	45,408,726	45,083,425	48,201,346
R1 - ***Asset Risk - Fixed Income Assets***	6,019,789	6,745,280	6,666,137	7,941,632	7,934,578
R2 - ***Asset Risk – Equities***	52,456,701	57,209,628	69,488,335	74,325,097	80,684,906
R3 - ***Asset Risk – Credit***	17,247,418	16,184,833	14,903,885	15,514,367	13,709,545
R4 -***Underwriting Risk – Reserves***	99,937,576	100,654,969	101,631,899	102,176,645	103,245,652
R5 - ***Underwriting Risk - Written Premiums***	56,154,339	55,234,918	53,997,075	55,754,469	60,138,046
Total RBC	273,772,362	280,258,936	292,096,057	300,795,635	313,914,073
Total RBC After Covariance	193,386,033	199,654,405	211,980,682	216,938,031	226,376,198
Authorized Control Level (ACL) RBC	96,693,017	99,827,203	105,990,341	108,469,016	113,188,099
Total Adjusted Capital (TAC)	578,401,613	643,578,743	692,557,389	690,336,975	732,657,366
RBC Ratio	**598%**	**645%**	**653%**	**636%**	**647%**

By contrast, the threshold for a regulatory response is 200 percent or less:

(1) No Action, if an insurer's TAC is at least twice its ACL;
(2) Company Action Level, if its TAC is 1.5-to-2.0 times its ACL;
(3) Regulatory Action Level, if its TAC is 1.0-to-1.5 times its ACL;
(4) Authorized Control Level, if its TAC is 1.0-to-0.7 times its ACL; and,
(5) Mandatory Control Level, if its TAC is less than 0.7 times its ACL

Turning to individual companies, we found that from 2008 to 2012, 2.3 percent to 3.2 percent of P&C insurers were subject to some regulatory response based on their TAC-to-ACL ratios. (Table 2, below.) Even under the extraordinary financial and economic stresses of 2008-2009, almost 97 percent of P&C insurers had the resources to withstand all of the risks measured by the RBC standard without danger of financial difficulty.

Table 2: Number of P&C Insurers Triggering Regulatory Action Level Events, 2008-2012

Action Levels	2008	2009	2010	2011	2012
No Action	2,566	2,571	2545	2538	2532
Company Action	29	19	13	14	16
Regulatory Action	16	10	17	13	14
Authorized Control	10	10	5	9	8
Mandatory Control	29	29	26	26	31
Total	2,650	2,639	2,606	2,600	2,601
No Action Percentage	**96.8%**	**97.4%**	**97.7%**	**97.6%**	**97.4%**

There is considerable variation in RBC ratios, however, based on the assets of P&C insurers. (Table 3, below.) In general, the RBC ratio is lower among larger insurers, because competition forces them to operate with lower capital margins. Nevertheless, the median RBC ratio for the largest P&C companies, those with assets of $10 billion or more, ranged from 474 percent to 556 percent from 2008 to 2012, or well more than twice the level triggering even the mildest regulatory response.[42]

[42] *Ibid.*

Table 3: Median RBC Ratios for P&C Insurers, by Asset Size, 2008-2012

	2008	2009	2010	2011	2012
Less than $10 million	1,605%	1,866%	1,729%	1,904%	1,934%
$10 million-$25 million	1,595%	1,610%	1,587%	1,522%	1,507%
$25 million-$100 million	1,039%	1,145%	1,108%	1,148%	1,150%
$100 million-$250 million	870%	920%	889%	907%	902%
$250 million-$500 million	861%	907%	908%	863%	894%
$500 million-$1 billion	773%	832%	784%	769%	803%
$1 billion-$10 billion	667%	720%	725%	689%	701%
More than $10 billion	*474%*	*528%*	*556%*	*503%*	*502%*
All Companies (unweighted)	**992%**	**1,047%**	**1,037%**	**1,039%**	**1,034%**

Moreover, the portfolios of P&C insurers appear to be very sound. The Treasury Department's most recent report on the industry found that the investments of P&C insurers are very conservative, manifesting none of the risky behavior that can lead to serious problems. In 2012, 65.3 percent of the financial assets of P&C insurers – $909.9 billion from a total of $1,382.9 billion in assets – were invested in high-quality investment-grade bonds.[43] Of the remaining one-third of their assets, $81.6 billion or 5.9 percent were held in cash and short-term cash-equivalents; and $215.9 billion or 19.2 percent were held in preferred or common stocks. Finally, $16.1 billion or 1.2 percent of all P&C assets were held in mortgage loans and real estate, and $592 million or 0.04 percent were held in derivatives. The remaining $115.8 billion were classified by the Treasury as "other investments."

P&C Insurers Would Remain Financially Sound After a Terrible Catastrophe

By industry standards, P&C insurers in compliance with current RBC capital standards should be sound under virtually any financial and economic conditions. The final question is, are those standards sufficient in the face of terrible natural or manmade catastrophes? Natural or manmade disasters produce what economists call correlated losses – tens of thousands of substantial claims at one time – on top of the industry's regular stream of claims from uncorrelated events. P&C insurers prepare for genuine catastrophes not only by building up their surpluses – loss reserves – over years, but also by spreading their risks across tens of thousands of policyholders in hundreds of places and shifting some of their potential liabilities to reinsurers.[44] In addition, insurers and reinsurers can further hedge their potential liabilities by issuing insurance-linked securities, called catastrophe bonds and catastrophe derivatives.

In 2012, P&C insurers maintained reserves of $596.2 billion for their incurred losses and for the losses and loss adjustment expenses for past events that remain unpaid. A standard industry rule designates 20 percent of policyholder reserves for catastrophic events (the "catastrophe surplus") with the other 80 percent to be held for normal risks. In 2012, therefore, the industry's catastrophe surplus totaled $119.2 billion – as compared, for example, to insured losses from super-storm Sandy of $25.85 billion, of which private insurers were responsible for $18.8 billion. (Table 4, below.) The privately-ensured losses from Sandy, then, accounted for less than 16 percent of the industry's total 2012 catastrophe surplus. The 2005 hurricane season

[43] U.S. Department of the Treasury (2013).
[44] King (2009).

included the worst natural disaster in U.S. history (Katrina) plus three other major storms (Hurricanes Rita, Wilma and Dennis). The insured claims from these disasters totaled $57 billion, or less than half of the industry's most recent catastrophe surplus.[45]

Table 4: Financial Operating Results for U.S. Property and Casualty Insurers, 2008-2012 (billions)[46]

	2008	2009	2010	2011	2012
Net Earned Premiums	$438.1	$419.0	$420.5	$433.9	$449.4
Incurred Losses & Loss Adjust Expenses	$339.2	$306.7	$309.1	$344.5	$335.0
Expenses	$118.1	$113.4	$119.5	$124.0	$129.0
Policyholder Dividends	$2.0	$2.0	$2.3	$1.9	$2.1
Investment Income	$51.2	$47.0	$47.2	$49.0	$47.7
Other Items	($0.1)	$0.8	$1.0	$1.2	$2.3
Pre-tax Operating Gain	$29.9	$44.7	$37.8	$14.8	$3.3
Realized Capital Gains (Losses)	($19.8)	($8.0)	$5.7	$7.2	$6.2
Pre-Tax Income	$10.1	$36.7	$43.5	$22.0	$39.5
Taxes	$7.7	$8.4	$8.9	$2.9	$6.0
Net After-Tax Income	$2.4	$28.3	$34.7	($19.2)	$33.5
Policyholder Surplus	**$455.6**	**$511.5**	**$556.9**	**$550.3**	**$586.9**
Catastrophe Surplus (20 Percent)	**$91.1**	**$102.3**	**$111.4**	**$110.1**	**$117.4**

As suggested by these calculations, a sound measure of the effectiveness of the current RBC standard is the industry's capacity to satisfy the claims from terrible natural catastrophes. The Congressional Research Service (CRS) recently modeled this capacity in the face of three truly extraordinary catastrophes: A once-in-a-century event with claims of $108 billion, events which theoretically should occur once every 250 years with claims of $164.5 billion; and events what may occur once every 500 years with claims of $217.0 billion (all estimates in 2012 $).[47] Table 4, above, provides the financial operating results for U.S. P&C insurers for the period 2008 to 2012. This financial analysis is one of the best measures available to gauge the industry's capacity to handle claims from truly extraordinary events.

The industry's catastrophe surplus of $117.4 billion in 2012 could clearly manage a once-in-a century catastrophe with $108 billion in claims, but not the projected claims for even more rare and terrible events. However, these calculations do not take account of the normal industry practice of hedging such catastrophic costs through reinsurance. For example, reinsurers based mainly in Germany, Great Britain, Switzerland and Bermuda absorbed 60 percent of the costs of the claims from Hurricane Katrina, the most expensive catastrophe for U.S. insurers on record.[48] The CRS model, again, projects total insured claims of $164.5 billion from a once-every-250-years catastrophe – nearly three times the combined claims of Hurricane Katrina, plus Rita, Wilma and Dennis. If U.S. P&C insurers transfer 40 percent of the projected claims from such a once-every-250-years catastrophe to the balance sheets of foreign reinsurers – 20 percentage-points less than were transferred for Katrina – the 2012 catastrophe surplus could handle the resulting claims on U.S. insurers of $98.4 billion. If reinsurers absorbed 50 percent of the

[45] Shapiro and Mathur (2008). In addition, the worldwide capacity of the reinsurers grew by 7 percent in 2012.
[46] Insurance Information Institute (2014).
[47] King (2013).
[48] *Ibid.*

projected claims of $217 billion from a once-every-500-years catastrophe – still a substantially smaller percentage than were transferred for Katrina – the 2012 catastrophe surplus of P&C insurers also could handle the resulting, remaining claims of $108.5 billion.

The CRS study notes that its estimates of the costs of its hypothetical catastrophes rely on current valuations for real estate and other property, and such cost estimates increase with time as real estate valuations rise and development expands. The study's author cautions, therefore, that problems could arise in the future if catastrophe liabilities increase faster than catastrophe surpluses. However, such esoteric risks could also be managed through increased foreign reinsurance and the use of catastrophe bonds and exchange-traded options and swaps that shift part of such extraordinary risks to investors. Catastrophe bonds work as follows. Investors purchase bonds covering very low probability events and place the funds in a trust account; and, until the specified event occurs, investors receive interest payments from the trust account and part of the premiums from the underlying policies. If a catastrophe as defined by the terms of the bond happens, the insurer that issued the bond claims the funds in the trust account.[49] If such an event does not occur in the bond's lifetime, investors reclaim the principal. In 2012, investors held $14.8 billion in catastrophe bonds, including $5.85 billion issued in 2012.[50] Finally, concerns that large and unexpected losses could trigger defaults in catastrophe bonds, which in turn could trigger larger financial problems, also are unwarranted. At present, the catastrophe bond market is too small to raise systemic issues. Nor are there grounds for concern if the market in the bonds grows larger, since they are fully collateralized through the funds held in the trust accounts for catastrophe payouts.

IV. The Structure of Higher Capital Standards for Property and Casualty IAIGs

The preceding analysis has established that under current RBC capital standards and industry practices, U.S. P&C insurers can handle the claims from any currently-conceivable circumstances. Nevertheless, the International Association of Insurance Supervisors (IAIS) is working to develop a new, global group insurance capital standard (ICS) that would apply much higher capital standards to large insurance groups with substantial foreign business (IAIGs), defined for now as groups with assets of at least $50 billion, gross written premiums of at least $10 billion, operating in at least three countries with at least 10 percent of its gross premiums written in foreign markets.[51] As also noted earlier, this effort is related to the IAIS program to develop a new, global basic capital requirement (BCR) for those companies deemed to be global systemically-important insurance companies (G-SIIs). In this effort, the IAIS is developing a "Common Framework for the Supervision of Internationally Active Insurance Groups" (ComFrame), including new supervisory standards covering corporate governance, enterprise risk management and capital adequacy. The IAIS represents insurance regulators and supervisors from 200 jurisdictions in 140 countries; and, the U.S. Financial Stability Board recognizes the IAIS as the international standard-setting body for the insurance industry,

[49] This market also includes catastrophe equity puts, in which an insurer purchases the put and receives an option to issue preferred stock at an agreed-upon price to the investors if a defined catastrophe occurs. Similarly, under a catastrophe risk swap, an insurer pays investors fixed payments in exchange for their obligation to pay the insurer "floating" payments if an insured catastrophe occurs.
[50] King (2013), *op. cit.*
[51] Linklaters (2013).

equivalent to the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

These developments should be matters of genuine concern for both the insurance industry and the overall economy. Thus far, the IAIS discussions of the BCR for G-SIIs reflect a preference for a European approach to insurance regulation, which relies on prescribed financial models applied uniformly across the industry, as compared to the U.S. approach based on qualitative and quantitative analysis of each insurer's business.[52] Moreover, the IAIS has acknowledged that the BCR for G-SIIs "will inform" the development of the ICS for IAIGs, raising concerns that the IAIS is prepared to impose additional, EU-style, factor-based global capital standards on many large U.S. P&C insurers through the ICS. Yet, as this analysis has demonstrated, there is no evidence that those companies warrant any additional capital requirements. The NAIC has expressed its concerns about the direction of ComFrame, noting that any final recommendations should not impose new burdens on insurers simply because they are large and operate internationally.[53]

The Basic Capital Requirement for G-SIIs

To appreciate how a new ICS for IAIGs would likely work, we begin with the IAIS's description of the factor-based approach adopted in the BCR for G-SIIs.[54] An insurer's BCR "Adequacy Ratio" is defined as its "Total Qualifying Capital Resources" divided by its "Required Capital," and its BCR is satisfied if its qualifying capital resources exceed its required capital. The measure covers all holding companies, insurance entities, banking entities and any other companies in the group designated as a G-SII. As with the RBC, "required capital" here is "calculated on a consolidated group-wide basis for all financial and material non-financial activities ...using a 'factor based' approach with 15 factors ... [and] a Market Adjusted Valuation Approach" based on the major categories of risk from both traditional and non-traditional insurance activities (NTNI), assets and non-insurance activities.[55]

Required Capital = Sum of (Liability factors multiplied by Liability measures) + (Sum of Asset Factors multiplied by Asset measures) + (Sum of NTNI factors multiplied by NTNI measures) + Sum of Other Factors multiplied by other measures)

A G-SII's BCR capital adequacy ratio covers several areas of risk also included in RBC ratios, but the results depend on the weight assigned to each factor. Whether the BCR model properly weights the factors will be very consequential. The EU Solvency II Framework states that the European Commission will determine whether non-EU regulatory regimes provide a level of protection for policyholders comparable to the Solvency II regime and therefore "equivalent" to Solvency II; and only insurers in "equivalent" jurisdictions will be allowed to operate in EU markets. If the EU does not accept U.S. "equivalence," difficult competitive

[52] For example, the factor-based, quantitative basic capital requirements developed by the IAIS for G-SIIs lack the flexibility to account for much of the variation and complexity in risks and capital needs within and among insurance groups. As a result, this approach can mask some companies' risks behind their factor-based scores and indicate that other, sound companies face serious problems.
[53] NAIC (2013-A).
[54] IAIS (2013).
[55] IAIS (2014-B)

issues will arise. Rather than seek such equivalence, the United States currently is working through the EU-US dialogue process towards the ICS. The results may be substantially the same, since the NAIC has concluded that the regulatory capital required under the EU solvency framework will be much greater than the capital required under the U.S. RBC approach.[56]

This view is supported by a recent study comparing the European Solvency II standard for minimum statutory capital requirements with U.S. and Canadian accounting standards for P&C insurers.[57] Its authors concluded that capital requirements for EU insurers based on Solvency II factors could be *nearly four times* greater than the capital standards for U.S. insurers under NAIC RBC formulas. To be sure, this calculation is based on assumptions about the levels and types of assets and liabilities held by hypothetical firms. Nevertheless, the analysis shows that applying European solvency and capital standards to U.S. insurers would significantly increase their capital requirements, particularly those operating in the E.U.

V. The Economic Effects of Higher Capital Requirements on U.S. Insurers

Next, we examine the potential impact on U.S. insurance premiums and coverage if the current U.S.-E.U. dialogue produces higher capital requirements for large U.S. P&C insurers. These estimates necessarily are tentative, because we cannot yet know how many firms would be affected, and the IAIS has no plans to release a list of companies to be designated as IAIGs.[58] For this analysis, we apply the three criteria which the IAIS has acknowledged have informed its deliberations about IAIGs – P&C insurers with assets of $50 billion or more, or direct gross written premiums of $10 billion or more, operating in at least three countries and at least 10 percent of its business conducted in foreign markets. On this basis, a minimum of seven major U.S. P&C insurers would qualify,[59] accounting for 26.6 percent of the U.S. P&C market based on direct premiums written in 2012.[60]

Higher capital requirements for IAIGs, therefore, would produce a very uneven playing field between those seven companies and non-IAIGs, including U.S. subsidiaries of foreign-based insurers that do not qualify as IAIGs in their own countries. Based on models developed for banking, higher capital requirements for more than one-quarter of the U.S. market for P&C coverage will have significant effects on premium rates and industry investment. Capital ratios in banking do not translate directly to the RBC ratios. Nevertheless, applying the models used to analyze how capital requirements affect lending and investment behavior in banks can help inform our understanding of how changes to the RBC ratio, in the guise of the ICS for IAIGs, will affect premium rates, volume and investments by affected insurers.

A review of the economic literature shows a range of effects which occur when capital requirements rise for financial institutions. One study found that banking institutions respond to higher capital requirements by slowing the growth of their assets, which leads to a slowdown or

[56] EU-US Dialogue Project Technical Committee (2012).
[57] Sharara, Hardy and Saunders (2010). The study focuses on P&C coverage, because it represents approximately 80 percent of the industry's aggregate solvency-risk capital requirements.
[58] American Council of Life Insurers (2013).
[59] Liberty Mutual, American International Group, Travelers' Companies, Berkshire Hathaway, Chubb Group, ACE Group, and CNA Insurance Services.
[60] U.S. Treasury (2013).

contraction in their lending.[61] These effects can be substantial, although they also can be moderated by phasing-in the additional capital requirements so firms can finance part of the additional capital from their retained earnings. To be conservative, we assume here that the higher capital requirements for large insurers would be phased-in gradually. Economists also have found that financial institutions pass along higher costs of capital to their customers through higher borrowing costs: Studies confirm that when the minimum capital ratio for banks increases by 10 percentage points, the interest rates charged for loans rises by 25-to-45 basis points.[62] Finally, studies have found that higher capital requirements induce many banks to shift part of their lending to the unregulated, "shadow-banking" sector.

We begin by estimating the likely extent of the contemplated increase in capital requirements for IAIGs. Under current rules, an insurer with an RBC ratio of less than 0.7 faces regulatory intervention (that is, when the ratio of its total adjusted capital to its required capital, given its risks, is 70 percent or less). As noted earlier, a recent study found that a shift to a Solvency II-type regulatory regime would result in capital requirements nearly four times greater than under current RBC standards.[63] Applying this study and the current 0.7 threshold as an absolute minimum capital requirement, we project that the minimum RBC ratio under a Solvency-II type regime would be 1.4 to 2.8 or two-to-four times the current minimum level. This would represent an increase in the minimum capital ratio for P&C insurers of 70 percentage points (under a minimum ratio of 1.4) or 210 percentage points (under a minimum ratio of 2.8). Such a large increase at once would shock insurance and investment markets, so we also assume that the increase is phased-in gradually. Therefore, we limit our estimates to the short run and project two changes in the minimum capital ratio: An initial increase from 0.7 to 0.85 and a second increase from 0.85 to 1.0, so capital standards rise 15 and 30 percentage points. We note that this analysis and the analyses which follow assume that insurers will seek to maintain their existing capital margin – the excess of actual capital over required capital.

To estimate the impact of the higher capital requirements for IAIGs on their cost of coverage, we will focus on homeowner and auto insurance, because the NAIC has published the average premium rates for homeowner and auto coverage for the years 2003-to-2011.[64] These categories of coverage accounted for 54 percent of all direct premiums written in 2011 and 2012 (39 percent for auto coverage and 15 percent for homeowner coverage).[65] First, we analyze those rates to calculate the annual increases when capital requirements are stable. (Table 5, below.)

[61] Hanson, Kashyap and Stein (2010).
[62] *Ibid.*
[63] Sharara, Hardy and Saunders (2010).
[64] Insurance Information Institute (2014).
[65] NAIC (2013-C).

Table 5: Average Premiums Paid By Homeowners and Automobile Owners, 2003-2011

Year	Average Homeowner Premiums	Average Auto Premiums
2003	$668	$830
2004	$729	$842
2005	$764	$832
2006	$804	$817
2007	$822	$797
2008	$830	$789
2009	$880	$787
2010	$909	$791
2011	$978	$820

These data show that premiums increased at average rates of 5.0 percent per-year for homeowners' coverage and 0.2 percent per-year for automobile coverage. We next use these calculations to estimate the average premium rates for homeowners' coverage and auto coverage first for the 2013 baseline year – $1,076 for homeowners coverage and $850 for automobile coverage – and then over the following five years (2014-to-2018), assuming that the capital standards for P&C insurers remain unchanged. (Table 6, below.)

Table 6: Estimated Average Premiums for Homeowners' and Auto Coverage With No Change in Capital Standards, 2013-2018

Year	Average Homeowner Premiums	Average Auto Premiums
2014	$1,128	$852
2015	$1,183	$854
2016	$1,241	$856
2017	$1,302	$858
2018	$1,365	$860
Average	**$1,244**	**$856**

Next, we estimate the increase in those rates for insurers affected by increases in their capital standards of 15 percentage-points and 30 percentage-points. We recall that research from the banking sector found that each one percentage-point increase in capital costs leads to an increase in the interest rates charged for loans of at least 2.5 basis points.[66] If this finding were applied directly to insurers, each one percentage-point increase in their capital requirements would produce an increase of at least 2.5 basis points in premium rates. In banking, these costs can be completely passed on to consumers. If the same held true for insurance, a 15 percentage-point increase in capital requirements would lead to annual increases in premium rates of 37.5 basis points or 0.375 percent per-year, and a 30 percentage-point increase in capital requirements would lead to an annual increase in premium rates of 75 basis points or 0.75 percent per-year.

How would these increases affect premiums in the mortgage and auto insurance industry? To examine this issue, we collected information on average mortgage rates for 30-year fixed mortgages under Freddie Mac over the last decade, 2004-2013.[67] The average mortgage rate was

[66] Hanson, Kashyap and Stein (2010).
[67] Freddie Mac (2014).

approximately 5 percent. Applying this to an average loan of $200,000, a typical monthly payment would be $1,074.[68] If capital requirements increased by 30 percentage-points, and the mortgage rate rose to 5.75 percent, the monthly mortgage payment would increase to $1,167. Under this scenario, the annual increase in premium prices would be about 8.7 percent. For a 15 percentage-point increase in capital requirements, mortgage rates would rise to 5.375 percent, and the annual premium would increase by 4.3 percent.[69]

To assess if these increases are in line with how property and casualty insurers would likely respond to an increase in capital requirements, we obtained data from SNL Financials on balance sheet items such as reserves and equity, revenues from premiums and investment income, and costs.[70] A study by Cummins and Phillips (2005) found that P&C insurers typically target a return on equity (ROE) of approximately 15 percent, although the actual value may differ based on the line of business.[71] Therefore, an increase in capital requirements that causes the return on equity to go down will likely be followed by an adjustment in premium pricing in order to maintain a ROE of 15 percent. Applying this analysis at the industry level and using typical values for the variables, we estimate that a 30 percentage-point increase in capital requirements would cause insurers to increase their premium prices by 7 percent, and a 15 percentage-point increase in capital requirements would cause premium prices to rise by about 4 percent. These increases are within the bounds produced by applying the 37.5 basis points or the 75 basis points increase to average mortgage rates following a 15 percentage-point and a 30 percentage-point increase in capital requirements, respectively. In the analysis which follows, we will model the changes in premium prices when a 15 percentage-point increase in capital requirements causes premium prices to increase by 4 percent, and a 30 percentage-point change causes premium prices to rise by 8 percent. The results for homeowners' coverage are presented in Table 7. Considering the actuarial pricing mechanism for homeowners' and auto coverage, we assume throughout this analysis that all other factors remain equal.

Table 7: Estimated Premium Increases for Homeowners' Coverage under Higher Capital Standards, 2014-2018

Year	15 Percentage-Point Increase in Capital Requirements		30 Percentage-Point Increase In Capital Requirements	
	Average Premium	*Premium Increase*	*Average Premium*	*Premium Increase*
2014	$1,173	$45	$1,219	$90
2015	$1,231	$47	$1,278	$95
2016	$1,291	$50	$1,340	$99
2017	$1,354	$52	$1,406	$104
2018	$1,420	$55	$1,474	$109
Average	**$1,294**	**$50**	**$1,343**	**$100**

This analysis suggests that increasing capital requirements for IAIGs on the scale contemplated in the ICS would lead to significant increases in premiums for homeowners' insurance coverage affecting 26.6 percent of the U.S. market (the IAIGs' market share). If an

[68] Panchuk (2012)
[69] For shorter-term mortgages, the corresponding monthly change will be lower.
[70] SNL (2014).
[71] Cummins and Phillips (2005).

agreement includes a 15 percentage-point increase in capital requirements, the cost of homeowners' coverage from an IAIG would average $1,294 per-year over the years 2014 to 2018, compared to $1,244 per-year without that increase. (Table 7, above.) The increase in the annual cost of homeowners' coverage from IAIGs, therefore, would average $50 over those years. Similarly, if the capital requirements for IAIGs increase by 30 percentage-points, the cost of their homeowners' coverage would average $1,343 per-year over the 2014-2018 period, compared to $1,244 per-year without higher capital requirements. The increase would average $100 per-year.

Similarly, if the FSB process leads to the large increases in capital requirements for IAIGs currently contemplated, the average price for automobile coverage issued by them will likely rise significantly. If an agreement includes a 15 percentage-point increase in capital requirements for IAIGs, the cost of their auto coverage is projected to average $890 per-year over the period 2014-to-2018, compared to an average of $856 per-year without a change in capital standards. (Table 8, below.) The cost of auto coverage from an IAIG, therefore, is projected to increase by an estimated $34 per-year. Similarly, if the capital requirements for IAIGs increase by 30 percentage-points, the cost of their auto coverage would average $925 per-year over the 2014-2018 period, compared to $856 per-year without higher capital requirements. In this case, the increase could average as much as $68 per-year.

Table 8: Estimated Premium Increases for Automobile Coverage under Higher Capital Standards, 2014-2018

Year	15 Percentage-Point Increase in Capital Requirements		30 Percentage-Point Increase In Capital Requirements	
	Average Premium	*Premium Increase*	*Average Premium*	*Premium Increase*
2014	$886	$34	$920	$68
2015	$888	$34	$922	$68
2016	$890	$34	$925	$68
2017	$892	$34	$927	$69
2018	$895	$34	$929	$69
Average	**$890**	**$34**	**$925**	**$68**

This analysis demonstrates the extent to which higher capital requirements for IAIGs could create a dramatically uneven playing field, as the expected premium increases associated with the higher capital requirements would leave IAIGs at a severe competitive disadvantage in the U.S. market for homeowners and auto coverage. We should expect that many IAIGs would absorb an even greater share of the costs associated with the new capital standards, which in turn would reduce their resources for other uses, including investment.

The Impact of Higher Capital Requirements for IAIGs on the Volume of their Premiums

Next, we turn to the impact of higher capital standards on the volume of insurance issued by the IAIGs, based on the estimated increases in premium rates or prices. In the preceding section, we found that while financial institutions face large additional costs when their capital standards increase, we should expect that state insurance regulators would allow IAIGs to pass along one-fifth to two-fifths of the additional costs in higher premiums. In this section, we will assess the impact of such increases in premium prices on the volume of insurance.

The nature of the insurance market suggests that the elasticity or sensitivity of demand for auto or homeowners' insurance to price is limited. In most places, auto and home owners are required to carry at least minimum insurance; in addition, they may be subject to additional costs for leaving their current insurer, such as the loss of "safe driver discounts" or the need to have their homes reappraised. Nevertheless, the largest study of auto owners' sensitivity to price increases for their auto coverage found an elasticity of - 0.57: A one percent increase in the price of coverage is expected to lead to a 0.57 percent decrease in demand for the coverage, which usually translates into continuing coverage but at lower levels than previously.[72] Researchers also have found that this elasticity varied relatively little across states and types of automobile. With regard to homeowners' coverage, one study suggests that a one percent increase in the price leads to a one percent decrease in demand; yet the elasticity of demand for homeowners' coverage is often thought to be less than for auto coverage, especially for coverage tied to a mortgage, because homeowners have more ways to reduce the cost.[73] For this analysis, we will apply the estimate for auto insurance premium elasticity to increases in both auto and homeowners' premium rates. While we apply the conservative value for the elasticity in this case, since only the IAIGs would raise prices as they adjust to the new capital requirements, the result would directly affect their competitiveness. Consequently, they could face much larger declines in demand than suggested here, and the elasticity could be significantly higher. From a policy perspective, it is important to appreciate that the higher capital requirements will produce a substantive competitive disadvantage for IAIGs relative to other insurers in the market.

To model these effects, we begin with NAIC data on the direct written premiums of P&C insurers for the period from 2003 to 2012.[74] (Table 9-A, below.) These data, drawn from the annual statements filed by insurers with the NAIC, show that premium volume grew at an annual rate of 1.5 percent over this period, when there were no major changes in capital standards.

Table 9-A: Premium Volumes of P&C Insurers, 2003-2012 ($ billion)

Year	Direct Written Premiums
2003	$451.3
2004	$474.2
2005	$484.3
2006	$496.3
2007	$502.3
2008	$490.6
2009	$475.4
2010	$475.1
2011	$492.4
2012	$515.1

Next, we use that underlying growth rate in written premiums to estimate the path of premium volumes over the next five years, again in the absence of changes in capital requirements. We start by applying that growth rate to the data on direct premiums in 2012 in

[72] Jaffe and Russell (1998).
[73] DeFusco and Paciorek (2014).
[74] NAIC 2013-C).

order to estimate direct written premiums in 2013; and that value, $522,688,572,950, provides the baseline for our projections for the next five years, 2014-2018. (Table 9-B, below.)

Table 9-B: Estimated Premium Volumes of P&C Insurers, Current Capital Standards, 2013-2018 ($ billion)

Year	Direct Written Premiums
2014	$530.4
2015	$538.3
2016	$546.2
2017	$554.3
2018	$562.5
Total	$2,731.7

From the preceding analysis, we found that based on studies in banking, the contemplated increase in capital standards for insurers, in principle, could drive up premium rates by about 4 percent or 8 percent per year, depending on the extent of the increase in those standards (15 percentage-points or 30 percentage-points). Therefore, we estimate that a 15 percentage-point increase in capital standards for P&C insurers would result in a reduction in written premiums by insurers affected by the new standards of approximately 2 percent. Similarly, a 30-percentage point increase in capital requirements would reduce the premium volumes of the affected insurers by about 5 percent.

Once again, we assume here that the higher capital requirements will affect the seven U.S. P&C insurers that currently meet the tentative criteria for IAIG status and which accounted for 26.6 percent of the U.S. P&C insurance market in 2012. We also assume that those insurers would maintain their existing capital margins, that is, the margin of actual capital over required capital. Table 10, below, presents the estimated range of effects on premium volumes from 15-percentage point and 30 percentage point increases in capital requirements: We estimate that they could produce reductions in premium volumes of 2.0 percent and 5 percent, respectively.[75]

[75] Note, we model the change in premium volume as a reduction in total written premiums due to a data constraint. To estimate the impact on consumers, we would want to estimate the reduced demand for insurance as a result of higher prices. However, the available data cover only the total value of written premiums, not the total number of policies written. Therefore, we use the reduction in total premiums as a proxy for the reduction in quantity of insurance demanded when prices rise. This assumption may not hold if the price elasticity of demand is significantly less than 1.0, so that the percentage increase in price is much higher than the percentage reduction in quantity. However, this is not a major concern for our model since even though we use the conservative value of the auto elasticity, the elasticity for home mortgages is at least 1.0, and the elasticity for auto insurers could be higher. More important, we model here a situation in which only a small fraction of insurers are subject to the higher capital requirements and therefore, are forced to raise prices when other insurers are not. This should make demand for their products even more elastic than we assume here.

Table 10: Estimated Effects on Premium Volumes from Higher Capital Requirements, Potential IAIGs and 26.6 Percent of Premiums Affected, 2014-2018 ($ billion)

Year	Premium Volume Affected (26.6 % of Projected Baseline)	2.0% Reduction in Affected, Direct Premiums	5% Reduction in Affected, Direct Premiums
2014	$141.1	$2.8	$7.1
2015	$143.2	$2.9	$7.2
2016	$145.3	$2.9	$7.3
2017	$147.4	$2.9	$7.4
2018	$149.6	$3.0	$7.5
Average	**$145.3**	**$2.9**	**$7.3**
Total	**$726.6**	**$14.5**	**$36.3**

This analysis suggests that a 15 percentage-point increase in capital standards affecting insurers that account for 26.6 percent of the market will slow the growth of new premiums by $14.5 billion over the five-year period, 2014 to 2018, or by an average of between $2.9 billion per-year. Similarly, a 30 percentage-point increase in those standards for those insurers would slow the growth of new premiums by between $36.3 billion over the five years, for an average annual reduction of $7.3 billion.

Impact of Higher Capital Requirements for IAIGs on their Investment

The increased capital requirements for IAIGs will likely result in less investments and less productive investment with adverse effects for growth. The direct effects follow from our previous analysis: When premium rates go up and the growth of premium volumes slows as a result of new capital standards, the revenues and incomes of the affected insurers grow more slowly, which in turn leads to less investment. In addition, higher capital requirements in the context of RBC ratios would likely force at least some of the affected insurers to revise the composition of their investment portfolios, away from the relative risk of stocks and real estate, and towards less-risky investments such as bonds and Treasury bills. This response also ultimately leads to lower levels of investment, since the returns from less-risky assets are lower. In this section, we explore these responses and effects.

In the preceding analysis, we found that a 15 percentage-point increase in the capital standards of insurers which account for 26.6 percent of the market could slow the growth of their new premiums by an average of $2.9 billion per-year for the period, 2014 to 2018. Similarly, a 30 percentage-point increase in those standards for IAIGs could slow the growth of their new premiums by an average of $7.3 billion per-year over that period. Such slowdowns in the growth of new premiums would likely mean less investment by those insurers, since their investments directly depend on their incomes and profits. Most premium revenues are used to cover claims and operating and other expenses, with the remainder invested.[76] Earlier, we presented data on the financial operating results of P&C insurers for the five years, 2008-2012. (Table 4, above.) Using these data, we estimate that an average of 5.0 percent of annual net earned premiums was

[76] American Insurance Association (2014).

available for additional investment in those years.[77] On this basis, we can estimate that a 15 percentage-point increase in the capital requirements for IAIGs would reduce investment by those insurers by $0.7 billion over the five year period, 2014-2018. Similarly, a 30 percentage-point increase in their capital standards would reduce their investments over those five years by an estimated $1.8 billion.

The second effect on the composition of their investment portfolios is more difficult to assess, because there is little systematic research on the investment decisions of insurers since RBC requirements have been in place, starting in 1994. In principle, an increase in capital standards could produce an increase in capital and/or a reduction in the average riskiness of the insurer's investments. In fact, researchers found that before 1994, the relationship between capital levels and the riskiness of investments was generally positive: Average risk increased with capital levels.[78] But once RBC requirements were in place, insurers could have changed or modified that behavior.

There is one recent study of the effect of higher RBC requirements on P&C insurers. The authors examined the relationship between an insurer's capital requirements and its asset risks and underwriting risks, comparing the period of 1994 to 2007, to 1992.[79] They found that those risks could account for roughly 87 percent of all risk-based capital, with risky assets defined as investments in equities and real estate. Further, they posited that the relationship between capital and risk has remained positive for many insurers. The authors also believe that some insurers see capital and risk as substitutable; and if that is true, among such insurers the constraints applied by RBC standards could induce those with high levels of capital to assume more risk. The researchers posit that a positive correlation between risk and capital may occur when an increase in risk leads an insurer to increase its capital levels as an additional buffer against solvency problems.

This reasoning suggests that P&C insurers with more than sufficient capital to accommodate higher RBC standards may respond to those higher requirements by investing more in relatively risky assets, while insurers with less adequate capital for the higher standards may try to build an appropriate buffer by raising additional capital or try to lower the average risk of their assets. The study classified P&C insurers as undercapitalized if their RBC ratio was less than 2, as marginally capitalized if their RBC ratio was equal to or greater than 2 but less than 3, and as well-capitalized if their RBC ratio was 3 or greater.[80] On average, over the entire period from 1994 to 2007, the relationship between capital and both types of risk, asset and underwriting, was positive for well-capitalized insurers. Among the undercapitalized and marginally capitalized insurers, the application of RBC requirements was accompanied by a reduction in investments in relatively more risky assets.

[77] This calculation is based on the following approximation: (Net earned premiums + investment income + realized capital gains) – (Incurred losses and loss adjustment expenses + expenses + policyholder dividends + taxes) = resources available for new investment.
[78] Cummins and Somer (1996).
[79] Cheng and Weiss (2012).
[80] *Ibid.*

We can use these results to project how a large increase in capital requirements affecting insurers with 26.6 percent of the P&C market would impact their investments. At the end of 2012, as noted earlier, the P&C industry held 65.3 percent of its investments in high-grade bonds, 19.2 percent in stocks, 1.2 percent in real estate and mortgages, and most of the remainder in cash or cash-equivalent instruments, and "other investments." Further, the Federal Reserve has issued its estimates of the total financial assets of P&C insurers for the years, 2003-2013:

Table 11-A: Investments in Financial Assets by P&C Insurers, 2003-2012 ($ billions)[81]

Year	Total Financial Assets
2003	$1,059.3
2004	$1,159.1
2005	$1,246.3
2006	$1,335.8
2007	$1,385.8
2008	$1,305.5
2009	$1,380.2
2010	$1,360.5
2011	$1,376.6
2012	$1,438.9
2013	$1,530.7

Based on these data, we calculate that the value of these investments increased at an average annual rate of 4.1 percent over the 10-year period. On this basis, we project the total financial investments of P&C insurers over the next five years, 2014 to 2018, in the absence of higher capital standards. (Table 11-B, below)

Table 11-B: Estimated Investments in Financial Assets by P&C Insurers, 2014-2018 ($ billions)

Year	Total Financial Assets
2014	$1,595
2015	$1,661
2016	$1,731
2017	$1,803
2018	$1,878

The higher capital requirements would affect the presumed IAIGs with 26.6 percent of the P&C market, and we assume here that they also hold 26.6 percent of the industry's total financial assets. Under current capital requirements, about 20.4 percent of these investments are held in stocks and real estate. If these insurers are well-capitalized, the higher capital standards could produce an increase in their investments in stocks and real estate. If they are marginally capitalized or undercapitalized relative to the higher capital standards, they would be expected to shift some of their relatively risky assets to safer investments in response to the new RBC standards. Data released by the NAIC covering P&C insurers, 2009-2012, show that about 12 percent of the insurers were marginally capitalized or undercapitalized, by the standards of the

[81] Board of Governors of the Federal Reserve System (2014).

recent study.[82] As noted earlier, however, large insurers with assets of $10 billion or more have lower median RBC ratios than smaller insurers (See Table 3, above), and therefore they are more likely to be marginally capitalized or undercapitalized relative to the new capital standards. This suggests that IAIGs are more likely to respond to the much higher capital standards contemplated by the ICS by shifting some their assets from relatively riskier equities and real estate to relatively safer bonds.

The following analysis assumes that the contemplated increase in capital requirements for IAIGs would have the above-described effect on U.S. IAIGs. As it is likely that only some of those IAIGs would respond in this way, the results provide an upper bound of the impact of the higher capital standards on the investment portfolios of P&C insurers. To estimate the extent of this effect from a 15 percentage-point increase in capital requirements, we adjusted the baseline of financial investments (Table 11-B, above) for the projected 2 percent slowdown in the growth of new premiums in response to a 15 percentage point increase in capital requirements. This adjustment reduces overall investment levels for IAIGs by about $145 million per-year or $726 million over the period 2014-2018. The results (presented in Table 12-A, below) suggest that IAIGs would respond to a 15 percentage-point increase in their capital requirements by shifting an average of $1.9 billion per-year in investment assets from equities and real estate to high-grade bonds, or $9.4 billion over five years.

Table 12-A: Impact on Investment of a 15 Percentage-Point Increase in Capital Standards Affecting Large Insurers with 26.6 Percent of the U.S. Market, 2014-2018 ($ billion)

Year	Baseline: All P&Cs' Financial Investments	IAIGs' Investments (26.6%)	IAIGs' Baseline Adjusted for Reduced Premiums	Share Invested in Equities and Real Estate (20.4%)	Two Percent Reduction in Those Investments
2014	$1,595	$424.3	$424.2	$86.5	$1.73
2015	$1,661	$441.8	$441.7	$90.1	$1.80
2016	$1,731	$460.5	$460.4	$93.9	$1.88
2017	$1,803	$479.6	$479.5	$97.8	$1.96
2018	$1,878	$499.6	$499.5	$101.9	$2.04
Average	**$1,739**	**$461.1**	**$461.0**	**$94.0**	**$1.9**
Total	**$8,667**	**$2,305.7**	**$2,305.1**	**$470.2**	**$9.4**

The investment impact of a 30 percentage-point increase in the capital requirements for IAIGs is similar to the impact of a 15 percentage-point increase. (Table 12-B, below.) The higher capital standard leads to a reduction in the growth of their investments of $1.9 billion over 2014 to 2018 or an average of $363 million per-year – as expected, twice the effect of a 15 percentage-point reduction. The impact on the IAIGs' investment portfolio in reduced investments in equities and real estate is virtually the same – $1.9 billion per-year and $9.4 billion over five years – since the reduction is only 2.0 percent of the 20.4 percent share of the IAIGs' portfolios invested in equities and real estate.

[82] NAIC (2014-D).

Table 12-B: Impact on Investment of a 30 Percentage-Point Increase in Capital Standards Affecting Large Insurers with 26.6 Percent of the U.S. Market, 2014-2018 ($ billion)

Year	Baseline: All P&C Financial Investments	Investments Affected (26.6%)	IAIGs' Baseline Adjusted for Reduced Premiums	Share Invested in Equities and Real Estate (20.4%)	Two Percent Reduction in Those Investments
2014	$1,595	$424.3	$423.9	$86.5	$1.7
2015	$1,661	$441.8	$441.4	$90.1	$1.8
2016	$1,731	$460.5	$460.1	$93.9	$1.9
2017	$1,803	$479.6	$479.2	$97.8	$2.0
2018	$1,878	$499.6	$499.2	$101.8	$2.0
Average	**$1,739**	**$461.1**	**$460.8**	**$94.0**	**$1.9**
Total	**$8,667**	**$2,305.7**	**$2,304.0**	**$470.0**	**$9.4**

These modest shifts in the portfolio assets of IAIGs would entail some small, additional costs, because as the IAIGs shift investments in relatively riskier assets to the less risky assets, investment income would be reduced as well.[83] Over the ten-year period, 2004-to-2013, the average return on equities was 7.34 percent, the average return on Treasury bills was 1.54 percent, and the average return on Treasury bonds was 4.27 percent. Shifting approximately $9.4 billion out of equities and into Treasury bills, or about four-tenths of one percent of their combined portfolios, would reduce their combined investment incomes by $54.5 million over five years; and shifting those assets from equities to Treasury bonds would reduce investment income by $28.9 million over that period. These reductions in investment income, in turn, would result in slightly lower investment in future years.

Additional Costs of a New Global Capital Requirement

The new capital standards for IAIGs currently under consideration could entail yet additional costs. The IAIS has pressed the case that the ICS be calculated using International Financial Reporting Standards (IFRS) and mark-to-market valuations. American insurers are subject to U.S. Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS); and therefore U.S. IAIGs would have to absorb additional accounting costs associated with the IFRS. In addition, adopting mark-to-market valuations for purposes of the ICS would introduce additional volatility in the capital calculations of the IAIGs, based on market fluctuations. As this volatility increased, their risks of appearing to be impaired would rise. As a result, the IAIGs might have to increase their capital margins, especially to avoid raising additional capital when tight markets or serious economic problems drive up the costs of capital. This volatility would further raise the effective levels of the new capital requirements, potentially increasing the effects projected above on premiums, premium rates and investment – all despite the fact, as our analysis has established, that the current state-based capital requirements for U.S. IAIGs are fully adequate to address the projected claims arising from virtually any conceivable catastrophe and the financial stresses arising from severe economic disruptions.

[83] Stern School of Business (2014).

VI. Conclusions

Globalization presents many genuine and important challenges for the regulation of businesses which operate across borders. Regulators of the same or similar businesses in North America, Europe, Latin America, Asia and Africa will approach many of the same issues in a variety of ways. Those differences are inevitable and often appropriate, since they may reflect legitimate differences in values, policy priorities and technical approaches. Financial regulators have a legitimate and even urgent interest in those aspects and operations of globally-systemic financial institutions that could adversely affect the economies of other nations. But globalization does not require the harmonization of financial regulation, any more than it demands or depends upon uniform fiscal and monetary policies across nations.

In this spirit, the current effort to develop and apply uniform capital standards for all large, multinational property and casualty insurance companies is misguided. P&C companies pose no systemic risks to other financial institutions or the economy, which could justify new standards. Moreover, there is no evidence that under current capital requirements, U.S. P&C insurers are ill-prepared for virtually any eventuality which could produce very large claims on their reserves. The new requirements currently being considered in the U.S.-E.U dialogue would impose substantial additional costs on large U.S. P&C insurers with substantial foreign business; and (based on our analysis of prior years and related projections) those additional costs would raise the price and slow the growth of their coverage for American households and businesses, and reduce new investments by those insurers. The United States should reconsider its current role in this effort.

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Questions for the Record Submitted by Rep. Bill Huizenga
"The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II"
November 18, 2014

Question for Michael McRaith, Director- Federal Insurance Office of the U.S. Department of Treasury

Thank you for your appearance before the November 18, 2014, House Financial Services Subcommittee on Insurance and Housing regarding the impact of international regulatory standards on the competitiveness of US. insurers. To follow up on the discussion, I would like to submit the below question to the aforementioned witness and have the answer included in the official hearing record.

Director McRaith, in your written statement, you wrote that: "Eliminating the observer status and concomitant annual fee has the additional, essential benefit of increasing IAIS transparency." Until recently, consumer groups and other public observers were permitted to attend almost all working group and task force meetings, such as governance, market conduct and insurance groups. This is similar to the way the National Association of Insurance Commissioners (NAIC) conducts itself. The IAIS subsequently voted on a proposal to limit such public access. Do you support or oppose allowing all consumer groups and other public observers continued access to IAIS working group and task force meetings? Did you support or oppose the IAIS resolution to limit such participation and why?

Answer:

Representatives of all 56 insurance regulators from the states, territories and the District of Columbia, the Board of Governors of the Federal Reserve System (Federal Reserve), and Treasury's Federal Insurance Office (FIO) are members of the International Association of Insurance Supervisors (IAIS).

The IAIS is the international standard-setting organization for the insurance sector. The standards set by the IAIS are not self-executing or legally binding but are implemented by the appropriate regulatory authorities in each country. In the United States, international insurance standards are to be implemented by the Federal Reserve and state insurance regulators.

Until recently, stakeholders interested in attending or participating in IAIS work streams were required to pay an annual fee of $20,400. In exchange for payment of the annual fee, these stakeholders became "observers" and were then entitled to special access to the IAIS web site, to IAIS meetings, and to IAIS social events. This is dissimilar from the way that state insurance regulators engage with stakeholders through the NAIC, where stakeholders may attend public meetings without having to pay an annual fee.

We supported changes to the IAIS observer status because the prior arrangement created a pay-for-play structure whereby the IAIS became financially dependent upon the industry for which

the IAIS establishes standards. Further, the practice of charging an annual fee to obtain observer status limited openness and transparency and unnecessarily restricted stakeholder engagement.

The IAIS structural changes eliminate the annual fee and the observer status in order to promote the involvement of all consumer groups and other public observers in the IAIS, not just those who can afford the annual fee.. For example, as announced in December 2014, the IAIS announced six (6) full day meetings open to all stakeholders and the public from February through October 2015. While additional public meetings will be announce, the current 2015 schedule affords opportunities for public engagement at the IAIS that far exceed any previous year. Further, following the move away from the pay-to-play dynamic, access to information on the IAIS web site is no longer restricted to those individuals or firms that could afford to pay the annual fee.

In addition, FIO, individually and in combination with state regulators and the Federal Reserve, receives input and feedback on a regular and constant basis from U.S.-based stakeholders. For example, on January 5, 2015, FIO, in conjunction with the state regulators and the Federal Reserve, hosted a substantive, technical discussion on issues relating to the international capital standard that included attendees from more than 25 companies and insurance trade associations. FIO intends to build upon this type of engagement as we move forward.

<u>Questions for Thomas Sullivan, Associate Director, Board of Governors of the Federal Reserve System from Representative Huizenga:</u>

1. Mr. Sullivan - in your written statement, you wrote that: "The Federal Reserve supports transparency in rulemaking and policy development and believes that standard-setting bodies be fully independent of the regulated." Until recently, consumer groups and other public observers were previously permitted to attend almost all IAIS working group and task force meetings, such as governance, market conduct and insurance groups. This is similar to the way the National Association of Insurance Commissioners (NAIC) conducts itself. The IAIS subsequently voted on a proposal to limit such public access.

Do you support or oppose opening these meetings to all interested parties and why?

While the Federal Reserve has been a member of the International Association of Insurance Supervisors (IAIS) for only a short time, the work of the IAIS has been underway for many years. The IAIS recently marked its 20th anniversary and continues to evolve as an organization. The Federal Reserve believes the IAIS, as an international standard-setting body, should be independent from the industry for which sets standards.

The IAIS recently voted to revise its approach for industry participation in standard setting. Under the new processes, industry will no longer provide financial support to the IAIS or be day-to-day participants in the development of international supervisory standards for insurance.

The Federal Reserve believes these reforms will provide a more transparent rulemaking process that will allow for input by the industry and the public more generally through the ability to provide public comments on rulemaking proposals. The Federal Reserve supports transparency in rulemaking and policy development and believes that it is critical that standard-setting bodies be fully independent of the regulated entities.

The Federal Reserve, along with our partners, the National Association of Insurance Commissioners and the Federal Insurance Office will continue to actively seek out and engage U.S. insurance stakeholders to ensure an understanding of their perspectives. For instance, the U.S. delegation has hosted several meetings in recent months with U.S. insurance stakeholders for open dialogue and active working sessions regarding matters of policy which are currently before the IAIS. This level of engagement will continue with U.S. interested parties.