Testimony of

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The State of the Insurance Industry and Insurance Regulation

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Introductory Remarks

Chairman Shelby, Ranking Member Brown, and members of the Committee, thank you for the opportunity to testify today. My name is Kevin McCarty, and I am the Insurance Commissioner for the State of Florida. I am also a past President of the National Association of Insurance Commissioners (NAIC) and serve as the Chair of the NAIC's International Insurance Relations (G) Committee. I present this testimony on behalf of the NAIC.

The NAIC is the United States standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia, and five U.S. territories. Through the NAIC, we establish standards and best practices, conduct peer review, and coordinate our regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

Insurance is critical to the U.S. economy and plays an equally important role in global markets. The U.S. insurance market is the largest and most competitive 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 taken individually, U.S. states make up more than 24 of the world's 50 largest insurance markets. My home state of Florida, for example, is the 12th largest insurance jurisdiction worldwide by premium volume. To help put that in perspective, the Florida market for insurance is about the same size as Canada's market, about 50% larger than Australia's market, and nearly twice as large as Switzerland's market for insurance. As U.S. state insurance regulators who cooperate closely on a regular basis, we 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.

As discussions move forward regarding the development of domestic and global capital rules, state insurance regulators continue to oppose imposing a one-size-fits-all bank-centric set of regulations on insurers and instead focus on the importance of company and product specific analysis and examination. While insurer capital requirements are important, such requirements are not a substitute for the other tools in the regulatory tool box and, if imposed incorrectly, can be unnecessarily onerous to the company and ultimately harmful to the policyholder. We are concerned that taking a uniform regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry. The NAIC and its members remain extensively engaged with our federal and international counterparts to ensure that our national state-based system has a prominent voice in the development and implementation of domestic and global capital standards and that they are adaptable to our markets and benefit our consumers.

Distinguishing Characteristics of Insurance Products and U.S. Insurance Regulation

The fundamental tenet of our U.S. system is to protect policyholders by ensuring the solvency of the insurer and its ability to pay insurance claims. Insurance companies are different from other financial institutions and from each other. There is a large amount of variability in insurance products. The insurance regulatory system is purposely flexible to address the depth and breadth of these differences. While insurance policies involve up-front payment in exchange for a legal promise to pay benefits upon a specified loss-triggering event in the future, banking products involve money deposited by customers and are commonly subject to withdrawal on demand. The

very nature of insurance significantly reduces the potential of a run-on-the-bank scenario for property/casualty, health and most life insurance products. For those limited products sold by insurers that could be subject to some level of run risk, mitigating factors exist such as policy loan limitations, surrender/withdrawal penalties, and additional taxes. Additionally, insurers typically maintain a diverse product mix so only a portion of the company's products would be subject to the already reduced level of run risk.

Insurance products, unlike banking products, do not transform short term liabilities into longer term assets. Insurance has shorter duration liabilities in many of the property/casualty and health product lines, and the assets held are similarly short term. Insurance has longer duration liabilities in life and annuity product lines, and these liabilities are matched against similarly longer term assets. This is a critical distinction from banking and other financial products. A key reason many other financial firms suffered during the financial crisis was that the duration of their assets and liabilities were not matched in a way that enabled them to fund their liabilities when they came due.

It is important to design regulation that best recognizes and addresses the differences in products and the financial institutions that offer them while providing the appropriate level of protection for policyholders. State insurance regulators want to make certain that insurance policyholders' assets are protected when an insurer operates within a large, diverse financial group. That is why state insurance regulators strongly support The Policyholder Protection Act (S. 798) to clarify our existing authority to wall off the insurance legal entity from contagion elsewhere in the group. It is critical that the regulatory walls around legal entity insurers that have protected policyholders for decades remain intact regardless of an insurer's organizational structure or financial circumstance.

Federal Reserve Capital Rules Should be Appropriate for the Insurance Business Model

Given the different business models and regulatory objectives between banking and insurance, state insurance regulators want to ensure that any new capital standards at home or abroad appreciate these distinctions. We are keenly aware of the many complicated considerations involved in setting capital standards appropriate for insurers, and are committed to assisting the Federal Reserve in its efforts to implement capital rules for savings and loan holding companies (SLHCs) and insurers that are designated systemically important financial institutions (SIFIs) by the Financial Stability Oversight Council. It is important to keep in mind that these standards are in addition to, and not in lieu of, state risk-based capital standards applicable to the insurers within those groups, so we would encourage the Federal Reserve to work closely with us to ensure their standards complement our existing regulatory authority. We supported the passage of the Insurance Capital Standards Clarification Act last year to give flexibility to the Federal Reserve to tailor its capital rules for these companies. We are hopeful that the Federal Reserve will utilize this flexibility to apply capital rules to these entities that are consistent with the insurance business model and our legal entity regulation and we are committed to assisting them in this important endeavor. We have had some constructive initial conversations with them and look forward to continued discussions in the future.

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

In addition to the regulatory changes occurring domestically, it is important to note that changes are occurring internationally at the same time. The International Association of Insurance Supervisors (IAIS) is simultaneously developing capital proposals primarily to address systemically important firms, but also new requirements on internationally active groups that are not deemed too big to fail, including many firms based in the U.S. 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 Financial Stability Board (FSB), to develop international standards for a basic group capital requirement (BCR) and additional higher loss absorbency (HLA) capital measures (capital buffers) that would be imposed on firms that are deemed too big to fail.

In addition, the IAIS is developing a global insurance capital standard (ICS) as part of a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). State insurance regulators are concerned about the development of international capital standards for the insurance industry as well as the process and speed with which the IAIS has been developing them. We have serious concerns about the aggressive timeline of developing a global capital standard given legal, regulatory, and accounting differences around the globe, but are fully engaged in the process to ensure that any development appropriately reflects the risk characteristics of the underlying business and does not undermine legal entity capital requirements in the U.S.

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 supplements and 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. Also, if the 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. 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 as well as with other jurisdictions around the world.

Of crucial importance to the international discussions will be the Federal Reserve's implementation of capital rules. But let me be clear, while the Federal Reserve has its

responsibilities, we have our own. Most of the Internationally Active Insurance Groups (IAIGs) that will potentially be subject to the ICS are not SLHCs or SIFIs that are also regulated by the Federal Reserve. To that end, while we are committed to collaborating with our federal and foreign counterparts where we can, we still have a responsibility to the U.S. insurance sector. We will not implement any international standard that is inconsistent with our time-tested solvency regime that has provided long-standing protection to policyholders and ensured a competitive and stable U.S. insurance marketplace.

Inclusive and Transparent Decision-Making Process is Critical to Effective Regulation

Critical to the credibility of decision-making at the IAIS is an inclusive and transparent decision-making process. It is difficult to achieve optimum regulatory outcomes or reach broad consensus about international standards without the input of those most affected, in particular the consumer we protect and the industry we regulate. That is why state insurance regulators adamantly opposed efforts at the IAIS to limit stakeholder engagement. We continue to believe the IAIS's decision represents 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. The IAIS has new stakeholder and consultation procedures in place and state regulators participating at the IAIS will assess the effectiveness of these new procedures and continue to advocate for increased transparency, and will urge other U.S. IAIS members to support this worthy goal.

We remain equally concerned with the lack of transparency at the Financial Stability Board. While we appreciate the role of the Federal Reserve, Treasury, and the Securities and Exchange Commission as members of the FSB, state insurance regulators supervise 100% of the private insurance market in the United States and to date have had only limited access into FSB discussions directly relevant to our sector. This direct participation has only occurred as a representative of our international standard setting body, the IAIS, and not after requesting inclusion from our own U.S. FSB representatives. Particularly given the role of the FSB in designating three U.S. insurers as globally systemically important insurers, we find the lack of support for our inclusion at the FSB by our federal colleagues troubling and not reflective of the best interests of U.S. insurers and policyholders. In light of the significant influence the FSB has on the IAIS, it is important that the entire "Team USA" be involved in insurance related discussions at the FSB.

For our part, 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. To that end, last year, the NAIC formed the ComFrame Development and Analysis (G) Working Group (CDAWG), which I chair, to provide ongoing review, and technical as well as expedited strategic input on ComFrame and the international group capital developments. In addition, the CDAWG has been exploring group capital concepts that would be appropriate for U.S. based internationally active insurance groups.

Most recently, the CDAWG helped review the first IAIS Consultation Draft on the ICS, which was issued in December 2014. State insurance regulators provided comprehensive feedback to the IAIS regarding the elements of the proposed ICS such as valuation and potential methods for determining capital requirements. The NAIC is currently working through its open and public process to update its position statements on ComFrame and international capital developments

with input from consumer and industry stakeholders. These documents serve to articulate the views of U.S. state insurance regulators toward the uses of capital within prudential regulation and help guide our ongoing work regarding IAIS capital proposals. As we work to affirm and update our positions, we welcome these additional perspectives to further enhance the focus of our regulatory priorities. We expect to finalize these positions shortly and will share them with the committee.

Conclusion

U.S. insurance regulators have a strong track record of effective collaboration and supervision, and the NAIC is committed to coordinating with our federal and international counterparts to help ensure open, competitive, and stable markets around the world. It is critical that we promote a level playing field across the globe through strong regulatory systems while recognizing that there will continue to be different cultural, legal, and operational differences in regulatory regimes around the world. Consistency in regulation globally is important, but preserving regulatory independence and diversity of thought can also serve as a buffer against contagion or one-size-fits all behaviors by financial firms that can result from one-size-fits-all regulatory approaches. Congress has delegated insurance regulatory authority to the states so we have a continuing obligation to engage internationally in those areas that impact the U.S. state-based system, companies, and consumers. U.S. state insurance regulation has a strong track record of evolving to meet the challenges posed by dynamic markets, and we continue to believe that well-regulated markets, both here and abroad, make for well-protected policyholders. Thank you again for the opportunity to be here on behalf of the NAIC, and I look forward to your questions.