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On Behalf of PCI and NAMIC

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Committee on Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance and Investment

Hearing on "Examining Insurance Capital Rules and FSOC Designation"
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Chairman Crapo, Ranking Member Warner and members of the Subcommittee, my name is Kurt Bock, Chief Executive Officer of COUNTRY Financial, and I appreciate the opportunity to testify today on behalf of the National Association of Mutual Insurance Companies (NAMIC) and the Property Casualty Insurers Association of America (PCI). Our associations together represent more than 2,000 insurance companies – roughly two-thirds of the property-casualty insurance market. These insurers and reinsurers represent a vast diversity of size and business model and provide insurance coverage critical to families and businesses throughout the U.S. and the world.

COUNTRY is a mid-sized financial company from America's heartland that has been awarded A.M. Best's highest rating category ("superior") for over 75 years. We were formed by a group of farmers in 1925 and now provide home, auto, business and life insurance, as well as retirement investments and education funding, to individuals, families, and Main Street businesses. We are very proud that COUNTRY has had the lowest auto complaint ratio with the Illinois Department of Insurance for 11 of the last 12 years and has ranked among the top two home insurers with the lowest complaint ratio for the last 12 years. COUNTRY Financial's top priority is always our consumers, and we assess any regulatory changes or proposals through the lens of our policyholders.

Our trade associations, representing the vast majority of the property-casualty insurance industry, believe that the current U.S. state-based insurance regulatory system is robust and well-positioned to meet the needs of the nation's insurance marketplace. It has helped produce

the strongest, most competitive and largest insurance market in the world. And it has helped our sector improve the quality of life and the safety of the homes, highways and workplaces of all Americans. Finally, our state-based regulatory system is open and transparent to all interested parties, accountable, and able to respond effectively to evolving challenges.

I am appearing before you today to warn that our time-tested and effective system now faces unprecedented challenges, both from international pressures to adopt global bank-like regulatory standards and from increased federal involvement in insurance as the Federal Reserve Board (Federal Reserve) and the Department of Treasury try to navigate their new responsibilities under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Insurance Capital Standards Clarification Act of 2014.

Having affirmed the primacy of state insurance regulation in both Acts, Congress must now increase its oversight regarding the unprecedented federal and international intrusion into state insurance regulation. Clarity regarding the intended outcomes of federal and international involvement is necessary. Such action should include a clear statement of policy, applicable to federal and international negotiations, that reaffirms and defends the existing state-based system of regulation for all U.S. insurers and insurance groups, that encourages greater collaboration and unity among our U.S. agencies, that supports more transparency and accountability, and that ensures any new regulations are rare and only address documented gaps in protecting U.S. consumers rather than just a forced compromise between state insurance and federal banking or global standards. We appreciate the ongoing discussions of potential reforms in the Committee and COUNTRY Financial and our trades look forward to assisting you in these efforts.

The Current U.S. Insurance Regulatory System

The U.S. has the largest and most diverse insurance market in the world, with a 150-year track record of comprehensive state solvency regulation protecting consumers. I am particularly proud of the role that our industry and COUNTRY Financial have played in helping to bring about safer homes, workplaces and highways—efforts that have saved countless lives and

prevented the waste of huge amounts of resources. And I am equally proud that our financial investment in America's future through the municipal bonds that we buy helps build critical infrastructure that leads to a higher quality of life.

The U.S insurance sector remained strong, stable and safe throughout the last several economic crises. (See Appendix 1). Despite a confluence in the last decade of record storms, market contractions and regulatory changes, property-casualty insurance has had no major recent insolvencies, has achieved record levels of policyholder surplus compared to premium to backstop our promises to policyholders (Appendix 2), and private sector insurance availability and competition is better than ever for consumers (Appendix 3) as demonstrated by the historic decline in the number of consumers having to turn to government residual markets. Compared to federally regulated banks, state regulated property-casualty insurers fared relatively well during the recent financial crisis (Appendix 4). They have suffered significantly fewer insolvencies, and the decline during the crisis in the stock valuations of publicly-held property-casualty insurers was not only far less than for banks but also less than for the New York Stock Exchange composite (Appendix 5). Property-casualty insurers also continue to be far less leveraged than banks and our failures are not correlated with broader economic cycles (Appendices 6 and 7). The local focus of our state-based insurance regulatory system has been extremely supportive of responsive property-casualty insurance markets that address regional needs as well as the specific needs of local insurance customers.

Dodd-Frank created a Federal Insurance Office (FIO) to advise Congress and facilitate a unified voice on international insurance issues, and the Financial Stability Oversight Council (FSOC) to identify and reduce systemic risk. In addition, Congress abolished the Office of Thrift Supervision (OTS), in the process incidentally giving the Federal Reserve new authority over insurance holding companies with thrift subsidiaries. These new agencies and new federal responsibilities are still being sorted out but in some cases concerns are growing that the federal agencies are either veering from the intent of Congress or are being pressured to do so internationally.

In particular, although Congress preserved the Home Owners Loan Act' and a distinct holding company structure to govern savings and loan holding companies differentiating them from bank holding companies, the Federal Reserve has been continuously assessing how to fit systemically important insurance groups and insurance groups with depository institutions into its bank holding company regulatory system. In this effort they must address the conflicting pressures of banking regulation focused on macro-economic stability, holding company source of strength for depositors and federal deposit insurance fund protection contrasted with a completely different insurance business model that does not contribute to systemic risk and is focused on legal entity regulation for consumer protection.

International Standard-Setting for Insurance

The property-casualty industry has serious concerns about recent international standard-setting efforts that have morphed far beyond their original mission to develop best practices or principle-based standards. Instead, these bodies are increasingly trying to extend particular capital standards and accounting practices used by certain regions on a global basis that could significantly undermine the current U.S. insurance regulatory system. While COUNTRY Financial and a majority of the members of our trade associations are domestic, all of the members have felt the impact of the international standards being imported to the U.S. Indeed, the movement toward more formulaic, one-size-fits-all prescriptive standards is accelerating and threatening both international and domestic-only insurers.

International decisions influence the content of regulation in the United States, and also influence the criteria by which the quality of U.S. regulation is assessed by organizations such as the International Monetary Fund (IMF). Standards initially being discussed only for systemically important or internationally active insurance groups are quickly bleeding into the more broadly applicable International Association of Insurance Supervisors (IAIS) International Insurance Core Principles (ICPs), in addition to creating enormous pressure on the state and federal regulators to conform.

U.S. regulators face intense pressure for global convergence from the Financial Stability Board (FSB), a largely opaque consortium primarily composed of international bank regulators, finance ministers and consolidated regulators that advocates one-size-fits-all global standards, as well as the IAIS, which has adopted in its Insurance Core Principles insurance standards based largely on Solvency II – a new top down, bank-like like regulatory system adopted but not yet implemented by the European Union. U.S. state solvency regulation has been extremely successful, due not only to the structure of the regulation but also to its particular focus on protection of insurance consumers rather than investors and lenders.

Changing the existing regulatory paradigm to a centralized banking or Solvency II-like system, as the FSB and IAIS urge, would compromise our current system and lead to harmful consumer protection outcomes that Congress neither envisioned nor intended. Both higher consumer costs and less competition would very likely result.

International Monetary Fund and the FSAP

Following the 2008 financial crisis, all countries participating in the G20 agreed to IMF assessments of their financial sector laws and regulations every five years. These reviews are called the Financial Sector Assessment Program (FSAP) and were designed to create more global consistency in financial regulation. In 2010 the IMF first assessed the insurance laws and regulations in the U.S. to determine their "observance" of the IAIS' ICPs.

After the 2010 FSAP, several new model laws were put in place by the National Association of Insurance Commissioners (NAIC) in response to the recommendations from that report. These included several new requirements for holding companies, including:

- new enterprise risk management requirements;
- additional risk-based capital requirements;
- reduced foreign reinsurance collateral requirements;
- a new corporate governance disclosure; and

- new internal audit function requirements (See Appendix 8 for details).

All of these new models have or will likely become accreditation standards, meaning that each state must adopt them to maintain their accreditation by the NAIC. These new model laws have already changed the fabric of insurance regulation in the U.S.

Despite the NAIC's efforts to develop model laws and movement at the state level to enact the model laws, the IMF returned in 2015 with lower scores for U.S. insurance regulation and more prescriptions for centralized regulation. Ironically, the IMF recognized the general effectiveness of the outcomes of the U.S. state-based regulatory system but criticized it for failing to conform more closely to the IAIS core principles. And unsurprisingly, the report supported a greater federal role in regulation. It is unclear how the new recommendations will be addressed by state regulators, the NAIC, and the Federal Reserve, but it is clear that in the current climate there will be more international pressure on our insurance regulatory system resulting in new requirements, new reporting, and increased costs – with little or no demonstrable benefit and a very real potential for harm.

The International Association of Insurance Supervisors and the ICPs

The IAIS used to be a forum for insurance regulators to discuss best practices, improve cooperation between regulators and inform developing countries that were creating an insurance regulatory system about the important issues to address. More recently IAIS members seeking to globalize their standards or centralize regulation have focused efforts on establishing Insurance Core Principles that are required standards for insurance regulation that members commit to adopt and are graded on their compliance. Beyond the Insurance Core Principles, the IAIS launched a new Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs), "ComFrame." Under current definitions, ComFrame would set a new regulatory scheme for the 50 largest international insurers, making up roughly a quarter of the U.S. property-casualty insurance market. ComFrame began as an attempt to promote

cooperation and coordination among insurance supervisors. It has now become an effort to impose a series of quite specific new regulatory standards on large international insurers regardless of their status as systemically important. There is little doubt that once established, there will be pressure to apply the ComFrame standards more broadly.

It is important to note that the IAIS is not bound by due process and does not formally consider the costs of the changes it makes to international insurance standards relative to the presumed benefits of these changes. With each new or revised ICP or standard, the IAIS adds costs to international regulatory enforcement and compliance with little regard for the impact of these costs on governments, insurers, and consumers. At the IAIS, the U.S. is represented by the Treasury Department through the Federal Insurance Office, the Federal Reserve, and state insurance commissioners; however, these entities do not always speak with a unified voice and are greatly outnumbered by other member countries.

Most of the property-casualty insurance industry 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. It is critical that our U.S. representatives cooperate and collaborate to advocate for the strengths of the U.S. system and oppose proposals that would not benefit U.S. consumers. Congress needs to restate this mission by clarifying the desired goals of the federal agencies in working with the state regulators and the U.S. insurance industry and discussing potential commitments to changes in regulation. More specifically, given concerns about the direction of the IAIS discussions on an insurance capital standard that would be applied to insurers that are not systemically important, just internationally active, Congress should direct U.S. representatives to forcefully advocate for the current state-based approach of risk-based capital requirements on a legal entity basis designed for policy holder protection, and not quantitative global capital standard for non-systemic insurance groups that focuses on protection of creditors, shareholders and others, beyond policyholders.

In addition, despite the introduction of bipartisan and bicameral Congressional resolutions and the opposition of state legislators, the IAIS has shut out interested parties from its working meetings. This action was opposed by our state regulators but they were not supported by our federal representatives. The resulting procedures are far less transparent than those of the states and NAIC. This episode serves as an unfortunate example of the lack of coordination between the members of the U.S. regulatory team participating internationally.

Financial Stability Board

Many decisions related to international financial services are being made by an arm of the G-20 known as the FSB. The FSB was established from a group of international central banks and finance ministers. It is housed in Basel, Switzerland, in the Bank for International Settlements, and has been chaired solely by various central banks. Unsurprisingly, the FSB tends to be bank-centric, and 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 lawmakers represented on the FSB and in fact there is only one FSB member focused primarily on insurance – the IAIS. The FSB decision-making process is largely opaque and there are few opportunities for communicating our members' concerns, or the concerns of interested parties, to the U.S. representatives on the FSB. Consequently, there is ample reason to doubt that the FSB fully understands how its decisions affect insurance markets, or that the critical differences between banks and insurance are fully appreciated.

It is important to ensure that federal agencies representing the U.S. on the FSB and at the IAIS are advancing policy positions that represent the interests of U.S. insurance consumers, insurance markets, insurance regulators, and the U.S. economy in general. To that end, the U.S. should insist on an open and transparent policy development process, and the U.S. representatives who engage with international bodies should share a common agenda and a

common message. That message should include a strong defense of the U.S. insurance market and existing state-based regulatory structure. It should also promote the interests of U.S. insurers and their policyholders. As in the case of U.S. involvement at the IAIS, the FSB represents an opportunity for better coordination between the members of the U.S. regulatory team participating internationally.

The Development of an International Capital Standard

No Identification of Problem; No Flexibility in Key Principles - On October 9, 2013, the IAIS announced that it would develop an Insurance Capital Standard (ICS) by the end of 2016 for all IAIGs, scheduled to be implemented beginning in 2019. The IAIS Executive Committee did not elaborate regarding the problem it was trying to solve or explain why the decisions were made, but insisted on a highly detailed, prescriptive formula for the ICS that would be applied to all countries; that all countries use the same valuation/balance sheet without regard to the costs and implications; and that the capital resources that companies use to meet the obligation be identical even when the capital instruments available to companies vary across countries.

Comparability Not Obtainable - Despite the goals of the IAIS to achieve a comparable ICS for all IAIGs around the globe, the application of the same capital standard to unique companies from very different regulatory environments with very different economic and political objectives will not produce comparable indicators of capital adequacy 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. Similarly, every insurance group has unique characteristics that cannot be fully captured in a single one-size-fits-all formula.

Exorbitant Costs; No Identification of Benefits - In its zeal to achieve comparability, the IAIS will succeed only in generating unnecessary costs to governments and insurers. The costs to the U.S. will be significant. Our country will be required to make major changes to its supervisory, corporate law, and accounting systems to accommodate the new group capital requirements.

Because the new standards will likely be derived from existing Solvency II standards, U.S. insurers will be placed at a competitive disadvantage relative to their foreign counterparts in the transition, and U.S. consumers will very likely bear the brunt of higher prices and fewer choices in the market.

A Better Solution - A workable global effort would not create competitive asymmetries between companies domiciled in different, but equally well-supervised, jurisdictions. What is needed is a flexible and dynamic principles-based and outcome-focused assessment that would recognize and improve understanding of diverse, successful approaches to solvency regulation. Under this approach, supervisors could achieve the desired goal of policyholder protection, and for systemically important insurers, the additional goal of insurer solvency, without the costs that would result from implementing new global systems in nearly every country in the world.

Unfortunately, the IAIS does not seem to be heading in this direction. Instead, the IAIS is developing more intensive capital requirements for non-systemically important IAIGs. This approach is based on the European Union model of requiring capital sufficient to prevent failure -- that is to protect bondholders and investors, and not the U.S. standard, which is focused on policyholder protections.

Beyond that fundamental disconnect, there are also many more granular, troubling aspects to the approach of the IAIS. While it now recognizes that the ultimate, "fully comparable" ICS cannot be developed by 2019, it continues to push forward for development and implementation of an "interim" ICS by 2019. This may require changing accounting standards and favoring 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 consumers and insurance markets. Although the ICS to be proposed by the IAIS is not statutorily mandated and would have to be implemented by the states, the majority of the property-casualty industry is concerned that it would create pressure on the states to harmonize existing state standards to the ICS.

One Voice – Team U.S.A.—On All Issues

The U.S. regulatory team participating internationally needs to seek public input on the international policy issues it addresses internationally with the IMF, the FSB, the IAIS and any other standard-setters whose actions affect U.S. insurance laws and regulations. Drawing on information acquired through consultations with interested members of the public, this team must present a consistent and unified voice both publically and privately. The decisions about international positions should be made in an open, transparent forum that includes due process for all stakeholders impacted by the decisions. This includes both state regulators and state legislators who adopt state insurance laws. The U.S. positions should reflect the basic instruction from Congress to support the existing state-based insurance regulatory system in international negotiations.

In regard to the ICS, the U.S. should be pursuing an outcomes-based, flexible approach that recognizes the successful, state-based U.S. system. All of the U.S. representatives need to set aside concerns about what the FSB or the IAIS will or won't accept and agree on a clear and coherent position from which to negotiate internationally on insurance regulation. The various U.S. representatives engaged in these discussions have taken ad hoc steps to communicate with the industry and U.S. regulators on these capital policy positions, but there remain inconsistencies in the U.S. positions advanced internationally. A better, more systematic process is needed for this major issue and for many other standards under discussion internationally.

The critical importance of a Team USA that advocates positions consistent with effective state-based regulation is not limited to capital standards. The FSB and IAIS are working on a vast array of insurance regulatory topics including governance, remuneration, market conduct, resolution and recovery, and cyber standards. These have a tremendous potential to help or

harm consumers and competitive markets, and our federal representatives should be fully engaged and cooperating with state insurance regulators in these projects. However, Congress can play a key role in helping to ensure that our federal representatives and state regulators are advocating consistent positions internationally on behalf of the U.S. insurance market and the regulatory system that protects its policyholders.

Federal Reserve Insurance Capital Standards

Until 2011, savings and loan holding companies were regulated by the OTS. In 2011, pursuant to the Dodd-Frank Act, the supervisory responsibilities of the OTS were transferred to the Federal Reserve, and savings and loan holding companies (SLHCs) were subjected to much greater risk supervision, liquidity and capital requirements, not just for the thrifts or banks but also the broader holding company. The Federal Reserve also has supervisory authority over entities designed by the FSOC as systemically important. Between its group-level regulation of insurers with thrifts or banks and insurers designated as systemically important, the Federal Reserve has group-wide supervisory authority over more than 30 percent of the insurance industry, measured by premium volume. It should be noted that this supervision is in addition to, not in lieu of, all existing state regulation for these groups and their legal entities.

In the congressional hearings and public forums leading to the enactment of the Insurance Capital Standards Clarification Act of 2014, an oft-repeated theme was that regulators should avoid using a one-size fits all approach to setting capital rules for financial companies under its jurisdiction. This was most typically reflected in the view that insurance companies should not be regulated like banks and subject to rules designed for banking. We agree with this approach, but recommend that the analysis should not end with banking versus insurance when looking at a diverse range of insurance companies and business lines.

While the Federal Reserve has authority with respect to SLHCs and designated systemically important companies, it is important to note that there are distinct differences in these two

categories of companies. SLHCs are subject to Federal Reserve jurisdiction as result of the presence of a depository institution and because Congress abolished the OTS, not because the companies pose any risk to the U.S. financial system. In addition, there are significant differences between property-casualty companies and life insurance companies necessitating very different capital structures and asset holdings. In fact, there are even substantial differences in the liabilities and asset needs facing different types of property-casualty companies (e.g., rate regulated homeowners' insurance versus environmental toxic tort liability).

Last year Congress passed with overwhelming support the Insurance Capital Standards Clarification Act of 2014. This legislation allowed the Federal Reserve to avoid imposing on insurers capital standards designed for bank holding companies. The Federal Reserve is now trying to ramp up its understanding of insurance to evaluate various domestic and international proposals regarding how it should supervise insurance holding companies under its jurisdiction. Numerous staff have spent considerable time and effort examining insurers, asking questions not only about their depository institutions and potential risks to the federal deposit insurance fund, but about many unrelated insurance and commercial activities as well.

Like COUNTRY Financial, some insurers have very small community or trust banks and wonder whether Congress truly intended to create an additional layer of intensive Federal Reserve supervision of insurance for Main Street community operations. We fully respect the integrity of the Federal Reserve in carrying out its new responsibilities, but would suggest that additional clarity from Congress regarding its intent under the Dodd-Frank Act could be helpful.

As the Federal Reserve increases its understanding of insurance and balances its new responsibilities, to what extent does Congress intend for its involvement to be proportional to the risks that insurer-owned banks pose to the federal deposit insurance corporation or broader systemic stability? And to what extent should insurance activities be regulated by our

primary functional regulator rather than by the Federal Reserve? In essence, what is the intent of Congress on state versus federal regulation of Main Street insurers?

We hope that to the extent that the Federal Reserve imposes supervisory requirements on insurance holding companies under its jurisdiction, including capital standards pursuant to the Dodd-Frank Act Collins Amendment and the Insurance Capital Standards Clarification Act, the Federal Reserve will focus on the holding company banking activities and rely to the extent possible on state regulatory standards for holding company insurance operations. In particular it is critical that the Federal Reserve not try to substitute a new capital measurement to replace state risk-based capital requirements and measurements. Rather, the Federal Reserve should recognize the state-based regulation of insurance operations and either exclude the insurance activities or aggregate the current state capital requirements of the insurance legal entities while focusing regulatory oversight on the non-insurance entities, the depository institution and, in the case of insurance systemically important financial institutions (SIFIs), the stability of the U.S. financial system. By doing so, the Federal Reserve would not need to try to replicate decades of sector-specific regulatory experience.

COUNTRY Financial and our trades would appreciate a dialogue that could be helpful to our regulators as well as our customers and look forward to participating as the regulators and Congress seek the right balance of oversight.

FSOC Designation Process

In passing the Dodd-Frank Act, Congress sought to ensure the stability of America's financial markets and reduce the exposure of taxpayers to costly bailouts. To accomplish this, the FSOC must follow the intent of Congress, which was to designate only those financial firms that pose true systemic risk. We are concerned that FSOC has not been sufficiently focused on identifying true systemic risk, and therefore strongly recommend that the Congress exercise robust and effective oversight of the FSOC designation process. This should include providing additional

legislative direction to ensure that relevant provisions of Dodd-Frank are implemented in a manner consistent with the intent of Congress and that the FSOC is properly focused on identifying true systemic risk.

Problems in the FSOC Nonbank Designation Process

The Dodd-Frank Act set forth a list of factors the FSOC is to consider when determining whether a nonbank is systemically important. However, FSOC's designation decisions regarding insurance groups has not provided a meaningful analysis of these factors, focusing instead primarily on issues relating to the size of the company and on hypothetical and arguably implausible scenarios under which material financial stress at the company would pose systemic risk to the economy. By declining to address the statutory systemic risk factors, the FSOC's designation decisions have not clearly established a coherent rationale for the decision based on activities in which the firm engages. This does not foster confidence in the FSOC's decisions. It also leaves all companies in the dark about what activities the FSOC considers systemically risky and thus provides no clear direction to companies on how to reduce systemic risk.

The Government Accountability Office (GAO), in a report released on November 20, 2014, also criticized FSOC for "using only one of two statutory determination standards (a company's financial distress, not its activities)" and noted that "FSOC may not be able to comprehensively ensure that it had identified and designated all companies that may pose a threat to U.S. financial stability."

FSOC's failure to address the ten specific "considerations" set forth in Dodd-Frank is particularly problematic with respect to recent insurer designations. One of those factors is the degree to which the company is already regulated by one or more primary financial regulatory agencies. State insurance regulation has a long-established, excellent record of protecting consumers against insurance insolvencies. Indeed, it could well be argued that its record is superior to that

of numerous federal regulators who have regulated banks, savings and loans, and other financial firms. Despite this, the designations seem to assume that state insurance regulators would be unable or unwilling to respond effectively to problems in insurance companies. For example, the FSOC worried that financial troubles at a life insurer could lead policyholders to seek to surrender their policies in a disorderly manner, but the FSOC failed to acknowledge that state insurance regulators have the ability to impose stays or take other action to manage any such surrender activity. Congress recognized that state regulators have a number of options to mitigate systemic risk, but the FSOC has disregarded those tools. In exercising its oversight responsibilities, Congress should reaffirm its instruction that FSOC consider and provide an in-depth analysis of each of these factors in determining whether an insurer should be designated as systemically important.

FSOC's decisions to designate three insurers as systemically important are particularly disturbing given that they were reached over the strong and substantive objections of both FSOC's Independent Member Having Insurance Expertise and the non-voting State Insurance Commissioner Representative. The FSOC's decision record does not make clear why the strong views of these two insurance experts were disregarded and provides no substantive refutation to the informed and well-reasoned arguments of these experts. We view this as one of the surest signs that the FSOC designation process is flawed and in need of increased congressional oversight and reform. At a minimum, Congress should consider directing the FSOC to provide a well-articulated and substantive discussion of its rationale any time it disregards the expert advice of those on the FSOC who Congress put there to bring insurance expertise to the table.

A byproduct of the lack of clear rationales for FSOC designation decisions is that the FSOC has not provided a roadmap for how companies can take action to eliminate activities that pose systemic risk and thus become eligible to have a designation of systemic importance removed. The ultimate goal of the Dodd-Frank Act was to reduce systemic risk and it created the FSOC primarily to do so. By failing to specifically identify the systemically risky activities required to

be addressed in companies it designates or to provide an “exit ramp” for such companies, the FSOC replaces an effort to reduce systemic risk with just another layer of federal control.

To its credit, FSOC recently adopted several new measures designed to address some concerns. The new measures include: improving engagement with companies being considered for designation; enhancing public transparency; and making the annual review process more meaningful. We applaud FSOC for taking these actions, which we view as improvements to the existing process. Nevertheless, they fall short of fully addressing the shortcomings we, the GAO, and others have identified. Most importantly, they do not bring the FSOC designation process fully into line with that envisioned by Congress and set forth in Dodd-Frank.

In considering how to exercise its oversight responsibilities over FSOC and improve the systemic risk designation process, we urge Congress and FSOC to keep in mind the following basic premises:

Size Alone Does Not Create Systemic Risk. FSOC must not create a new class of “too-big-to-fail” companies, blindly designating companies as systemically important simply because they are large without adequately analyzing other far more significant factors indicative of systemic risk. Few, if any, financial companies are systemically important solely because they are large. Engaging in highly risky activities, coupled with interconnectedness, leverage, concentration and other considerations set forth in Dodd-Frank, is what creates systemic risk. Unless FSOC fully considers and analyzes all of those factors, it cannot gain a holistic view of the true nature of the risks a company does and does not pose.

Goal Should Be to Reduce Systemic Risk. FSOC must recognize that its goal is not to impose punitive regulation on financial companies, but to reduce systemic risk. If FSOC is true to that goal, it will work with companies to consider approaches to reducing systemic risk before, during, and after consideration of a company for designation. To do otherwise fails to provide the protection to the economy that Congress envisioned when it passed Dodd-Frank and

instead only causes significant market distortions and increased costs for consumers with little significant benefit.

Insurance Is Not Systemically Risky. There was widespread recognition during the legislative process that led up to the passage of Dodd-Frank that traditional insurance activities simply are not systemically risky. Property-casualty insurers, in particular, have low leverage, are not interconnected with other financial firms, do not pose a "run-on-the-bank" threat, are highly competitive with low market concentration, have low failure rates, and have their own effective and self-financed resolution system. When one of Dodd-Frank's namesakes, former House Financial Services Committee chair Barney Frank, testified last summer in a hearing assessing the Act, he said that he didn't believe "asset managers or insurance companies that just sell insurance are systemically important." Mr. Frank also said it was never his intention that a nonbank designated by the FSOC should be regulated as a SIFI in perpetuity, and noted that he had sent a letter to FSOC stating that view.

Transparent, Activities-Based Analysis. FSOC needs to make its systemic risk determinations more systematic and transparent. This includes following the mandate of Section 113 of Dodd-Frank to assess the *activities* in which a company engages – not just its size and hypothetical scenarios of financial distress. It also includes identifying activities that pose systemic risk and publicly announcing them *before* designating a company as systemically important. This will allow companies to reduce systemic risk before it becomes necessary for FSOC to consider designation. This would provide much greater confidence to the general public that true systemic risk is being addressed and rooted out of the economy.

Indeed, the GAO noted that "FSOC's public documents have not always fully disclosed the rationales for its determination decisions" and that "the lack of full transparency has resulted in questions about the process and may hinder accountability and public and market confidence in the process." The GAO recommended that "making FSOC's designation process more

systematic and transparent could bolster public and market confidence in the process and also help FSOC achieve its intended goals."

Off-Ramp. Once a company has been designated, a fair process is needed to give the company a reasonable roadmap for eliminating the activities that led to the determination so that the company can be de-designated. There is no process for this now, but this is also essential to achieving the goal of reducing systemic risk.

Deference to Functional Regulators. Although almost all members of FSOC are regulators, no single member has expertise in all sectors of the financial services industry. In keeping with congressional direction in Section 113(a)(2)(H) of Dodd-Frank, FSOC *must* begin to recognize and utilize the expertise of the primary functional regulators and engage in meaningful analysis of how that regulation can or does work to reduce systemic risk. This is especially true with respect to insurance because the vast majority of FSOC members have no background in that industry or its regulation. This means, in part, being more mindful of the strong views of insurance experts on the FSOC, but even more importantly, it means consulting with state insurance regulators before and during the designation process. The non-insurance expert members of FSOC need to devote significant time and attention to the state-based regulatory system and develop a much more sophisticated understanding of it before considering another insurance company for designation.

Congressional Legislation. While increased Congressional oversight of FSOC is important, Congress needs to consider statutory changes to more tightly direct FSOC's decision-making processes. For example, H.R. 1550, introduced by Representatives Dennis Ross (R-FL), and John Delaney (D-MD), would make a good start. The bill would require FSOC to:

- consider the appropriateness of the imposition of prudential standards as opposed to other forms of regulation to mitigate the identified risks;

- at least annually reconsider nonbank SIFI designations and to respond with specificity how the Council assessed any material factors presented by the company to contest such designation;
- revote nonbank SIFI designations every five years at the request of the affected company, including consideration of a plan by the company to reduce its systemic impact;
- notify a nonbank financial company that it has been identified for a potential SIFI designation and to provide with specificity the basis for the consideration, an opportunity to meet with FSOC to discuss FSOC's analysis, and a list of the public sources of information being considered by the Council as part of such analysis;
- before making a designation, vote to approve a resolution that identifies with specificity any risks to the financial stability of the United States FSOC has identified relating to the nonbank financial company;
- provide a potential designee's primary financial regulatory agency at least 180 days from the date of the resolution to respond to FSOC regarding how the risks could be addressed by existing regulation other regulatory action to mitigate the identified risks; and
- every five years assess the impact of designations on SIFIs and the wider economy, including whether the designations are improving the financial stability of the United States.

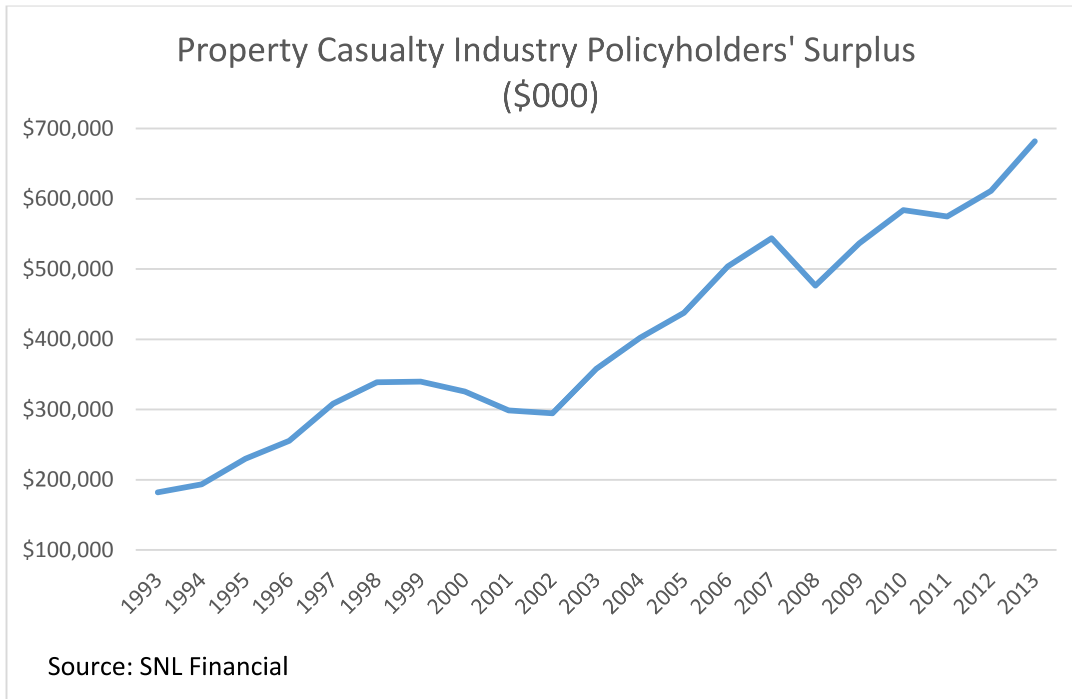
We would further urge that additional requirements for FSOC to give greater deference to functional regulators be included along with requirements to report to Congress on any designations, including detailed descriptions of how FSOC fully followed the requirements of Section 113 of Dodd-Frank.

Conclusion

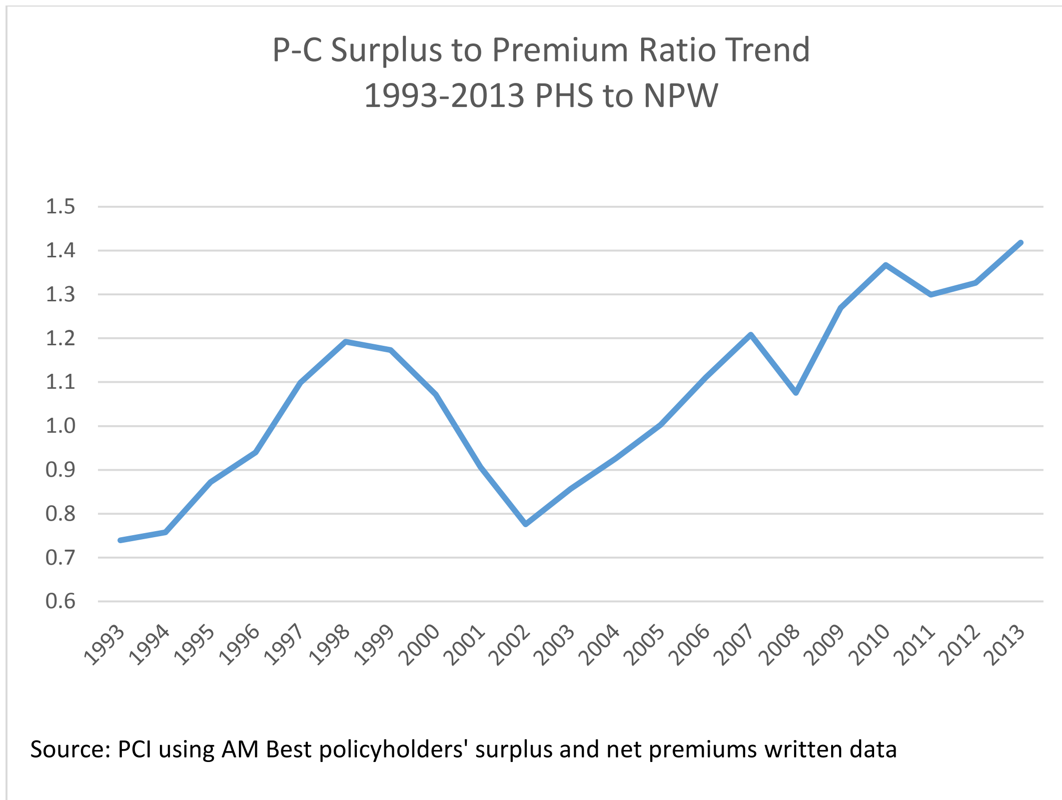
The stakes in the subjects we have addressed herein could not be higher for consumers and the competitiveness of our markets. Congress has an essential role in overseeing the increasing federal and international intrusion into the well-established state-based system of insurance regulation, encouraging greater collaboration and transparency in standard-setting discussions, and providing clear guidance to federal officials as they interface with a state-based regulatory system and international globalization pressures. Congress should help guide our country's involvement at the IMF, FSB and IAIS to facilitate a stronger global insurance regulatory environment through cooperation, coordination and consistency, as opposed to creating one-size-fits-all standards for every country in the world. New requirements and changes should be based on existing identified gaps in consumer protection. We must avoid a systemically dangerous over-reliance on uniformity, and we must not disregard the fundamental differences in regulatory and legal systems or fail to adequately consider potential costs. Congress can also encourage the regulators not only to meet together as Team USA but to develop a common strategy to support the U.S. overseas in all international insurance regulatory discussions. Domestically, Congress can ensure that federal involvement with insurers is appropriately tailored to specific regulatory objectives (such as protection of a significant thrift or overseeing specifically identified systemically important activities not currently regulated for solvency) and does not undermine the primary mission of state insurance regulation to protect consumers.

We look forward to working with Congress, federal representatives, and state regulators and lawmakers to ensure the continued support for the time tested state-insurance regulatory model.

Appendix 1



Appendix 2



Appendix 3

PROPERTY CASUALTY Market Concentration Analysis

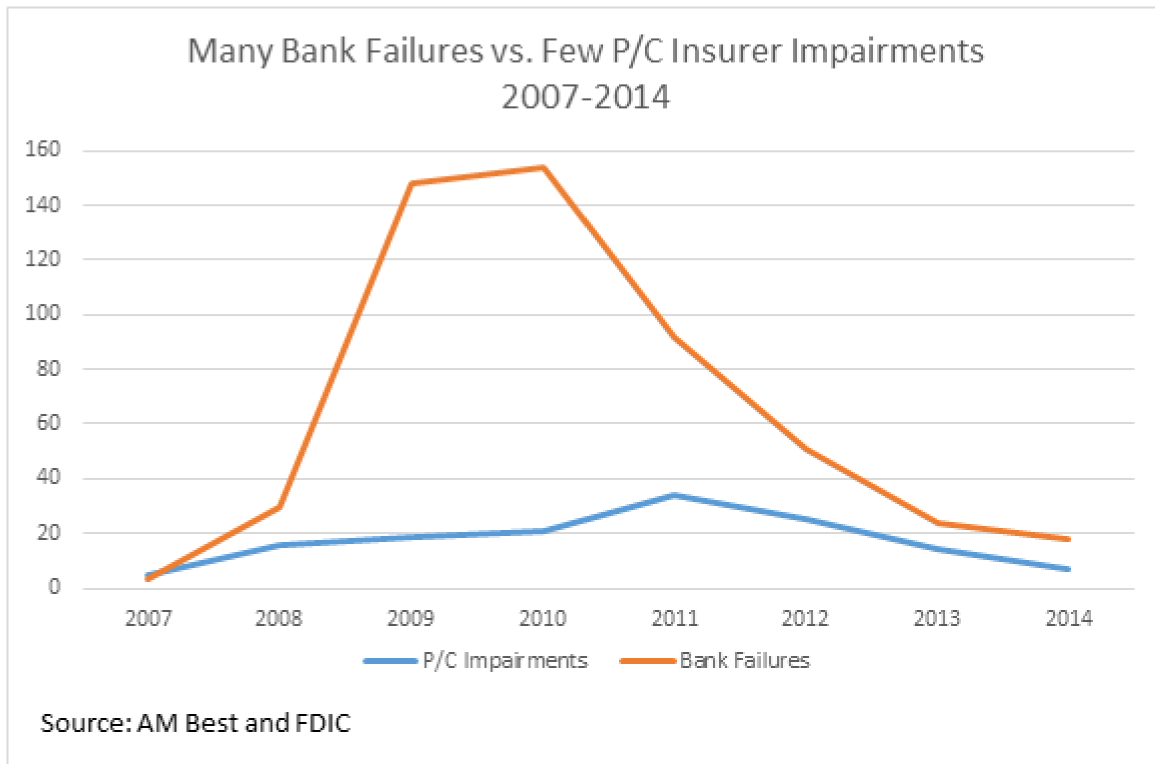
DOJ Considers Score of 1500 - 2500 to Be Moderately Concentrated, But Almost All Insurers Fall Well Below

Herfindahl-Hirschman Index (HHI) based on 2013 U.S. Total (all states and DC)

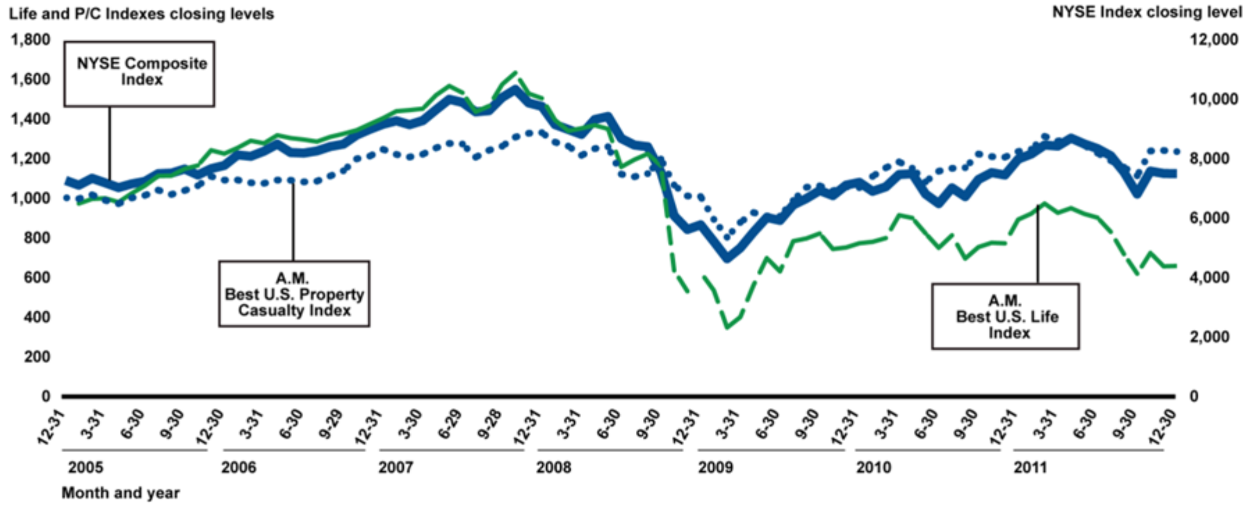
Line	HHI Indiv. Cos.	Number of Indiv. Cos.
Homeowners	301.9	873
Personal Auto	349.0	877
Commercial Multi-Peril	88.6	800
Workers Compensation	88.9	704
Medical Prof. Liability	216.2	343

Notes:
1. The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.
2. Markets in which the HHI is between 1500 and 2500 points are considered to be moderately concentrated, and those in which the HHI is in excess of 2500 points are considered to be concentrated.
Source: NAIC Annual Statement Database via SNL Financial

Appendix 4

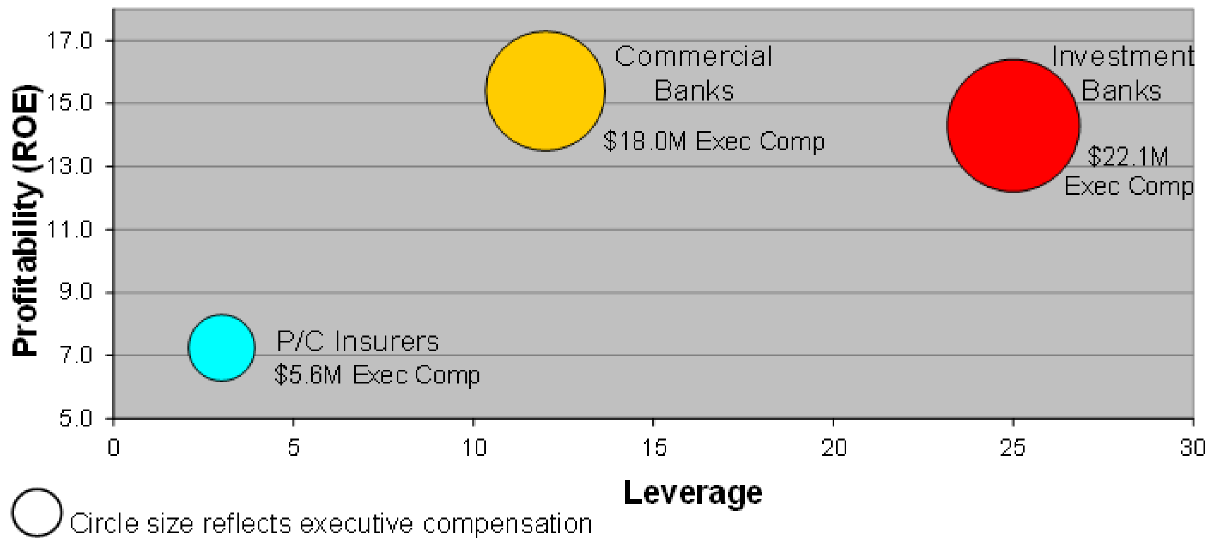


Appendix 5



Source: GAO analysis of A.M. Best data on the A.M. Best U. S. Life and Property Casualty Indexes and the New York Stock Exchange Composite Index.

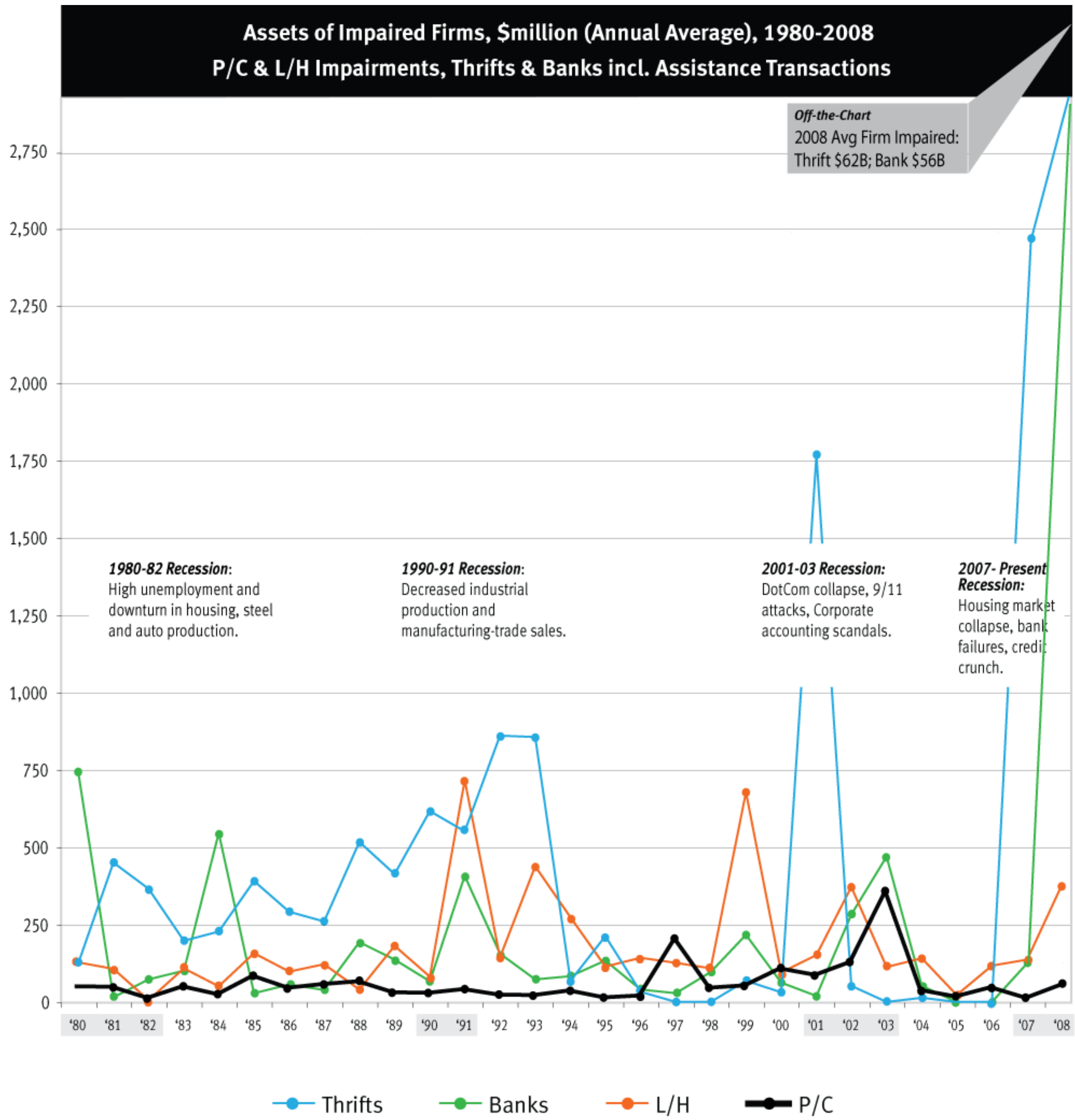
Appendix 6



Source Information:

1. Profitability is based on industry 1998-2007 average annual rate of return; Insurance Information Institute, and Securities Industry and Financial Markets Association.
2. Leverage reflects 2007 Property/Casualty, commercial bank and investment bank results; 2009 *Economic Report of the President* (banks) and PCI calculations of total liabilities as a proportion of net admitted assets using A.M. Best data (insurers). Chart depicts investment banks levered 25 to 1; commercial banks 12 to 1; and PROPERTY CASUALTY insurers 3 to 1.
3. Executive compensation is based on 2004-2008 annual average CEO compensation from the top three firms in 2008 where data are publicly available; Morningstar.com and for State Farm, PROPERTY CASUALTY Annual Statements and Pantagraph.com newspaper article. Please note the commercial banks figure is based on the 2nd, 3rd and 5th largest firms; and the investment banks figure is based on the 2nd- 4th largest firms. In the chart above, the size of each industry's circle represents executive compensation: PROPERTY CASUALTY insurers $5.6 million; commercial banks $18.0 million; and investment banks $22.1 million.

Appendix 7



Appendix 8

U.S. NAIC Model Changes Since 2010 Related to International Pressures

Group Supervision: FSAP Recommendation

- 2010 revisions to the Model Insurance Holding Company System Regulatory Act and Insurance Holding Company System Model Regulation; these are accreditation standards for all states and include the following:
    - Created Supervisory College requirement for international insurers
    - Created Enterprise Risk Reporting Requirement for all insurance groups
    - Added access to Financial Reporting of any affiliates of a group (even non-insurance)
    - Expanded filing requirement for intercompany agreements and amendments
- 2014 additional revisions to the Model Insurance Holding Company System Regulatory Act to create definition, designation and authorities of a group-wide supervisor for international companies; in process to become an accreditation standard for all states
- **48 states have enacted the 2010 model act or have bills awaiting signature with the remaining states to enact by year-end; 7 states have enacted some version of the 2014 model**

Enterprise Risk Assessment: FSAP Recommendation

- 2011, 2012 ORSA Guidance Manual and Risk Management Own Risk and Solvency Assessment Model Act adoption – to require an Enterprise Risk Management function as well as annual assessment and reporting for companies of a size over $500 million premium or insurance groups over $1 billion; in process to become an accreditation standard for all states
- **28 states have enacted the 2012 ORSA model act or have bills awaiting signature with 11 more states pursuing in 2015; the ORSA guidance manual applies automatically to these states**

Reinsurance: EU/US Dialogue Recommendation

- 2011 revisions to Credit for Reinsurance Model Act and Regulations – significantly reducing collateral requirements for foreign reinsurers; an accreditation standard for states
- **At least 28 states have enacted the 2011 revisions to the model act**

Capital Adequacy: FSAP Recommendation

- 2013 added Catastrophe Risk Based Capital Factors for Earthquake and Hurricane risks
- 2014 added Operational Risk Based Capital Factors
- 2013-2014 Investment Risk Based Capital Factors – under evaluation and reassessment
- **All RBC changes will be automatically applied to all states; no adoption necessary**

Corporate Governance: FSAP Recommendation

- 2014 Corporate Governance Annual Disclosure Model Act; in process to become an accreditation standard for all states
- **One state enacted this new model with two awaiting governor signatures**

Internal Audit: FSAP Recommendation

- 2014 Internal Audit Function Requirement added to Model Audit Rule for companies of a size over $500 million premium or insurance groups over $1 billion; in process to become an accreditation standard for all states