Testimony of the

Property Casualty Insurers Association of America (PCI)

Subcommittee on Housing and Insurance

Committee on Financial Services

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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.