American Property Casualty Insurance Association
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STATEMENT BY DAVID A. SAMPSON, PRESIDENT AND CEO, FOR SEPTEMBER 12, 2019 HEARING OF SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

The American Property Casualty Insurance Association (APCIA) thanks the Committee for holding this very timely and important hearing on "Developments in Global Insurance Regulatory and Supervisory Forums." APCIA is the primary national trade association for home, auto, and business insurers. APCIA promotes and protects the viability of private competition for the benefit of consumers and insurers, with a legacy dating back 150 years. APCIA members represent all sizes, structures, and regions – protecting families, communities, and businesses in the U.S. and across the globe.

APCIA is deeply concerned that the International Association of Insurance Supervisors (IAIS) will adopt an international capital standard that is unfit for purpose and potentially harmful to U.S, insurance groups, despite continued objections by U.S. state insurance regulators as represented by the National Association of Insurance Commissioners (NAIC), the Federal Reserve Board (FRB), and the Federal Insurance Office (FIO) of the U.S. Department of Treasury (collectively, "Team USA"). Guarding against this threat is precisely the purpose of the Heller-Tester International Insurance Capital Standards Accountability Act that Congress enacted last year. APCIA asks for continued strong Congressional involvement and support for our Team USA representatives as they engage with their international counterparts and urge a broader perspective that includes valid and robust alternative approaches to capital assessment.

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. The U.S. property casualty industry has played a major role in helping to bring about safer homes, workplaces, and highways through efforts that have saved countless lives and preserved important resources. Over the last three years, United States consumers suffered record losses from historic natural disasters – hurricanes, wildfires, earthquakes, and tornadoes. The insurance industry rose to the challenge, communicating closely with policyholders, working with federal and state disaster crews and regulators, and speeding claims payments to families and businesses suffering losses. Despite these tremendous challenges, U.S. industry solvency and financial strength have remained at record highs.

Although the capital standards of the U.S. insurance regulatory system have served the U.S. well, the IAIS continues to push for global approval of its proposed Insurance Capital Standard (ICS), which is not yet fit for purpose and is inconsistent with the U.S. insurance regulatory system. The IAIS currently intends at its November 2019 meeting in Abu Dhabi to force approval of its latest version of the ICS for a final monitoring period and subsequent implementation. U.S. regulators – the FRB and the individual state insurance regulators – have unequivocally stated that the ICS, as currently proposed, will not be adopted as part of the U.S. insurance regulatory system. Without significant revisions, however, the proposed ICS could potentially create competitive imbalances and discriminate against U.S. insurers if widely implemented in other jurisdictions.

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The ICS is currently "unfit for purpose."

The current version of the ICS is "unfit for purpose" for many reasons, including the following:

- the approach does not identify where capital weaknesses and available capital exist within a group (by entity or jurisdiction);
- there is no recognition of the restraints or costs related to moving capital within a group;
- regulators would need authority that extends beyond their home jurisdictions to apply the ICS, *i.e*., the requirement is extra-territorial; and
- the valuations used in the standards under the market-adjusted valuation (MAV) approach are unaudited.

There are inherent difficulties in trying to draft a single global insurance capital standard. Perhaps the most pervasive of these problems involves differences in the needs and demand for private-sector insurance products and services across jurisdictions. Such needs are founded in differences in core jurisdictional-specific aspects such as legal structures, and national policies involving taxation, catastrophe recovery, policyholder protection systems, private vs. public sector funding and involvement, and a myriad of other issues that make it impossible for one global capital system to appropriately capture these inter-jurisdictional differences in a consolidated approach.

Rather than attempting to develop a system that builds upon and complements current, well-established regulatory systems, the IAIS decided to develop a one-size-fits-all global group standard modeled after the nascent European banking-style Solvency II regulatory system. As a result, the ICS produces a single group ratio that does not provide sufficient information on how group-wide risks impact the legal entity insurers within the group.

The ICS is intended to be a group indicator of capital adequacy, applicable to Internationally Active Insurance Groups (IAIGs). The ICS will be part of another IAIS supervisory product, referred to as the "Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)." As the ICS has evolved from the ComFrame context in which it was created, it has become heavily skewed towards the banking/Solvency II approach. Indeed, the ICS imposes group capital requirements that are fundamentally inconsistent with the more extensive group supervision approach adopted by the United States and other jurisdictions.

Additional challenges in establishing a global capital standard arise due to jurisdictional differences in accounting and valuation standards. U.S. statutory accounting principles (SAP) and generally accepted accounting principles (GAAP) require valuation of property-casualty claim and expense liabilities at management's best estimate of their undiscounted ultimate cost, which is subject to an independent audit and can be back-tested. The current ICS proposal bases insurance liabilities on market-adjusted valuation (MAV), discounting insurance liabilities to present value and then adding a risk margin for the uncertainty in the expected liability – measures which preclude back-testing and therefore diminish reliability.

Under the MAV-based ICS proposal, short-term movements in market value create artificial and excessive volatility in capital requirements, even though the amount and timing of policyholder benefit and claim payments are unaffected by such market movements. The ICS proposal incorrectly assumes that the insurance group's capital, which may be domiciled in different states or countries, is fungible within the group, even in times of stress and across jurisdictions, without acknowledging the costs (including impact on policyholder protection) associated with moving that capital. In addition, the ICS does not recognize all material sources of capital typically available to U.S.-based insurance groups.

Lastly, the ICS proposal would be an inefficient approach to providing a global capital standard as it would require a global body to maintain the relevancy of risk factors for the products written throughout all the jurisdictions of the world even as new products arise and risks evolve in various regions/countries. In contrast, an aggregation approach leverages the work of local regulators to keep their capital standards relevant. The incentive and closeness to local risks makes local regulators more qualified for the task of keeping capital standards appropriate to their respective jurisdictions than a centralized global body.

Thus, APCIA is concerned that the combined impact of the above-mentioned adverse capital consequences of the MAV-based ICS proposal could negatively impact the availability and affordability of long-term insurance and retirement security products, as well as certain other property-casualty products, while also imposing significant implementation and ongoing maintenance costs on regulators and the U.S. industry. In brief, implementation of the ICS into the U.S. state-based regulatory system creates the potential to do more harm than good for the protection of U.S. policyholders.

Team USA and U.S. stakeholders strongly oppose the ICS.

Leadership at each of the Team USA constituent bodies have objected to the application of the ICS to the U.S. insurance marketplace. In addition, U.S. Treasury Secretary Steven Mnuchin stated at the May 2019 NAIC International Forum that if "these standards are adopted by foreign jurisdictions, they could have significant implications for U.S. insurers operating overseas, and potentially for our domestic insurance sector and regulatory regime" (https://home.treasury.gov/news/press-releases/sm688). Secretary Mnuchin criticized the "ICS's market valuation approach and the negative effects it could have on the ability of insurance companies to provide long-term savings products, which are important to insurers and policyholders in the United States." Mnuchin suggested that, instead of racing to meet a "fixed schedule that mandates completion of the ICS at a specific point in time," the IAIS should "recognize and accommodate the diverse approaches to solvency regulation taken by various jurisdictions around the world, including our U.S. state-based regulatory system", and specifically recognize the U.S. aggregation approach to group capital as "outcome equivalent" to the ICS.

In January, FRB Vice Chairman for Supervision Randal Quarles stated that, "the ICS would face implementation challenges in the United States. For instance, such a framework may fail to adequately account for U.S. accounting frameworks, both Generally Accepted Accounting Principles (GAAP) and the NAIC's Statutory Accounting Principles, introduce excessive volatility, and involve excessive reliance on supervised firms' internal models." (https://www.federalreserve.gov/newsevents/speech/quarles20190109a.htm) Vice Chairman Quarles further stated that a "capital standard that uses market-based valuation can introduce volatility and procyclicality, and one that is excessively volatile or procyclical can influence a firm to veer away from a long-term perspective and concentrate instead on the short term. This can have undesirable consequences, including diminishing product availability."

At the May 2019 NAIC International Forum, the President of the NAIC, Maine Superintendent of Insurance Eric Cioppa, stated that the ICS "car is still missing two wheels." Cioppa specified that:

- The ICS is currently not fit for purpose; with many believing that no number of technical tweaks can address the fatal design flaws within the ICS.
- Alternatives to the ICS need to be recognized, such as an aggregation method.
- As currently designed, the ICS will negatively impact the ability of insurers to offer long-term products and make long-term investments.
- The idea of the ICS providing a "level playing field" is unrealistic and unnecessary for assessing an [internationally active insurance group's] group capital position, nor is it reflective of the strength of any particular supervisory approach.
- The assessment of comparable outcomes needs to focus on qualitative elements and the overarching objective, not simply a quantitative exercise that compares one number to another. (https://www.naic.org/documents/190513_speech_2019_forum_cioppa.htm)

U.S. insurance supervisors are building a better approach that should be equally recognized.

The states and the FRB are developing aggregation-based group capital assessment systems that promise to be a better fit for the U.S. market and regulatory system than the ICS in addition to being much more susceptible to ongoing maintenance and continued relevancy. Both the states and the FRB are building upon the current U.S. legal entity solvency regulation regime and accounting systems to develop this approach. The aggregation methodology leverages the existing legal-entity regulatory approach in the U.S. to allow both a legal entity/jurisdictional view, as well as a combined view, of an insurance group's capital.

The NAIC's Group Capital Calculation initiative (GCC) and the FRB's parallel Building Block Approach (BBA) are both based upon aggregation of current insurance *company* capital resources and capital requirements, using the long-established state risk-based capital (RBC) system and, where applicable, corresponding existing requirements for non-U.S. subsidiaries of a U.S.-based insurance group. These approaches would require significantly reduced transition costs since they are based on current accounting and capital requirements. Because the GCC and BBA require aggregation of legal entity information (rather than the ICS' consolidated, top-down approach), they will be more transparent in that regulators will know both the location and availability of capital *within* legal entities of the group (which is not a feature of the ICS). The aggregation methodology uses audited data (which the ICS does not), can be applied by any home jurisdiction (and a number of other jurisdictions are interested in using an aggregation method), and provides a pragmatic incremental way forward for the U.S. to achieve the IAIS' stated goals for the ICS without compromising the current accounting and regulatory framework. The aggregation methodology also addresses the issue of capital fungibility, which is a fatal flaw in the ICS approach.

<u>Team USA should continue to advocate for recognition of the U.S. aggregation approach as outcome-equivalent to the ICS.</u>

APCIA and the vast majority of the U.S. insurance marketplace share the concerns of our U.S. state and federal Team USA insurance leaders. To avoid these adverse consequences, recognition and acceptance by the IAIS of the evolving U.S. domestic aggregation-based approach to group capital assessment is essential. As noted, an aggregation methodology leverages the existing regulatory system to provide solvency information from the perspective of the entity, the group, and jurisdiction. Before acting on the ICS proposal, APCIA strongly supports efforts by Team USA to negotiate for IAIS agreement on:

- a plausible way forward for acceptance by the IAIS of an aggregation methodology, and
- an explicit commitment to developing a framework by which all capital assessment methodologies can be evaluated for comparable outcomes.

Achieving these commitments will require highly coordinated and assertive leadership by Team USA, which must speak with a unified voice. Strong Congressional support and oversight of these efforts will be critical to the United States' success at this stage in the IAIS' deliberations. APCIA greatly appreciates the Committee's ongoing and bipartisan oversight to ensure that a strategic and coordinated effort remains a high priority for Team USA.

<u>Timing – the IAIS is seeking to lock-in the ICS at its November 2019 Meeting.</u>

At its Annual Conference in mid-November, the IAIS will vote to approve the current MAV-based ICS for a five-year monitoring period before implementation. During that monitoring period, pursuant to terms of the "Kuala Lumpur Agreement" agreed to by IAIS members in 2017 (KL Agreement), IAIS members will be expected to require the 50 or so IAIGs to annually report group capital on an ICS basis to their group-wide supervisors and members of their supervisory colleges. After the monitoring period and adoption of the final version of the ICS, member jurisdictions, including the United States, will be expected to implement the ICS in their home jurisdictions. However, the FRB and the NAIC have already stated that U.S. insurance regulators will not adopt and implement a MAV-based ICS in the U.S.

The KL Agreement also provides for continued consideration of other variations of the ICS:

- GAAP Plus: utilizes local country accounting rules, with certain defined adjustments;
- Internal Models (IM): uses company-specific capital models; and
- Aggregation: adds together the entity capital requirements and capital resources within group; the KL Agreement provides that this approach will be evaluated by the IAIS on the basis of producing comparable outcomes to the MAV-based ICS.

The global insurance industry, Team USA, and several other country regulators recognize that the ICS is severely flawed and will certainly not be fit for purpose by November 2019, even for those jurisdictions that plan to adopt a MAV-based ICS. The IAIS has accepted the possibility that changes may be necessary during the monitoring period, and that a separate IAIS vote will be held on the revised ICS before it is expected to be implemented. In the meantime, however, IAIGs that will report on an ICS basis strongly believe that those results must be kept confidential, since they would likely not be an accurate reflection of the company's solvency position and would be inherently misleading. Some banks, rating agencies and other third parties have already begun asking IAIGs for their ICS results. APCIA's concern is that competitive pressures on those groups may force disclosure of ICS information. Part of the problem rests with the labelling of the "monitoring period" – even the IAIS now admits that the only thing worthy of "monitoring" is how the ICS and its revisions perform over an extended period.

The November 2019 IAIS meeting will also be a critical watershed moment for whether Team USA can achieve IAIS agreement on a process for determining whether the U.S. aggregation method is sufficiently comparable to the ICS so as to be an outcomes-equivalent means to implement the ICS. The IAIS has not arrived at any criteria for determining comparability and does not plan to do so until some undefined point in time during the 5-year monitoring period. Team USA has indicated that most other IAIS members with whom they are engaged in ICS negotiations hold the view that comparability is simply a matter of comparing the resulting numeric ratios of ICS and aggregation; *in other words, any other method must produce a numerical ratio nearly identical to the ICS or else be considered to fail the comparability test*. This view of outcome comparability essentially assumes that the ICS itself – as a metric - is the perfect benchmark for determining comparability. Instead of demanding strict adherence to an unproven and flawed ICS approach as a measure of comparability, Team USA and the U.S. industry are asking the IAIS to (1) develop an independent way by which all methods are compared (including the MAV-based ICS) to unbiased and objective benchmarks, that (2) uses both quantitative and qualitative methods, that (3) defines "outcome" as the point in time corrective supervisory intervention is triggered by each system, and that (4) makes a comparison on that basis.

What Team USA should seek instead

- Team USA should insist that, before moving forward with adoption of the MAV-based ICS , the IAIS adopt a clear process for creating a comparability framework, based upon independent standards, by which aggregation, the MAV-based ICS, internal models, GAAP Plus, and other jurisdictional group capital assessment methods can be evaluated by the IAIS as achieving comparable outcomes in policyholder protection. The U.S. cannot – and state regulators have indicated that they will not – adopt and implement an ICS that is based upon market-adjusted valuation, as it is inconsistent with the U.S. regulatory system. Put simply, the ICS cannot be considered a global capital standard if the world's largest market – the United States – is not included. There must be clear, unbiased means for both the aggregation method and the MAV-based ICS to be assessed against impartial standards in determining whether the aggregation method may trigger supervisory action *at a similar point* as the ICS.

- Team USA should insist that the IAIS clarify: (1) that the ICS is not fit for **any** purpose during the period 2020-2024, other than to test how it behaves over a period of years, and that the ICS will be subject to significant revisions as necessary with appropriate consultation with stakeholders; (2) that the IAIS will seek consensus that a revised ICS is fit for purpose **before** requesting its adoption and ultimate implementation by member jurisdictions; and (3) that individual company ICS results should be kept strictly confidential during the monitoring period. These commitments are essential to ensure that IAIGs are not harmed during the period by a standard that does not provide an accurate picture of capital adequacy. The IAIS should also consider using a different label than "monitoring period", one that cannot be read to imply that ICS is useful to third parties for any purpose.

- U.S. insurance groups should not be required to report on an ICS basis during that period but can do so voluntarily. Since U.S. regulators have made it clear that the MAV-based ICS will not be required in the U.S. and that an aggregation method will be implemented instead, it would be costly and senseless to require U.S. IAIGs to also provide a MAV-based ICS report. That said, we understand that eight U.S.-based groups are participating in IAIS field testing on a voluntary basis, and nothing should prevent them from continuing with the monitoring period reporting should they so choose.

- Team USA needs to be committed to constructive engagement now and in the long-term and empowered and encouraged to apply the full authority of the United State to insist on a favorable resolution of these issues. Team USA should stand firmly united against moving forward with the ICS 2.0 if there is not an appropriate part to that outcome.

- **U.S. success at the IAIS in November will require a complete commitment and high-level leadership by Team USA, strong support and urging from Congress, and full cooperation from the U.S industry**

APCIA appreciates the efforts of all the members of Team USA to represent U.S. interests at the IAIS and to maintain a unified commitment to an ICS that reflects the U.S. state-based regulatory system, and we have worked hard to encourage continually increased cooperation among them. It is critical now more than ever that Team USA unite behind a strong U.S. position and advocate it vigorously at the IAIS, using all the appropriate resources, political capital, and leadership at this pivotal watershed moment -- not only at the November IAIS committee meetings and Annual General Meeting in Abu Dhabi, but during the preceding meetings of key IAIS working groups and its Executive Committee during September and October. This Committee's hearing comes at exactly the right time to promote and reinforce this unity, political will, and commitment.

Team USA should also be encouraged not to make concessions to other parties within the IAIS without receiving an appropriate quid pro quo in return. It is essential that, at the time when key decisions are made, both the U.S. and European sides have something important at stake. One-sided negotiations have not worked well during this process. In particular, adoption of internal models as part of the ICS must be accompanied by acceptance of the aggregation method as an outcomes-equivalent basis for implementation of the ICS in the U.S.

Conclusion

The IAIS is trying to move forward with proposed global group capital standards that have been criticized as unfit for purpose by the U.S. state insurance regulators, Treasury, the FRB, and much of the global insurance industry. APCIA hopes that Congress will make it a priority to ensure that Team USA remains united and committed to working closely together, domestically and internationally, with the support of the marketplace, to demand a better deal -- one that will work for the U.S. marketplace and recognize and accept the U.S. system. We thank the Committee for underscoring the importance of this effort.