Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittees on Financial Institutions and Consumer Credit
and Insurance, Housing, and Community Opportunity
Committee on Financial Services
United States House of Representatives

Regarding:

Examining the Impact of the Proposed Rules To Implement Basel III Capital Standards

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Introduction

Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and members of both Subcommittees, thank you for the opportunity to testify today. My name is Kevin McCarty, and I am the Commissioner of Insurance for the State of Florida. I am here as President of the National Association of Insurance Commissioners (NAIC), and I present this written testimony on behalf of that organization. The NAIC is the United States standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia, and five U.S. territories. Through the NAIC, we establish standards and best practices, conduct peer review, and coordinate our regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

As financial institutions have evolved over time, many have become larger, more diverse, and increasingly international. More often than not, these institutions are subject to a myriad of regulatory requirements designed to protect consumers of different financial products. The challenge for policymakers and regulators alike is to ensure that these regulatory requirements, designed to address different products and the different types of institutions that offer them, provide consumers with the appropriate level of protection given the unique risks each firm faces while not conflicting or otherwise being unduly burdensome to the companies subject to them.

The NAIC recognizes that certain insurance groups have made business decisions to engage in non-insurance activities, particularly banking activities, which could subject such companies to consolidated holding company supervision by the Federal Reserve. Unfortunately, in applying such consolidated supervision, the natural tendency is to eschew nuance for a seemingly simpler "one size fits all" approach. It is our long-held belief and experience that the "one size fits all" approach to regulation does a disservice to consumers and companies alike by putting in place requirements that are not appropriately sized to the risks facing the institution and its customers. In this regard, the prospect of bank-centric regulatory rules being imposed on or impacting insurance legal entities that have very different business models is quite problematic, and it is critical that the regulatory walls around legal entity insurers that have successfully protected policyholders for decades not be displaced or disrupted.

Today, I will provide the Committee with the differences between insurance and banking products, an overview of the current financial solvency framework and risk-based capital regime for U.S. insurers, discuss the NAIC's suggestions for the proposed rules relating to Basel III Capital Standards issued by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, and finally address the related concept of global capital standards.

Differences Between Insurance and Banking Products

Insurance products are fundamentally different from banking products. Banking products involve money deposited by customers and are subject to withdrawal on demand, which the bank is liable for at any time. Insurance policies involve up-front payment in exchange for a legal promise to pay benefits upon a specified loss-triggering event in the future. The very nature of insurance significantly reduces the potential of a run-on-the-bank scenario for property/casualty, health and most life insurance products. For those limited products sold by insurers that could be subject to some level of run risk, mitigating factors exist such as policy loan limitations, surrender/withdrawal penalties, and additional taxes. Additionally, insurers typically maintain a diverse product mix so only a portion of the company's products would be subject to the already reduced level of run risk.

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

Insurance Regulation's Financial Solvency Framework

Importantly, the national state-based system of insurance regulation was specifically designed to address the unique nature of insurance products. The system's fundamental tenet is to protect policyholders by ensuring the solvency of the insurer and its ability to pay insurance claims. Strict standards and keen financial oversight are the hallmarks of our solvency framework. Such regulatory oversight begins with the premise that insurance companies are different from other financial institutions and the products they sell are different. It is for this reason that insurance regulators purposely avoid "one size fits all" approaches and, instead, opt for company and product specific analysis and examination. In this regard, while insurer capital requirements are important, such requirements are not a substitute for the other tools in the regulatory tool chest and, if imposed incorrectly, can be unnecessarily onerous to the company and ultimately harmful to the policyholder.

State laws and regulations provide the structure of the financial solvency framework, requiring insurers to be licensed before selling their products or services. All U.S. insurers are subject to regulation in their state of domicile and in all other states where they are licensed to sell insurance. Such licenses are unique to the types of products that an insurer wishes to sell. Regulators assess the license application, which includes a review of the ownership structure,

quality and history of management, internal controls, and projected financial condition. Insurers who fail to comply with regulatory requirements are subject to license suspension or revocation, and states may exact fines for regulatory violations.

Detailed and transparent insurer reporting and disclosure requirements are equally critical components of our solvency framework. Insurers are required to prepare comprehensive financial statements using the NAIC's Statutory Accounting Principles (SAP). SAP utilizes the framework established by Generally Accepted Accounting Principles (GAAP), but unlike GAAP which is primarily designed to provide key information to investors of public companies and looks at ongoing-concerns, SAP is specifically designed to assist regulators in monitoring the solvency of an insurer by using more of a winding up approach.[1] Thus, the assets, liabilities and surplus reported in statutory financial statements are typically much more conservative. The NAIC's Accounting Practices and Procedures Manual includes the entire codification of SAP and serves as the consistent baseline accounting requirement for all states. Unlike GAAP which provides for consolidated financial statements for an entire holding company, the financial statements filed with the NAIC are prepared using SAP at the legal entity insurer level.

Quarterly and annually, each insurer must file financial statements with the NAIC, including a balance sheet, an income statement, and numerous schedules and exhibits showing financial conditions. The NAIC serves as the central repository for this data, including running automated prioritization indicators and sophisticated analysis techniques enabling regulators around the country to have access to national-level data without the redundancy of reproducing this resource in every state. This centralized data and analysis capability was cited by the International Monetary Fund as "world-leading" in its most recent assessment of U.S. insurance regulation.[2]

Insurance regulators utilize the financial statements and other information as part of their continuous, intensive financial analysis to identify issues that could impact solvency. At least every quarter, regulators assess a company's reserve adequacy, leverage, liquidity, surplus, asset quality, investment concentration, or other trends reflected in the filings. Every 3-5 years, regulators engage in full scope on-site examinations. Such exams are risk-focused and are used as a means of validating that the insurer's systems are performing as claimed in their financial statements and regulatory filings. On an ongoing basis, insurance regulators assess business plans, material transactions, and any reputational or contagion risk posed by such transactions to determine whether to approve, deny, or require additional solvency protections. They analyze impacts of major economic and insurance events through the use of special data requests and stress testing.

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[1] A detailed presentation on differences between SAP and GAAP was appended to the NAIC's October 22 Comment letter on proposed Federal Regulatory Capital Standards, available at: http://www.naic.org/documents/cipr_testimonies_121022_basel3.pdf.

[2] 2010 International Monetary Fund Country report No. 10/126, "United States: Publication of Financial Sector Assessment Program Documentation – Detailed Assessment of Observance of IAIS Insurance Core Principles."

As part of our solvency system's "Windows and Walls" approach to group supervision, insurers are required to report on any reputational or other contagion risks posed by non-insurance affiliates, the "windows" into the rest of the group. In the event of the insolvency of an affiliate of an insurer, regulators have the authority to "ring-fence" the insurance company, thereby preventing the affiliate from endangering the solvency of the insurer and protecting policyholders. These are the "walls" in the "Windows and Walls" approach.

Insurers are required to have a certain amount of capital and surplus to establish and continue operations. The NAIC risk-based capital (RBC) system[3], which is embedded in statute in all 50 states, was created to provide a capital adequacy standard that is related to risk, raises a safety net for insurers, is uniform among the states, and provides regulatory authority for timely action. It requires an insurer to hold a minimum amount of capital based on analysis of risks on the insurer's balance sheet before regulatory action is triggered, but it is <u>a regulatory tool not intended to be used as a target capital amount.</u>

The RBC system has two main components: 1) the RBC formula, that establishes a hypothetical minimum capital level that is compared to a company's actual capital level, and 2) statutory authority granting successive levels of regulatory intervention power, based upon risks assessed in the formula compared to the insurer's capital amount. A separate RBC formula exists for each of the primary insurance types: Life, Property/Casualty, and Health. The formula focuses on the material risks that are common for the particular insurance type. For example, interest rate risk is included in the Life RBC formula because the risk of losses due to changes in interest rate levels is a material risk for many life insurance products. Investment and other asset risks, on the other hand, are experienced by all insurers and so are included in all three formulas. Investment risk includes: default of principal and/or interest for bonds and mortgage loans, default and passed dividends for preferred stock, decrease in fair value for common stock and real estate. Other asset risks included in the formulas cover credit risk and concentration risk.

There are five outcomes to the RBC calculations, which are determined by comparing a company's Total Adjusted Capital to its Authorized Control Level RBC. The level of required RBC is calculated and reported annually. Depending on the level of reported RBC, a number of remedial actions, if necessary, are available as follows: (1) No action; (2) Company action level; (3) Regulatory action level; (4) Authorized control level; (5) Mandatory control level.

<u>The Proposed Federal Capital Rules</u>

The NAIC provided its official comments to the rules proposed by the Federal Reserve, the OCC, and the FDIC on October 22, 2012. While our focus in the written comment was to provide technical clarifications on the specific insurance related questions set forth in the

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[3] A more detailed overview of the RBC system is available at: http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf.

proposed rules, we want to emphasize our interest in promoting an open dialogue that will help these agencies better understand the insurance business model and regulatory regime in order to develop an approach that best captures the risk involved in supervising the consolidated entities, while respecting the existing regulation of the insurance entity.

We believe it is imperative that in their efforts to appropriately regulate thrift and bank holding companies, Federal regulators have the information necessary to craft rules appropriate to the risk profiles of the enterprises being regulated. We remain concerned with the bank-centric approach the proposed rules appear to take, and continue to emphasize that the regulatory walls around legal entity insurers should not be displaced or disrupted.

To that end, we provided input on the proposed definitions of separate accounts and policy loans, which may be in conflict with state law and may need to be re-evaluated for risk-weighting purposes, respectively. We also discussed the use of RBC for managing underwriting risk, the requirements for surplus note reporting, and laid out the differences between SAP and GAAP accounting, all of which I described to you earlier. Of particular concern is the proposal's treatment of RBC as a minimum capital requirement for insurers, rather than as a regulatory trigger for intervention. Given that insurers typically hold significantly more capital than the RBC trigger levels, the proposed rule suggests either a misunderstanding of insurer capital or an implication that capital above the minimum RBC levels is "excess" and therefore available to support capital deficiencies created by actions of the holding company or other affiliates. We would strongly object to policyholder dollars being used without insurance regulator approval to subsidize losses of the holding company.

We fully recognize the need for capital transfers within groups. However, state insurance regulators have statutory authority, laid out above, to restrict extraordinary dividend amounts used to accomplish such transfers to other group entities to maintain an adequate level of capital and surplus in the legal entity insurer to protect policyholders – considering current and prospective risks. This adequate level of capital is an amount much higher than the minimum RBC amount.

We further indicated to the Board that insurers typically have different liquidity needs and rely more on unassigned funds than other financial institutions and, therefore, have less of a need to issue various types of capital instruments. Finally, we provided the agencies with data regarding the total amount of outstanding surplus notes and the significance of that amount relative to industry capital and surplus.

While the focus of the proposed rules and this hearing is the implementation of the Basel III capital requirements, even more important than a capital requirement, minimum or otherwise, is ensuring appropriate regulatory requirements for risky activities and active solvency oversight. Capital requirements alone cannot enhance the safety and soundness of complex financial institutions – they are just one tool in a bigger toolbox. For instance, the Basel III capital

requirement would not have prevented the AIG meltdown. Regulatory requirements need to be applied to unregulated financial risks, e.g., requiring reserves for risks written or limiting the ability to write derivatives for a certain threshold of covered positions. Frequent solvency monitoring, off-site and on, must be performed; and risks of unregulated entities within the group must be a part of this monitoring. As the Federal Reserve develops its consolidated supervision regime for bank and thrift holding companies that are engaged in insurance activities, we welcome the opportunity to discuss our regulation of insurance entities as well as approaches to supervision that takes into account the unique nature of insurance companies and products.

Global Capital Standard

In addition to the regulatory changes occurring domestically, it is important to recognize that changes are, at the same time, occurring internationally as well. Insurance markets have evolved over the years to become increasingly global, interconnected, and convergent – a trend that will undoubtedly continue in years to come. Indeed, we recently welcomed nearly 600 of our regulator colleagues from across the globe to Washington, DC for the IAIS annual conference. At that forum and others, state regulators continue to show that we are heavily invested in the future of insurance globally, and the NAIC is committed to coordinating with our international regulator colleagues to ensure open, competitive, stable markets around the world. In this regard, the most important thing we can do is to promote a level playing field across the globe through strong regulatory systems while recognizing that there will continue to be cultural, legal, and operational differences in regulatory regimes around the world. Our national state-based system in the U.S. has a strong track record of evolving to meet the challenges posed by dynamic markets, and we continue to believe that well-regulated markets both here and abroad make for well-protected policyholders.

With that said, I want to address the concept of a global capital standard for insurance, which has previously been raised at the IAIS and in the context of the Common Framework project, or "ComFrame." Much in the same way a bank-centric, one-size fits all approach to capital standards is not appropriate domestically, it is also not appropriate at the global level for numerous reasons.

Firstly, state regulators are concerned that an overconcentration on capital calculations can breed a dangerous overconfidence in the ability to measure requirements perfectly. Capital requirements are but one of many tools in the U.S. system, and go hand in hand with solvency, monitoring, enforcement, and the world-leading data collection described earlier.

Furthermore, a single global group capital standard also runs the risk of itself creating systemic risk: if it is wrong or creates the wrong incentives, there is no fallback, whereas diversity of regulation and requirements minimize the scope of such an eventuality. Total uniformity is neither necessary nor prudent, especially given that most insurance products are still local, and

that there is far less ability on the part of international insurers to participate in local markets without meeting local regulatory requirements.

Thirdly, the entire point of solvency capital is the protection of policyholders when things go wrong and local capital requirements at the insurer level are needed – it is for this reason that the NAIC believes arguments about regulatory arbitrage or a level playing field miss the point. A capital standard is not for when things are going well – it's a backstop for when everything goes wrong. Unless the so called global capital standard for insurers is to be looked at on a legal entity basis, fungibility of capital in a crisis is likely to be a serious impediment to achieving any sensible global capital standard requirements. Any assessment of group capital cannot be a unilateral exercise; it requires the understanding of local jurisdictional capital requirements, the assessment of intra-group transactions, the accounting framework, the nature and fungibility of capital, and the use of stress testing. Indeed, the existence of global capital standards in the banking sector did not prevent the last crisis, and overlaying such an approach on the insurance sector could exacerbate the next crisis.

Conclusion

In light of the 2008 financial crisis and subsequent developments, the insurer business model continues to evolve. We at the NAIC, along with our fellow financial regulators at the federal and global levels, must also evolve and improve the way we supervise our markets. We must continue our ongoing efforts to develop better structures and tools to help us anticipate risk.

We will continue to work with and advise our federal and international colleagues as they gain a better understanding of existing financial standards required of insurers here in the United States and seek to assist them in developing a regulatory approach that appropriately captures the complete risk profile of an insurance enterprise, while keeping in place the walls of legal entity insurance regulation that protect policyholders. We look forward to sharing our expertise and experiences regulating insurers here in the United States, which we hope will assist our colleagues as they continue to implement capital and other regulatory changes here at home and abroad.

Thank you again for the opportunity to be here on behalf of the NAIC, and I look forward to your questions today.