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Testimony of

Julie Mix McPeak

Commissioner

Tennessee Department of Commerce and Insurance

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Subcommittee on Housing and Insurance

Committee on Financial Services

United States House of Representatives

Regarding:

The Impact of U.S.-EU Dialogues on U.S. Insurance Markets

Introductory Remarks

Chairman Luetkemeyer, Ranking Member Cleaver, and members of the Subcommittee, thank you for the invitation to testify today. My name is Julie Mix McPeak, and I am the Commissioner of the Tennessee Department of Commerce and Insurance, the Vice President of the National Association of Insurance Commissioners (NAIC), the Chair of the NAIC's International Relations Committee, and Vice-Chair of the International Association of Insurance Supervisors' (IAIS) Executive Committee. On behalf of my Department, my fellow state insurance regulators, and the NAIC, I appreciate the opportunity to testify today.

For 145 years, state insurance regulation has had a demonstrated track record of protecting U.S. policyholders, promoting financial stability in the insurance sector, and ensuring a competitive U.S. insurance marketplace. Whenever there have been issues of concern, we have addressed them. Whenever there have been periods of economic and financial distress, we have surmounted them. Today we can say the U.S. insurance sector is stronger than ever and our regulatory oversight is more effective than at any time in our history because state regulators never stop enhancing a system that works for the U.S. marketplace. Notwithstanding this track record and recent years of intense dialogue and substantive work, including collaboration in international supervisory colleges, the European Union (EU) has yet to fully recognize our system as equivalent under its new Solvency II insurance regime. In doing so, the EU appears to be seeking a competitive advantage for its domestic insurance industry at the expense of our own. Compounding the problem, rather than encouraging the EU to recognize our system on its merits, or encouraging the EU to overturn its discriminatory equivalence mandate, the Treasury and the Office of the United States Trade Representative (USTR) are now pursuing a formal Covered Agreement under the pretense that U.S. concessions are necessary to achieve EU recognition. Not only are we skeptical of the need for a Covered Agreement, we are also wary of its potential substance and strongly object to the lack of transparency in the process. We are simply not convinced that the perceived benefits of a potentially preemptive Covered Agreement to the U.S. insurance sector are worth the cost of U.S. insurance consumer protection.

Insurance Marketplace in the U.S. and EU

By way of background, the United States represents nearly 39% of all global insurance premium—more than $2 trillion. Taken individually, U.S. states make up 26 of the world's 50 largest insurance markets, including my home state of Tennessee. By comparison, the European Union represents 26% of global premium, approximately $1.36 trillion, and European countries, taken individually, make up 12 of the world's top 50 insurance markets. In 2015, EU-based reinsurers[1] wrote approximately $24.2 billion in reinsurance premium in the U.S., while U.S.-

[1] As Switzerland is not part of the EU, it is worth noting that Swiss-based reinsurers separately wrote approximately $12.6 billion in reinsurance premium in the U.S. in 2015.

based reinsurers wrote approximately $7.2 billion in the EU—a three-fold advantage. As you can see, the U.S. market is open and attractive to European insurers and reinsurers, so the EU has strong economic incentives to protect its companies' ability to do business in the United States while having other countries conform to their Solvency II system. These market conditions have weighed heavily on the EU's interest in promoting Solvency II as a worldwide standard, as well as promoting the perceived notion that a federal Covered Agreement is required in order to afford the U.S. equivalence under Solvency II's equivalence mandate. Our view is that a Covered Agreement is not necessary to resolve the uncertainty caused by EU's equivalence mandate, and international standards should be flexible and reflect consensus best practices, and not be a validation of one regional system in an attempt to impose that approach on the rest of the world.

Solvency II

A product more than ten years in the making, the EU began implementing its new Solvency II regime in January 2016. Certain key aspects, such as discount rates, will not be implemented for another 16 years and implementation thus far has been uneven across the EU despite claims that it is a uniform system. The European Union's Solvency II Directive provides for the European Commission to make "equivalence" determinations for third countries in the areas of group supervision, group solvency (i.e., group capital), and reinsurance. Each of these equivalence determinations also require that an appropriate confidentiality regime be in place. Non-EU-based companies from countries that have been deemed equivalent are subject to significantly less regulatory duplication to operate in the European Union than those jurisdictions that have not been deemed equivalent.

However, at this point, it is unclear the degree to which an equivalence determination would benefit the United States in economic terms. First, many European subsidiaries of U.S. companies are already structured in a way to meet the new Solvency II requirements in the absence of equivalence. Second, the United Kingdom, the 4th largest insurance market in the world, recently voted to exit the European Union and has announced an initiative to reexamine their insurance regulatory regime creating uncertainty as to the long-term application of Solvency II. Third, Europe has embarked on a mission to seek worldwide conformity with their system, which benefits their companies relative to companies in other countries. In fact, most of the countries that have received an equivalency determination have received it only on a temporary or provisional basis with significant conditions attached, designed to conform their regulatory systems to Europe's. Finally, while the Solvency II paradigm might be appropriate for the EU, state insurance regulators and, more recently, the Federal Reserve have determined that it is inappropriate for the U.S. market and unworkable for regulatory purposes. As Federal Reserve Board Governor Daniel Tarullo explained in May:

> "The valuation frameworks for insurance liabilities adopted in Solvency II differ starkly from U.S. GAAP and may introduce excessive volatility. [Solvency II] is also inconsistent with [the Federal Reserve's] strong preference for building a predominantly standardized risk-based capital rule that enables comparisons across firms without excessive reliance on internal models. Finally, it appears that Solvency II could be quite pro-cyclical."[2]

The case simply has not been made that the benefit to the U.S. insurance industry and consumers of conforming U.S. standards to more closely resemble European standards in order to achieve an EU Solvency II "equivalence" determination is worth the cost of preempting our U.S. regulatory regime, undermining U.S. consumer protections, and disrupting our own competitive and resilient marketplace.

U.S.-EU Dialogue

Nevertheless, for many years leading up to the launch of Solvency II earlier this year, state insurance regulators and European regulators have been meeting on a regular basis to facilitate mutual regulatory understanding and cooperation. We have long contended that although our regulatory system is structured differently than Europe's, it results in similar outcomes, and should not be a basis for imposing duplicative regulation on U.S. insurers operating abroad.

In 2012, the NAIC, Treasury's Federal Insurance Office (FIO), the European Commission, and European Insurance and Occupational Pensions Authority (EIOPA) convened a joint project (known as the U.S.-EU Insurance Project) to enhance the understanding of each other's approach to solvency oversight and to explore ways to increase transatlantic cooperation, with the implicit understanding that the project would lead to mutual recognition of our respective regulatory systems.

As part of this project, technical groups were formed to explore several core areas of insurance regulation including three areas subject to an equivalency determination and are now at issue in the Covered Agreement negotiations: 1) Confidentiality/Professional Secrecy, 2) Group Supervision, and 3) Reinsurance. With respect to confidentiality, the incorporation of freedom of information principles and public records access into our legal system, which we view as an appropriate transparency and accountability feature of our system, often has been characterized as a deficiency by EU counterparts. This view, however, has ignored the ability of state insurance regulators to collect and maintain certain confidential information that should be protected from disclosure and share that information with other regulatory and law enforcement bodies, including internationally, that can commit to keeping that information confidential. The

[2] Governor Daniel Tarullo, Board of Governors of the Federal Reserve System, "Insurance Companies and the Role of the Federal Reserve," May 20, 2016, National Association of Insurance Commissioners' International Forum, Washington, D.C., Keynote Address

technical committee charged with reviewing these issues concluded that while there may be differences in the form and application of professional secrecy and confidentiality laws in the U.S. and EU, the two systems are substantially similar in the subject matter addressed and the outcome to be achieved. We will always remain open to addressing any one-off issues that arise; however, in our experience, and as the technical committee found, both systems tend toward the same outcomes in terms of protecting confidential information and facilitating information exchange among regulatory bodies. Last year, the European Commission found that the U.S. system had substantial confidentiality protections in place as part of its provisional equivalence finding for the U.S. group solvency approach.

With respect to Group Supervision, despite significant educational efforts and the exchange of technical information on the part of the NAIC, it remains unclear what specific deficiencies the EU believes exist with our system of group supervision. The technical group received multiple detailed presentations from the NAIC regarding, among other things, U.S. insurance holding company laws and regulatory practices, how U.S.-led supervisory colleges are conducted, the U.S. Own Risk and Solvency Assessment (ORSA) requirements and use, corporate governance standards and disclosure, and group financial analysis. By all accounts, the NAIC believed Europe was generally satisfied with the state-based system regarding group supervision.

With respect to reinsurance regulation, while there is much we have in common, there are differences with respect to our approach to collateral requirements for foreign reinsurers operating in our respective jurisdictions. By way of background, collateral is used to ensure rapid payment by reinsurers to ceding insurers and ultimately to ensure policyholders' claims are paid. Under its Solvency II regime, Europe does not require collateral for reinsurance transactions between EU countries and with those countries that have received an equivalence determination. In the United States, historically, state insurance regulators had required that an unlicensed reinsurer, foreign or domestic, post collateral in a U.S. financial institution equal to 100% of the reinsurer's financial obligation as a means of ensuring payment of claims, and in the case of foreign reinsurers, rendering moot the potential challenge of enforcing judgments in a foreign court. In spite of some compelling arguments to maintain collateral, we recognized the concern of our European colleagues for a more level playing field and began the process of reducing collateral requirements. In 2011, the NAIC adopted revisions to our Credit for Reinsurance Model Law in November 2011, allowing reduction of the 100% collateral requirement for reinsurers in solid financial health (certified reinsurer) subject to a an effective regulatory regime (a qualified jurisdiction).[3] The NAIC has also established a peer review system surrounding the certification of foreign reinsurers by states, which provides a foreign reinsurer an opportunity for a passport[4] throughout the U.S.

[3] Determinations are made by the NAIC Qualified Jurisdiction (E) Working Group. Jurisdictions are evaluated based both upon the authorities they have as well as their administrative practices.

[4] "Passporting" refers to the process under which a state has the discretion to defer to the certification of a reinsurer and the rating assigned to that certified reinsurer by another state.

As of today, 35 states and U.S. territories have adopted amendments to our credit for reinsurance laws that would implement this reduction. Those 35 jurisdictions represent more than 68% of direct insurance premium written in the U.S. across all lines of business. We are currently aware of nine additional jurisdictions that are actively considering the model or similar proposals, which would raise this market share to approximately 93%. This new approach on collateral will also become a NAIC accreditation requirement on January 1, 2019, which will help drive further state adoption and achieve a high degree of uniformity and consistency. As of September 1, 2016, the NAIC has approved seven jurisdictions as qualified jurisdictions, including the only four EU countries that applied, and 28 certified reinsurers, including seven European-based reinsurers that have been approved through the NAIC's process.[5] We believe this is an excellent example of states responding quickly to global market developments while preserving our focus on U.S. policyholder protection. To the extent the main political driver of a covered agreement is the reduction of collateral requirements across the country, we are confident we will achieve that result in relatively short order without the threat of federal preemption. We would urge our federal colleagues, and Congress, to bear in mind that the states are charged with the protection of U.S. policyholders, and thus it is both our responsibility and our obligation to determine the appropriate reinsurance collateral rules and levels to ensure insurance consumers are protected.

The U.S.-EU Dialogue project's factual report documented how the U.S. and EU have many more commonalities than differences including in the areas subject to a potential EU equivalence determination. As evidence of this, last year, the EU granted provisional equivalence to the United States regulatory system's group solvency regime and, as indicated earlier, acknowledged that the regulatory system had substantial confidentiality protections in place—without federal action or a covered agreement. However, while this allows European companies to continue operating in the U.S. without additional regulatory requirements, it did little for U.S. companies operating in Europe. Notwithstanding this recent decision and the substantive evidence produced through the Dialogue project, the EU still has not reached an equivalence determination on the United States in the areas of group supervision and reinsurance. This is not a surprise given the EU's incentives to create a more favorable competitive environment for its companies at the expense of other countries.

Covered Agreement

Yet, in lieu of pressing the European Commission to recognize our proven system and pushing back on disparate treatment of U.S. insurers and reinsurers, the Treasury and USTR instead have pursued a covered agreement presumably with hopes of resolving the equivalency question for

[5] As of January 1, 2015, Bermuda, France, Germany, Ireland, Japan, Switzerland, and the United Kingdom are qualified jurisdictions.

the United States.[6] This federal action could lead to unnecessary preemption of insurance consumer protections and otherwise undermine our regulatory system. In fact, FIO has suggested that it plans to use a Covered Agreement to insert itself in the process for qualifying jurisdictions for collateral reduction[7], a clear contravention of the Dodd-Frank Act, which specifically prohibits the office from exercising regulatory or supervisory authorities or using the covered agreement process to establish such authorities.[8] Any attempt to use a covered agreement to expand the federal government's involvement in insurance regulatory process is something the states strongly oppose, and we urge Congress to intervene should such a federal intrusion come to fruition.

Further, unlike a trade agreement, which is subject to established procedures for consultation and input, and which also requires a vote by the legislative branch, a covered agreement lacks these established processes and requires no further legislative action despite having the potential to preempt state laws and authorities—laws and authorities that have been carefully designed to supervise a multi-trillion dollar industry that touches virtually every American, and that have been repeatedly deferred to by Congress. Given these implications, a covered agreement should be subject to at least as much, if not more, transparency and input than bilateral or multilateral trade agreements. However, in the nine months since Treasury and USTR informed Congress of their intent to negotiate a covered agreement with the EU, the entirety of what is publicly known about the agenda, objectives, and specific impact on U.S. prudential regulation is encapsulated in that initial two page letter to Congress. Moreover, even though state insurance regulators had been repeatedly promised "direct and meaningful" participation in the negotiations, the small group of us included in the process are merely observers, subject to strict confidentiality with no ability to consult our fellow regulators, and the broader community of stakeholders has no insight whatsoever into the process. This must change, and we are aware of no federal rule or law that applies to the covered agreement process that would preclude this type of transparency and accountability. We urge Treasury and USTR to establish greater transparency and seek broader public feedback from state insurance regulators, state legislators, insurers, consumer representatives, and other stakeholders. Additionally, we urge Treasury and USTR to take preemption of state insurance consumer protections and any expansion of the federal government's role in insurance regulation off the table. State legislatures and Congress should decide the specifics of U.S. insurance regulatory power and who shall exercise it—not the EU and federal negotiators.

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[6] The authority to pursue a covered agreement was included in the Dodd-Frank Act as a unique stand-by authority to address, if necessary, those areas where U.S. laws might treat non-U.S. insurers differently than U.S. insurers, such as reinsurance collateral requirements. USTR and Treasury must consult with Congress and submit any proposed agreement to the House Ways and Means, House Financial Services, Senate Banking, and Senate Finance Committees for a 90 day review period before it can become effective.

[7] Treasury Department: Federal Insurance Office, "How to Modernize and Improve the System of Insurance Regulation in the United States," December 2013, Washington, D.C.

[8] 31 USC 313(k) ("Nothing in this section or section 314 shall be construed to establish or provide the Office or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance.")

Recently, in what appears to be an attempt to gain leverage in the negotiations, certain EU member countries such as Germany and the U.K. have begun taking discriminatory actions against U.S. companies as they implement Solvency II. At our NAIC National Meeting last month, we provided a forum for stakeholders to report on their treatment in Europe so we could further evaluate the nature and extent of these new regulatory requirements being imposed on U.S. insurers. Though it is still not clear how material the impact is to the U.S. insurance sector, this is troubling and state insurance regulators are not sitting idly by. As part of the NAIC's qualified jurisdiction process an assessment is required as to the extent of reciprocal recognition afforded by the non-U.S. supervisory authority to reinsurers domiciled in the U.S. In this regard, we have initiated a review of Germany and the U.K.'s recent regulatory actions relative to U.S. insurers for further consideration of whether sufficient reciprocity still exists.

Conclusion

In conclusion, the U.S. insurance regulatory system is among the best in the world and the EU has the authority to recognize the remaining elements of the U.S. system as equivalent without further action by state or federal officials. After a decade of dialogue and information exchange, the EU has all the information it needs to reach this obvious conclusion and avoid future regulatory retaliation. Instead of negotiating a potentially preemptive agreement behind closed doors to solve a problem of the EU's creation, we again urge our federal colleagues to push back on the EU and urge them to reconsider their laws before agreeing to preempt ours.

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