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Pension Benefit Plans

Examining Income Replacement During Retirement
In a Defined Contribution Plan System

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Introduction

Thank you for the invitation to testify today. My name is Julie Mix McPeak and I serve as the Commissioner of Insurance for the State of Tennessee. I also serve as Chair of the National Association of Insurance Commissioners (NAIC)'s Life Insurance and Annuities (A) Committee and present this testimony on behalf of the NAIC. 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.

I appreciate the Council's effort to examine income replacement during retirement. With increased life expectancy and the shift toward defined contribution plans, managing financial assets throughout retirement is a growing challenge. To assist in your development of recommendations to address this challenge, I have been asked to provide an overview of state insurance regulators' oversight of the life insurance and annuities industry. Life insurance companies are subject to stringent laws and regulations, and state insurance regulators have broad authorities to identify and address issues before they threaten an insurer's solvency or otherwise pose an issue for the protection of policyholder interests. My testimony will focus on three areas: (1) the fundamental features of the insurance regulation financial solvency framework; (2) insurance regulators' receivership authority to resolve troubled insurers; and (3) insurer market conduct regulation and consumer protections.

Insurance Regulation's Financial Solvency Framework

The state regulatory system in the United States has more than a 140 year history of regulation and continues to evolve as regulators respond to emerging issues, new products and changes in the financial landscape. The strength of this system was evident during the financial crisis. While hundreds of banks failed, less than 20 insurers became insolvent. 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 serve as critical

components of our solvency framework. State regulators review for approval and restrict key activities, require insurers to meet explicit financial requirements, monitor insurers' compliance and financial condition through various solvency surveillance and examination mechanisms, and take corrective action on insurers when necessary through a regulatory intervention process.

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. 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 Reporting and Disclosure Requirements

A critical component of our system is detailed and transparent insurer reporting and disclosure requirements. 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 uses a going-concern concept, SAP is specifically designed to assist regulators in monitoring the solvency of an insurer by utilizing more of a winding up approach. 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.

Electronic data file and PDF versions of each insurer's statutory financial statements are filed with the NAIC on a quarterly and annual basis and include a balance sheet, an income statement, and numerous required schedules and exhibits of additional detailed information. For example, insurers are required to report on Schedule D each long-term bond, preferred stock and common stock investment that they own and have acquired or disposed of in the current reporting period. Schedule DB requires a life insurer to report each individual derivative position held, by type;

whether that position is used for hedging purposes; and identification of the position being hedged. Schedule DL requires reporting on securities lending programs including a detailed listing of collateral received by the lender, reinvested collateral held, and the ability to match the fair market value of the reinvested cash collateral to the value of the cash to be returned.

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 has been cited by the IMF as world leading.

Risk-Based Capital Requirements

Our regulatory system also places significant emphasis on capital standards. Insurers are required to have a certain amount of capital and surplus to establish and continue operations. The NAIC risk-based capital (RBC) system, which is embedded in statute in all 50 states, was created to provide a capital adequacy standard that is related to risk, serves as 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 a regulatory tool and not intended to be used as a target capital amount.

This system is comprised of two main components: 1) an RBC formula and 2) statutory authority for successive levels of regulatory intervention which is based upon risks assessed in the formula compared to the insurer's capital amount. The formula applies factors to audited annual statement amounts for assets, premiums, claims, expenses, and reserves, and such factors increase for items with greater underlying risk. The RBC formula provides a minimum capital and surplus to support insurer risks such as: asset risk, specifically the risk of default or fluctuation in fair value of investments; insurance risk or the risk of inadequacy of premiums and reserves; and interest rate, credit, or other market risk. A separate RBC formula is used for the

life, property and casualty, and health industries that reflect the unique investment, underwriting, and other risks to the sector.

Investment Laws and Approval of Material Transactions

State insurance investment laws are another important part of the solvency regime. These laws provide limits on the amount and type of investments insurers can make to ensure that insurance companies invest their funds conservatively to limit the company's risk exposure. Aided by the disclosures described above such as Schedules D, DL, and DB, insurance regulators ensure that companies' investments are within the requirements provided by state law. In addition, regulator approval is required of certain material transactions, such as large investment or reinsurance transactions. In an insurance holding company system, insurers also need regulatory approval for change in control and the amount of dividends paid.

Standard Valuation Law, Actuarial Opinions, and Stress Testing

With regard to regulation of the life insurers, all U.S. domestic life insurance companies are subject to minimum valuation requirements for life insurance contracts. These minimum valuation requirements are defined in the Standard Valuation Law that has been adopted by all 50 state legislatures. The Standard Valuation Law, in addition to specifying the minimum reserve requirements for all life insurance and annuity contracts, also requires all life insurance companies to annually file an opinion of a qualified actuary. The qualified actuary must give an opinion as to whether the reserves and related actuarial items held in support of the policies and contracts are computed appropriately, are based on assumptions that satisfy contractual provisions, are consistent with prior reported amounts and comply with applicable laws of the state. The qualified actuary's opinion must take into account the assets held by the life insurance company with respect to the reserves and related actuarial items, including but not limited to the investment earnings on the assets and the considerations anticipated to be received and retained under the policies and contracts, make adequate provision for the life insurance company's obligations under the policies and contracts, including but not limited to the benefits under and expenses associated with the policies and contracts.

In addition to the Standard Valuation Law, all 50 states have adopted the Actuarial Opinion and Memorandum Regulation (AOMR) which defines the requirements for the actuarial opinion, rules that are applicable to the appointment of an appointed actuary, standards for asset adequacy analysis and the requirements for documenting the asset adequacy analysis. In particular, the AOMR states that if the appointed actuary determines as the result of asset adequacy analysis that a reserve should be held in addition to the aggregate reserve held by the life insurance company and calculated in accordance with methods set forth in the Standard Valuation Law, the life insurance company shall establish the additional reserve. The Standard Valuation Law and the Actuarial Opinion and Memorandum Regulation are accreditation requirements and currently all 50 states are accredited.

Importantly, life insurers are also subject to periodic stress tests. In general, this involves an annual cash flow testing exercise designed to test the company's resilience to specific interest rate scenarios. Most companies run both a set of stochastically generated interest rate scenarios (typically 1,000 scenarios) as well as a set of 7 deterministic interest rate scenarios that were prescribed by state insurance regulators, referred to as "the New York 7." The American Academy of Actuaries has developed an economic scenario generator that randomly generates both interest rate scenarios as well as market rate scenarios. Such scenarios provide a good set of stress tests to ensure that life insurance companies have either well matched asset and liability cash flows or have established additional reserves that are available to cover any interest rate or reinvestment rate risk that is embedded in their balance sheets.

Ongoing Regulatory Oversight

State regulators monitor an insurers' compliance with laws and regulation, and a company's financial condition through solvency surveillance and examination mechanisms. 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. 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 and to identify and consider prospective risks.

Peer Review

An equally important component of the national state-based system of insurance regulation is the peer review that states apply to each other. The linchpin of this peer review is the NAIC Accreditation Program, which establishes and maintains robust solvency and financial regulatory standards, some of which I have just described. As I mentioned, all 50 states and the District of Columbia are currently accredited. Accredited insurance departments are required to undergo a comprehensive evaluation by an independent review team every five years, as well as an interim review annually, to verify the departments continue to meet baseline, high quality financial solvency oversight standards. The accreditation standards require state insurance departments to have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs, as well as the necessary resources and staffing expertise to implement and enforce that authority.

Another critically important layer of peer review for regulators' solvency monitoring efforts is the Financial Analysis Working Group (FAWG). For more than two decades, state insurance regulators have shared information and ideas through FAWG, which exists to identify, discuss, and monitor potentially troubled insurers and insurance groups that are typically of national significance. FAWG leverages the expertise of select chief financial regulators from around the U.S. to provide an additional layer of solvency assessment. FAWG also identifies market trends and emerging financial issues in the insurance sector, often concentrating on a particular segment of the market, product, exposure, or other problem that has the potential of impacting the solvency of the overall industry.

Insurance Company Receivership

Next, I would like to focus on the receivership process. In the unlikely event that an insurer becomes troubled and is unable to be remedied through normal regulatory activities, state insurance receivership laws provide authority for regulators to attempt to prevent insurer insolvencies or to minimize losses and provide protection to policyholders and other claimants in the event of insolvency. Under state receivership laws, regulators dealing with a troubled company have a number of options. They can seek mergers with healthier companies, reinsurance arrangements, non-renewal of part or an insurer's entire book of business, or place the insurer in "run-off mode" where no new business is written, but claims continue to be paid.

If an insurer does become insolvent, the state receivership laws give policyholders priority over most claimants. In cases where the assets of an insurer are insufficient to pay policyholder claims, the states have guaranty funds to serve as a backstop and protect policyholders of most lines of life and property and casualty insurance. Similar to FDIC backing for bank depositors, guaranty funds cover an insured's financial obligation to policyholders, annuitants, beneficiaries, and third party claimant's up to statutory limits. Together, the broad authorities provided to state insurance regulators under the state receivership laws and the guaranty fund backstop ensure that policyholders are protected and insurance companies are resolved in an orderly manner.

Market Conduct Regulation

In addition to our solvency regime and our authorities to unwind troubled insurers, regulators also have broad authorities to police the conduct of insurers and agents. Through market regulation state regulators ensure consumers are charged fair and reasonable insurance rates, have access to beneficial and compliant insurance products, and insurers operate in ways that are legal and fair to consumers. Market conduct examinations occur on a routine basis, but also can be triggered by complaints against an insurer. These exams review producer licensing issues, complaints, types of products sold by insurers and producers, producer sales practices, compliance with filed rating plans, claims handling and other market-related aspects of an insurer's operation. When violations are found, the insurance department makes recommendations to improve the insurer's operations and to bring the company into compliance

with state law. In addition, an insurer or insurance producer may be subject to civil penalties or license suspension or revocation.

State regulators, through the NAIC, began the Market Conduct Annual Statement (MCAS) in 2002 with the goal of collecting uniform market conduct related data. The MCAS provides market regulators with information not otherwise available for their market analysis initiatives. It promotes uniform analysis by applying consistent measurements and comparisons between insurers. MCAS has been a collaboration of regulators, industry and consumers who recognize the benefits of monitoring, benchmarking, analyzing, and regulating the market conduct of insurance companies.

Suitability of Sales of Lifetime Income Products

As part of our work in ensuring that insurers and agents are acting appropriately in the marketplace for annuities, the NAIC has taken specific action to require that agents and companies selling annuities take affirmative steps to ensure the suitability of the annuity for the consumer.

For example, the NAIC's *Suitability in Annuity Transactions Model Regulation* sets forth standards and procedures for recommendations to consumers that result in a transaction involving annuity products to ensure the insurance needs and financial objectives of consumers are appropriately met at the time of the transaction. The *Annuity Disclosure Model Regulation* establishes standards for the disclosure of certain information about annuity contracts to protect consumers and foster consumer education. The *Life Insurance and Annuities Replacement Model Regulation* provides regulatory oversight of insurer and producer annuity and life insurance replacement activities. The *Model Regulation on the Use of Senior-Specific Certifications and Professional Designations in the Sale of Life Insurance and Annuities* establishes standards for the use of senior-specific certifications and professional designations by insurance producers in the sale of life insurance and annuities to all consumers regardless of age.

In addition, as part of the NAIC's Uniform Licensing Standards, every state requires any individual who wants to sell annuity products to successfully pass their approved examination as well as to meet minimum background and integrity standards prior to beginning their sales career. States also have requirements in place in order for producers to renew their licenses on an annual basis.

Conclusion

As life expectancy increases, ensuring income through retirement is an important topic for discussion and we fully appreciate the focus that this will place on the annuity industry and its supervision. I appreciate the Council's focus on this issue and the opportunity to outline state insurance regulators' oversight and consumer protections. Moving forward, the NAIC's Life Insurance and Annuities (A) Committee has recently formed a working group to consider options that would help employers become more comfortable with the soundness of the annuity providers as part of the Department of Labor safe harbor.

As state insurance regulators, it is our responsibility to protect policyholders and ensure a healthy, competitive market for insurance products. We have developed a conservative financial solvency regulation regime designed to ensure that insurer obligations will be met both today and many years in the future, and a market conduct regime designed to ensure that life insurance annuity customers are treated fairly.

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