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EXAMINING INSURANCE CAPITAL RULES AND FSOC PROCESS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE FEDERAL RESERVE'S IMPLEMENTATION OF THE COLLINS AMENDMENT TO TAILOR CAPITAL RULES FOR INSURERS ON FSOC'S DESIGNATION PROCESS FOR NONBANK SIFIS AND FOR INTERNATIONAL CAPITAL DEVELOPMENTS FOR INSURERS

APRIL 30, 2015

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EXAMINING INSURANCE CAPITAL RULES AND FSOC PROCESS

THURSDAY, APRIL 30, 2015

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Senator CRAPO. The hearing will come to order. Welcome, everyone, and, Senator Warner, welcome. Today's hearing will focus on the Federal Reserve's implementation of the Collins fix to tailor capital rules for insurers on FSOC's designation process for nonbank SIFIs and for international capital developments for insurers.

Banking and insurance present different risk profiles, and Congress recently passed legislation to allow the Federal Reserve the ability to tailor holding company capital rules for insurers.

The Federal Reserve needs to utilize this flexibility so that the proposed rule is consistent with the insurance business model and follows a formal rulemaking process to maximize opportunities for public comment.

Last year, I requested that the Government Accountability Office initiate a study to examine the process FSOC uses when designating nonbank financial institutions as systemically important financial institutions. The report concluded that FSOC's process lacks transparency and accountability, insufficiently tracks data, and does not have a consistent methodology for determinations.

I am interested in finding bipartisan solutions to ensure that FSOC is more transparent during the designation process about which activities, together or separately, pose the greatest risk from a company so that they can be addressed. That includes providing an off ramp or a way for a company to take action to mitigate or prevent the identified risk and to no longer be designated as a SIFI.

The European Union and the International Association of Insurance Supervisors are undertaking separate initiatives that have raised concern also in the United States. The EU's Solvency II regulatory modernization program includes a reciprocity designation which some believe could disadvantage U.S. insurers if the United

States is not judged a reciprocal jurisdiction. The IAIS, following a charge from the Financial Stability Board, is developing new capital standards for insurers.

These developments raise several questions about the direction and timeliness given the regulatory differences between the United States and Europe. The American model for insurance regulation focuses on policy holder protections and is mainly State-based regulated while the European model is more focused on the impact of failure on the overall market in Europe. How will these standards likely impact consumers and State-based insurance regulation in the United States? If these standards are not compatible with our system, what will be our response? These and a number of other questions are critical for us to answer, and I look forward to the information that will be provided by our witnesses today.

I also want to again take this opportunity to indicate how pleased I am to be working with Senator Warner today. We are closely coordinating, and I am confident that we can work together to find solutions that will help to address these issues.

Senator Warner.

STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Thank you, Chairman Crapo, and thank you for holding this hearing. And let me also agree with you on your focus on SIFI designation and trying to make sure, as we talked at another hearing, that I do not think when we created the notion of SIFI that there was the "Hotel California" concern that once you check in you can never check out. We do think we need to figure out how SIFIs can—if institutions choose to try to leave that designation, that there is a clear and more transparent path.

I also believe that the United States has a vital interest in the success of international organizations designed to improve financial supervision and stability. I think we all recall that the financial crisis of 2008 was global in nature and taught us that systemic risk does not respect geographic borders. The infamous AIGFP, the financial products unit structures derivatives that blew up AIG, was headquartered in London, for example. AIG's interconnected relationships as a counterparty with nearly every major in the United States threatened additional instability only a day after Lehman Brothers failed.

The stark examples emanating from London is one of the reasons why I have supported increased cooperation amongst global regulators to coordinate regulations in response to risks posed to the economy and financial system by financial institutions. It is the principal reason why I held a hearing in this Committee in May 2013 assessing progress on cross-border resolution.

Understandably, much of the focus on cross-border activity is focused on how to treat derivatives and design adequate bank capital standards. I understand, however, that insurance, as the Chairman noted, is also receiving significant attention at the International Association of Insurance Supervisors in Europe.

As our regulators pursue discussions at the IAIS, it is important to remember that the United States has a unique system of insurance regulation, as was mentioned by the Chairman, namely, State-based aimed at ensuring policyholders are made whole in the

event of an insurance company's insolvency. This is why I raised a number of questions of the Federal Reserve and the Federal Insurance Office in a letter last year to determine how these organizations are taking the U.S. system into account while balancing the need for global cooperation and stability.

Additionally, as some insurance firms now face Federal scrutiny as a result of owning thrifts or SIFI designation, it is important for the Federal Reserve to distinguish between the business of banking and the business of insurance. Again, I think this is an area where in the initial Dodd-Frank we perhaps went too far, and so I was pleased where Congress passed a fix, the so-called Collins amendment, last year to provide that appropriate flexibility to the Federal Reserve in implementing capital standards for insurance firms. I am eager to see how those standards will develop.

Finally, as we look at how we can make the FSOC more transparent and as the FSOC continues to evaluate financial firms, including insurance companies, again, restating what I said earlier, the ultimate goal of SIFI designation is to reduce risk, not to simply create a whole new level of regulation.

So I look forward to hearing from our witnesses, and, again, thank you, Mr. Chairman, for calling this hearing. And I think if we can find—if there is any group that can find bipartisan agreement, it will be us. Thank you, sir.

Senator CRAPO. Thank you, Senator Warner.

We have three witnesses today: Mr. Robert Falzon, Executive Vice President and Chief Financial Officer of Prudential Financial, Incorporated; Mr. Kurt Bock, who is the Chief Executive Officer of COUNTRY Financial; and Mr. Daniel Schwarcz, a professor at the University of Minnesota Law School.

Gentlemen, we welcome you all. We appreciate your taking your time and bringing to us your expertise. We would like to ask you to take no more than 5 minutes, if you will, to summarize your testimony. Your written testimony is a part of the record, and we would like to have plenty of opportunity to engage with you in questions and answers.

With that, we will start with you, Mr. Falzon. Thank you.

STATEMENT OF ROBERT M. FALZON, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, PRUDENTIAL FINANCIAL, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS AND THE AMERICAN INSURANCE ASSOCIATION

Mr. FALZON. Thank you. Chairman Crapo, Ranking Member Warner, Members of the Subcommittee, I am Rob Falzon, the Chief Financial Officer at Prudential Financial. As a domestic nonbank SIFI and an internationally active insurer, as well as a global SIFI, we cannot thank you enough for holding this oversight hearing on these important issues facing the insurance industry. Today I am here on behalf of the American Council of Life Insurers and the American Insurance Association.

This morning, I will touch on three areas: first, the appropriate implementation of domestic capital standards for insurers under supervision of the Federal Reserve; second, developments in international supervision and capital standards; and, third, rationalization of the process of de-designating nonbank SIFIs.

The fundamental business proposition upon which insurance is built is that well-run and appropriately capitalized companies will be positioned to honor the commitments that we make to our customers for decades into the future and through all economic scenarios.

Good regulation of insurance is critical to this proposition. If you have served on this Committee for a while, it has probably become apparent to you that we have not sought to eliminate appropriate oversight. Quite the contrary. We support a robust supervision and capital regime that provides our customers with confidence that we have the financial strength to keep our promises.

However, with the supervisory power that is invested in our regulators comes the responsibility to ensure it is done appropriately, in a way that maps the specific risks we face to the regulatory constructs for holding capital and for managing those risks.

Members of this Committee and this body showed a clear understanding of this last year when bipartisan legislation sponsored by Senators Brown, Johanns, and Collins was approved by unanimous consent and signed into law by the President. That bipartisan legislation, for which we appreciate every Member's support, did not eliminate the capital requirements called for in Dodd-Frank. Instead it simply clarified the Federal Reserve's authority to develop regulatory standards that reflect insurance businesses and risks rather than defaulting to mandatory, arbitrary, and inappropriate bank-centric standards that are completely disconnected to the risks of insurance.

We have spent a lot of time with our new regulators at the Federal Reserve and are impressed with the professionalism and knowledge they have brought to this new area of jurisdiction. But with any new endeavor, especially one as different from the historic charge of regulating banks, the Federal Reserve needs ongoing and continued diligence in exploring, understanding, and getting it right.

We are hopeful that in writing capital rules and supervisory standards for insurers the Federal Reserve will take the time provided through the Administrative Procedures Act to publish an Advance Notice of Proposed Rulemaking in order to gain as much as input as possible to ensure that these rules result in a world-class regime, one that properly captures risks and appropriately assesses capital.

While the Federal Reserve is working on fulfilling its domestic capital mandate for insurers they supervise, there are also ongoing talks with the IAIS to develop a common global supervisory and capital framework for large international insurers. We believe it is important for the authorities from the United States to remain engaged in these standard-setting forums and to play an active role, effectively and successfully representing the interests of the U.S. insurance regulators, companies, consumers, and markets.

While there was initial concern that an overly ambitious timeline set by the IAIS would rush into a judgment and a misaligned standard, we are pleased with reports that this timeline has been extended, affording U.S. authorities more time and latitude to develop appropriate domestic standards before finalizing a global framework. We strongly believe that all efforts should focus on get-

ting domestic standards right before agreeing to any international standards. The lessons learned through a robust rulemaking process at home will only help to inform U.S. participants and provide them with valuable data and experience in shaping international standards.

We would like to recognize that the U.S. participants—the Federal Reserve, the National Association of Insurance Commissioners, and Treasury—have made progress in advocating for appropriate standards. However, much work remains to be done and should only be done after first getting our standards completed at home.

Last, I would like to address one other issue which the Committee explored at a hearing last month: FSOC's SIFI designations. As you are aware, Prudential was designated as a SIFI in 2013, thus subjecting us to Federal Reserve oversight for the first time in the company's 140-year history.

We continue to disagree with the determination and believe that FSOC reached the wrong conclusion. However, what is not clear to us is what we can do to change the outcome or even to reduce our systemic footprint. Every year, we have an opportunity to petition FSOC to rescind the designation. We have done this. This designation, which requires the same super majority as that needed to designate, is an important provision and underscores that Dodd-Frank did not intend the SIFI designation to be permanent. However, more meaningful evidence to support the initial designation is both appropriate and needed to help companies understand why they were initially designated and what actions could be taken to be dedesignated.

We think one area where Dodd-Frank clearly could be strengthened in would be in requiring the FSOC, when it considers designating a company, to be much clearer in identifying the risk factors that are the cause for concern, and in the annual review to clearly articulate to companies the steps they can take to reduce their systemic footprint.

Mr. Chairman, Ranking Member Warner, thank you, and I look forward to answering your questions.

Senator CRAPO. Thank you, Mr. Falzon.

Mr. Bock.

STATEMENT OF KURT BOCK, CHIEF EXECUTIVE OFFICER, COUNTRY FINANCIAL, ON BEHALF OF PCI AND NAMIC

Mr. BOCK. Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, my name is Kurt Bock, Chief Executive Officer of COUNTRY Financial, an A-plus rated mutual company providing home, auto, business, life insurance, and investment services to Main Street America. I am testifying on behalf of PCI and NAMIC who together represent three-quarters of all property casualty insurers.

COUNTRY is not a systemically important insurer, but what we are is important to almost 1 million households. I am also here on their behalf.

Our insurance market faces unprecedented challenges from increased Federal and international intrusion into the U.S. State insurance regulatory structure. Though not perfect, the State system has successfully protected consumers for over 150 years and has

fostered the development of a property casualty insurance market that is highly competitive, extremely well capitalized, and very stable.

Most importantly, our U.S. insurance system is consumer-focused rather than creditor-centric in contrast to the banking system and many international insurance systems that we are being pressured to emulate.

In the Dodd-Frank Act, Congress largely affirmed the primacy of State insurance regulation. However, Congress also abolished the Office of Thrift Supervision and transferred its authority over insurance holding companies with thrifts to the Federal Reserve, which has had numerous unintended consequences.

COUNTRY Financial is a Main Street insurer that owns a very small thrift, only $30 million in assets, focused on wealth management for our customers. We have no transactional deposits or loans. Despite this minimal banking footprint, COUNTRY is now subject to Federal Reserve regulation, including detailed discovery questionnaires and regular visits by examiners that seek to learn all aspects of our businesses.

Our industry has no complaints about the very professional Federal Reserve staff, but what we do wonder is whether Congress truly intended to create Fed supervision of Main Street insurers and whether the Fed's efforts can be more proportional to the banking risk involved.

It is essential that the Fed get it right when it comes to setting a capital standard for companies they regulate, such as adopting an aggregate legal entity capital approach, relying on State-based measures and triggers.

Our industry is also very concerned about international agencies that are trying to pressure the United States to compromise on global standards that would undermine our current U.S. regulatory system and its focus on consumer protection. When I hear our Federal representatives are overseas negotiating new global insurance standards, I really have to ask: What problem are they trying to fix? The chief mission of bodies such as the International Association of Insurance Supervisors ought to be to facilitate a stronger global insurance regulatory environment through cooperation and coordination, rather than attempting to create one-size-fits-all requirements for every country in the world. One-size-fits-all does not work in bathing suits or when devising global regulatory standards.

Furthermore, IAIS decisions are largely made behind closed doors. Stakeholder comment letters, testimony, and debates with the IAIS seem to fall on deaf ears, with key decisions appearing to have been preordained. I hope you are as deeply concerned by this lack of transparency and accountability as I am.

U.S. insurers have been told not to worry because these international standards do not have the force of law and must still be adopted domestically. However, we were also told there would be opportunities to debate the global designations of systemically important insurers, yet U.S. regulators have faithfully executed domestically every single SIFI designation that was agreed internationally, in some cases even over the strong objections of FSOC's insurance experts and the primary functional regulators.

COUNTRY Financial and our trades focus starts and ends with the consumer, and it is not at all clear that the current domestic and international regulatory activities will benefit them in any way. Ultimately, there will be a cost which the policyholder will be asked to pay.

We welcome your oversight and legislative involvement on these issues. One first step would be to pass the Policyholder Protection Act, introduced by Senators Vitter and Tester. This bill would ensure that Federal banking regulators cannot inappropriately use assets intended to protect insurance consumers to bail out other affiliated financial firms and that State regulators retain the power to resolve troubled insurers in the manner they judge most appropriate.

We applaud Senators Heller and Tester for their leadership in discussing potential legislative reforms, and on behalf of NAMIC and PCI, but most importantly on behalf of all of our consumers, we would very much appreciate your involvement and action on these issues.

I would be glad to answer any questions.

Senator CRAPO. Thank you very much, Mr. Bock.

Mr. Schwarcz.

STATEMENT OF DANIEL SCHWARCZ, PROFESSOR AND SOLLY ROBINS DISTINGUISHED RESEARCH FELLOW, UNIVERSITY OF MINNESOTA LAW SCHOOL

Mr. SCHWARCZ. Thank you very much, Chairman Crapo, Ranking Member Warner. Today I am going to talk about two issues paralleling my written testimony. The first issue I want to talk about is FSOC transparency.

As you know, one of the core goals of Dodd-Frank was to ensure that firms that pose a systemic risk to the economy, like AIG, like Lehman Brothers, like Bear Stearns, are regulated appropriately in light of that fact.

To accomplish that, Dodd-Frank created FSOC and entrusted FSOC with a flexible and adaptive approach to attempt to discern whether individual firms pose a systemic risk to the larger economy. That flexible and adaptive approach was born of experience, and that experience was that trying to formulaically define what types of institutions pose a systemic risk does not work. We thought we had done that well by saying that banks defined are systemically risky and firms like AIG that are just insurance companies are not. But the financial system is too fluid and too complicated to allow for simple, formulaic definitions of systemic risk.

In that light, Dodd-Frank created FSOC and said consider all of these factors, including your own judgment, and on the basis of an individualized judgment, decide whether firms are systemically risky.

I believe that that was appropriate, but it, of course, inevitably creates potential transparency concerns. And the reason for that is that any broad standard that allows for adaptability and flexibility is going to at the same time create some level of opacity.

My view is that FSOC has done a reasonable job of balancing the inherent transparency concerns in its structure with transparency. The most important thing that I think FSOC has done that I think

it is important to recognize is it created a quantitative screen at the front end whereby firms are not going to be designated as systemically significant, at least presumptively, if they do not meet certain quantitative thresholds. That provides substantial certainty to most nonbank financial firms that they are not systemically risky.

It also has adopted additional reforms more recently to enhance transparency. Now, that is not to say that FSOC could not improve further, and I do support the idea that FSOC should be clearer in its designations about what types of activities and features of SIFIs render them a SIFI and what firms might be able to do to get out of SIFI designation.

But what I want to caution against is the notion that clear formulas or clear quantitative thresholds can be enunciated such that firms can either avoid SIFI designation in the first place or achieve an off ramp.

Systemic risk is not currently susceptible to easy, simple definitions, and that is why we have an expert body of financial regulators that we entrust to do a searching job. So while I support the idea of a process for firms to appeal the idea of SIFI designation and to ask whether specific reforms would allow them an off ramp, what I think we need to be careful to avoid is mandating some sort of clear off ramp that would be formulaic and that would not respect the need to engage in individualized risk assessment.

The second issue I want to talk about with my brief time remaining involves capital standards. As you know, the Federal Reserve is entrusted with developing capital standards for firms that are designated as SIFIs as well as for insurance companies that own an FDIC-insured institution. That capital regime should indeed be designed in light of both the strengths and the weaknesses of the State risk-based capital framework. That framework works well to protect policyholders, I believe. But at the same time, it is not specifically designed to address systemic risk concerns. That is not the province traditionally of State insurance regulators.

And so my view is that the Fed needs to design a capital regime that is appropriate to address systemic risk concerns. What would that mean? I believe that means that the Fed needs to start with a consolidated balance sheet. It needs to look through individual legal entities that are the structure of the risk-based capital framework and specifically avoid some of the potential shell games that can be played with individual legal entities that can be used to limit a risk.

Moreover, I believe that the Fed framework needs to consider the possibility of valuing assets at market value, because when you are dealing with a systemic firm, part of your concern has to be about how would that systemic firm deal with a scenario in which it did have to liquidate its portfolio immediately.

So for those reasons, I believe that it is appropriate for the Fed to engage with the IAIS and to take elements of the IAIS framework with it in terms of developing a broader standard.

Thank you very much.

Senator CRAPO. Thank you very much, Mr. Schwarcz.

Before I go to the questions, I have received statements from the American Academy of Actuaries and the National Association of

Professional Insurance Agents, which I would like to enter into the record, without objection. Seeing none, they will be entered into the record.

Senator CRAPO. Let me start with a question. I just would like to ask a general question to the entire panel, and it is basically on the off-ramp question, which you each have discussed to some extent in your statements. And, by the way, I think that the information you presented both in your written testimony as well as what you have presented here today has been very helpful.

The FSOC Member with Expertise, Mr. Woodall, has stated that FSOC should be more transparent during the designation process about which activities, together or separately, pose the greatest risk from a company so that they can be addressed, and each of you have discussed this in general. My question basically relates to whether there is an agreement from the panel or whether you have some further observations on the issue as to whether FSOC should specify the systemically risky activity that caused the company to be designated and how this could provide guidance or a road map to take action to mitigate or prevent the identified risk.

Why don't we start with you, Mr. Falzon, if you have any response to that.

Mr. FALZON. Thank you, Senator. So a couple of thoughts.

First, we disagree with the designation of Prudential as being systemically risky. There is an annual process that is provided to us post-designation that allows us to petition against that designation. We have done that, and we will continue to do so. The frustration or challenge that we face is that lacking the justification for the on ramp, we lack the tools to define the off ramp. I hear the points that have been made by my colleague to the far left on the potential risks of being overly quantitative in that specification of the off ramp. However, I believe that if you are able to designate a company and define those characteristics that cause it to be systemic, you ought to similarly be able to designate those characteristics that would cause it to be less systemic.

If you think about the objective of this regulation, it is not to simply classify companies as systemic and then box them in that and hold them into that designation for a long term but, rather, to encourage them to reduce those activities that are leading to systemic risk in the U.S. economy. Without the tools to identify the activities that give rise to that risk, we are unable to address appropriately our activities in a way that would be constructive and responsive to the intent of the regulation.

Senator CRAPO. Thank you.

Mr. Bock?

Mr. BOCK. Thank you, Chairman. I will just preface this by saying we are in the business of managing risk, and to know the why and the how is always important to us. And we do a good job of managing it when we know the why, which I believe is one of the issues, and in terms of the lack of transparency of the process.

Our concerns obviously come down to Main Street, and Main Street's concern is what would be next, what would be next in this process, because it appears that size is a part of the designation, not necessarily activities, and for us it really extends Fed oversight

into activities that do not pose systemic risk. So for us our questions always are: What is going to be next?

Senator CRAPO. Thank you.

Mr. Schwarcz?

Mr. SCHWARCZ. I believe that in a case where you have an institution where there is a single activity that poses a systemic risk, then absolutely FSOC should specify that. But I also believe it to be the case that FSOC's opinions, at least with respect to certain institutions, have suggested that there are a number of activities that in the aggregate pose a risk.

Now, I do believe that FSOC should be clearer about the relative importance of those activities in its overall designation. But I also think that when, for instance, you have five or six or seven different factors that are playing in, it is the interaction of those factors. And for that reason, it is harder to say, well, if you stop this activity, you are no longer systemic. That is why I support a more robust process for petitioning plans and saying, look, if we stop these two or three activities, or if we change our risk profile in this way, would this allow us an off ramp? I think that is the more appropriate approach.

Senator CRAPO. So if I understand you correctly, Mr. Schwarcz, you are suggesting that there be an ability for a designated company or a company that is in the process of being evaluated to engage with FSOC and to understand the factors that are being analyzed and engaging in an analysis or a discussion between the parties to determine whether changes in the risk factors could result in a different outcome, whether the designation has already occurred or whether the process is simply being analyzed.

Mr. SCHWARCZ. Absolutely. I completely agree with that. I just think we need to be careful to recognize that these issues are very complex, and so sometimes it is going to be a dialogue back and forth, and it is not going to be something you can clearly define *ex ante.*

Senator CRAPO. My time has expired for my questions, but I do want to just ask, very quickly, Mr. Falzon, did you have that kind of experience with Prudential as the designation process moved forward?

Mr. FALZON. No, we have not. And while I take the points mentioned that there may be a variety of activities that give rise to the designation, I believe that the FSOC has an obligation to provide a road map of whatever combination of criteria are necessary in order to de-risk the institution on a U.S. systemic basis.

Senator CRAPO. All right. Thank you.

Senator Warner?

Senator WARNER. Mr. Chairman, I want to continue in this line of questioning, because when we had Secretary Lew here recently, I think we had pretty broad agreement from both sides of the aisle that there needed to be this clearer path to de-designation. I think Professor Schwarcz's point is a good one, that because there is a variety of factors that go into this designation, it may not be a single metric that allows you to de-designate. And I guess one of the things that we have seen starting, I believe, around the turn of the year, FSOC internally and Treasury internally announced changes both in terms of trying to improve transparency. We had Secretary

Lew here saying that he agreed with the sense that, again, back to my "Hotel California" analogy, that you should be able to check out even if you do get stuck checking in.

And, Mr. Falzon, just recognizing that you have disagreed with the designation from its starting point and filed, have you seen any kind of change in approach in the last couple of months since it seems like the FSOC and Treasury have kind of been moving in this direction?

Mr. FALZON. Our period for review for reaffirmation of the designation, our opportunity to petition is coming up in late summer or early fall of this year. We have just received notice, I believe, that, in fact, this process has begun. So we have not had the opportunity to see a change in behavior since the first time that we petitioned was in advance of the hearings that you just referenced.

I would hope that there would be a change in conduct. I have not yet seen evidence of that.

Senator WARNER. What about in terms of—there also seemed to be a greater acknowledgment that there needed to be more iterative back-and-forth as you even go through the designation process, so, again, more conversation. Have you seen any of those changes to date?

Mr. FALZON. We have not been a participant in any of the conversations. Now, recognize that we have already been designated, and, therefore, our opportunity to engage in a dialogue in advance of designation has already passed. So what we are hopeful is that that dialogue would occur in the context of the annual reviews in which we have this petition opportunity. Again, we have not yet seen that, but there is time between now and when that comes up for formal review.

Senator WARNER. I guess one thing I would also like to ask comments from the whole panel is I think one of the things that we have seen progress is that there is a growing recognition from the Fed and others that the insurance business is different than the banking business, and, you know, one of the tools that I think most of the banks would concur with is that the process of the stress tests have been effective and are a good measuring tool.

How do we go about and how do you think any kind of general comments about a stress test on the insurance side of the ledger that could be as effective as it has proven to be on the banking side? Just quickly going down the whole panel.

Mr. FALZON. Yes, that is an excellent question. Let me reiterate the very point that you made. In our interactions with the Fed, particularly post the passage of the Collins amendment fix, we have actually seen a marked difference in our interactions with the Fed, and it is much more open and constructive, and we have welcomed that. So there has been a visible difference.

With regard to stress testing, stress testing applies to insurance companies just as it applies to banks. Stress testing is different for an insurance company than it is for a bank. You need to look at a combination of market stresses and insurance stresses, and you need to recognize that those stresses typically do not manifest themselves in the very short term. There are certain risks that we take that would manifest themselves in the short term, catastrophic risk by way of example. But many of the risks we take are

associated with long-term liabilities, things like life insurance. That is a mortality risk. The evidence as to whether that mortality risk was appropriately taken or not will be very far into the future. And so as you think about stress testing, you need to think about adapting it to the very specific risks that we take.

We do believe that there is a single construct that you can use for the insurance industry that would capture the variety of risks that insurers take by having bespoke inputs into that construct. And we are working across the life and P&C industry in order to develop that construct and bring it in a proposal to the Federal Reserve .

Senator WARNER. Very briefly, Mr. Bock and Dr. Schwarcz.

Mr. BOCK. Thank you, sir. For us, obviously it is important, as you have all recognized, to understand that insurance is different than banking. But also property/casualty companies are different than life. Our issues and stress are always different, and liquidity is something that is not an issue for us in terms of our stresses. But we do ensure that we follow those insurance risks through our modeling, cap modeling, *et cetera,* to make sure that obviously we protect our policyholders, which is the goal of our testing.

Mr. SCHWARCZ. Absolutely, I think stress testing is very important. I think the difference is the Fed needs to stress-test specific to systemic circumstances, and so the types of stresses that it is going to consider are stresses to the broader financial system that occur simultaneously with stresses to the firm.

The other point I would like to make is it is absolutely true that most of the time life insurers' liabilities are long term. But the very reason or one of the core reasons why firms get designated as SIFIs even though they engage predominantly in insurance is because liabilities that seem long term and usually are long term can become short term in systemic scenarios. For instance, policyholders can cash out or surrender; guaranteed investment contracts can be canceled. So stress testing for SIFIs needs to specifically look at the possibility that otherwise long-term liabilities will become short term and ask whether or not the firm can handle that given the sort of dominant assumption that in most times the liabilities are very long term and predictable.

Mr. FALZON. Senator, I need to object to the observation that was just made. I think that both the review process for Prudential as a designation as a SIFI and that that was done for Metropolitan Life, we demonstrated with a body of evidence that, in fact, the acceleration of liabilities on an insurance company's balance sheet does not give rise to systemic risk and, in fact, has been fairly modest. The evidence does not support the conjecture of that argument.

Mr. SCHWARCZ. Can I just say one thing? Much of the information is not in the public domain, so I cannot say one way or another whether that is right.

What I can say is that the FSOC decided in its public basis that indeed there was systemic risk associated with the possibility of a run on—and that was one of the bases of its designation. So I cannot personally say whether that is right. I have not gone through the books. They are not available to me. But FSOC has indicated that is one of the reasons why both Prudential and MetLife were

designated, and for that reason, stress tests need to take that into account.

Senator WARNER. Thank you, Mr. Chairman. I hope we get a second round. I have got a couple more questions I would like to ask.

Senator CRAPO. We will.

Senator Warren?

Senator WARREN. Thank you very much, Mr. Chairman.

You know, Congress is debating whether to give the President fast-track authority, that would reduce Congress' ability to shape major trade agreements. The fast-track bill would give the President that authority potentially through 2021, and that means that fast track would apply not only to TPP in Asia but also to the TTIP, the trade deal that we are currently negotiating with the European Union.

Now, one of my concerns about fast track is that a future President could use it to negotiate a TTIP agreement that weakens our financial rules or disrupts our regulatory system. The European approach to regulation is different from our own in many respects, and harmonizing our rules in a trade deal could mean real problems in regulating our financial services industry.

Take insurance regulation, for example, what we are talking about here today. The International Association of Insurance Supervisors, or IAIS, is working on finalizing new capital standards for "internationally active insurance groups." But Europe and the United States have very different approaches to regulating insurers with Europe using higher capital standards and the United States using reinsurance to protect policyholders.

So, Mr. Falzon, could you describe how the European regulatory approach compares to the American regulatory approach and how those differences affect how European and U.S. insurers operate? Briefly, if you could.

Mr. FALZON. Very briefly, first, we do support the engagement on the U.S. side in the international development of a global set of standards. We would note that the United States is the largest insurance market in the world, and, in fact, as was heard in earlier testimony to this Committee, if you took the top 50 insurance markets and you made each individual State a market, we would account for 26 of the largest 50 insurance markets in the world.

Senator WARREN. I am asking about the difference, though, in the regulatory approach.

Mr. FALZON. Yeah, so the point being, however, that we should be leading in the development of these global standards. In terms of the differences, the European model is based on a system of the business model that they have and the accounting constructs that they have. Now, that accounting construct is something called IFRS, very different than U.S. GAAP. It has a marked-to-market concept embedded within it, and it leads to a type of accounting which is not well suited to the products that we deliver in the United States, particularly those products in the insurance arena which are long term and demonstrate enormous volatility if you begin to mark them to market.

Senator WARREN. OK. Very helpful.

Professor Schwarcz, so you think it makes sense for the Fed and our State insurance regulators to tailor those capital standards to fit the existing regulatory structure in the United States?

Mr. SCHWARCZ. Absolutely, I do, and I think that the way that that needs to be done is for the Fed to consider specifically the ways in which the State risk-based capital regime is focused on policyholder protection, and to then say, OK, well, what do we need to do to supplement that regime to bring a macroprudential perspective, a systemic risk perspective?

So I think that that question of how to supplement is one that requires being very cognizant of the unique regulatory regime we have and building on that regime to address different concerns than those that are at the core of what State insurance regulators do.

Senator WARREN. Good. Thank you. That is very helpful. I believe in strong capital standards for financial institutions, but I am glad that in the case of IAIS capital standards, there is going to be an opportunity for our regulators to tailor those standards to fit the American approach to regulation.

What alarms me is that if regulatory changes are included in a future trade deal with the EU, that opportunity for tailoring disappears. We have stronger financial rules than the EU in many areas. If Congress passes fast track now and a future President in 2018 or 2020 agrees to weaken financial rules as part of the trade deal with Europe, it will take only 51 votes in the Senate to make those changes the law.

That should worry anyone who supported Dodd-Frank and who believes that we need strong rules to prevent the next financial crisis. So thank you all for being here.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you, Senator Warner and Senator Warren. We have got both of you sitting here.

I want to pursue the same line of thinking just from a little different angle, and that is with regard to international capital standards. Two of the three insurance companies that FSOC has designated as systemically important were first designated by the international Financial Stability Board, and because three voting members of FSOC first engaged at the international FSB level to determine if a U.S. company is systemically important, there is a concern that the FSOC designation for those companies was predetermined essentially and that something very similar is going to occur now as we deal with capital standards.

This is something that, Mr. Bock, you raised in your testimony, and so I want to go to you first. But before I do so, I guess the question is: Is this a valid concern? And do these developments raise questions about the direction and timeliness given the regulatory differences between the United States and European models? Mr. Bock, we will start with you, and then let us go to Mr. Schwarcz and Mr. Falzon.

Mr. BOCK. Thanks, Mr. Chairman. Obviously, as Senator Warren indicated and as you have heard many times, there is a tremendous difference between our systems. The timetables and regulations really should not be driven by international pressures. We certainly have to recognize the State system in the United States

has been a valuable system, has protected U.S. consumers for 150 years. So our concern is that, yes, it is being driven fast, and we have not gotten our Federal standard in front of us yet to even understand that. So for us, the concern that you have is the same concerns that we have.

Senator CRAPO. Thank you.

Mr. Schwarcz?

Mr. SCHWARCZ. So I guess I would distinguish between designating a firm as systemically significant and then capital rules. Whether or not a firm is systemically significant I think should be a question that the Europeans have just as much insight in as we do. I mean, the question is really one of, to the extent a firm failed in a sort of weak financial setting, would that have broader consequences in the financial system. So I think it is appropriate in that context to learn from what the Europeans think and what other people in the international community think. That should not preordain our conclusion, but absolutely I think it should inform it.

My understanding is that that is exactly what happened, that it informed our decision, but it did not in any way preordain it.

To distinguish the capital question, when you are talking about, OK, exactly how should you implement capital rules, that is a question that, I think as we have discussed earlier in this hearing and as Senator Warren's question raised, one needs to implement capital standards in a particular jurisdiction that are reflective of the broader regulatory system.

So I absolutely, again, think we need to learn from the IAIS. We need to learn from our international colleagues. There are some elements of the capital regime they are developing that I think should be incorporated. But I think that we cannot sort of adopt wholesale the views that they are developing, and I do not think that is what will happen. But I do think we need to learn from them and take them seriously.

Senator CRAPO. Thank you.

Mr. Falzon?

Mr. FALZON. It is difficult to compare or to speculate as to whether the designation internationally influenced the domestic designations because both processes lacked transparency. And, in fact, the global process has no transparency whatsoever. We had a single conference call that we were involved in in the process of that entire designation, and so we are not part of a hearing or an opportunity to present or appeal. So difficult to speculate.

With respect to our regulatory system, I would share the observation that we have a strong system in place that actually on the whole has done quite well in the United States and that we should be leveraging that, plugging the gaps that exist in that system, when we think about things around group supervision that were evidenced as areas of weakness through the crisis, but that basic construct enhance, in order to provide the systemic protection that we all agree is important, should then be developed and exported as opposed to relying on a convention that is developed in an international arena to be imported into our marketplace.

Senator CRAPO. Well, thank you. This is very helpful. It is a very important discussion. As Senator Warren's comments indicate, there is a concern that this interaction between the U.S. and Euro-

pean models, through trade negotiations or otherwise, may be utilized to weaken U.S. standards. I hear the same thing argued from the other side, folks worried that it may be utilized to force the United States to adopt standards or designations that we did not want to nor need to adopt. So it is a very interesting conversation and a problematic issue that we need to get resolved properly.

Senator Warner?

Senator WARNER. Thank you, Mr. Chairman. While Senator Warren and I differ on the trade approach, I concur she raises an interesting question that I have not fully thought through and think we need to get some answers on.

I have kind of two slightly off-topic questions. One is we have had this extraordinarily low interest rate environment for some time and potentially foreseeably into the future. What does that do in terms of your balance sheet risks? I mean, obviously there is a lot of good things about that low interest rate phenomenon, but for the insurance industry it poses a different series of risks. Again, if very briefly we could get some response.

Mr. FALZON. So low interest rates are a challenge for the industry in that it reduces our long-term profitability should it be sustained in our return on equity.

From a balance sheet standpoint, however, the risk of low interest rates already sits on our balance sheet. Statutory reserving requires that we do a stress test on low interest rates, and in that stress test we dramatically lower the level of rates from where they are today and presume that they stay at the depressed level over a lifetime.

The reserve that gets created by virtue of that scenario then has to be booked onto our balance sheet and backed with real hard financial assets. So from a balance sheet standpoint, the risk of sustained low interest rates has already been reflected and accounted for, and we are well suited to protect our customer obligations and to prevent any systemic consequences of that environment prevailing for a longer period of time.

Senator WARNER. Mr. Bock and Professor Schwarcz?

Mr. BOCK. Thank you, Senator. The challenge obviously, as you know, it does compress margins. One of the challenges obviously is not to reach for risk in order to generate income. We do not do that. As a mutual company, we take care of our policyholders first, and that means we do the appropriate things to manage in an unprecedented low interest rate environment.

Mr. SCHWARCZ. I generally agree with what has been stated. The one thing I do want to sort of emphasize is that there are certain elements of the State regime, particularly the reserving regime, that do, in fact, protect policyholders, but there is also some change afoot with respect to how companies book reserves, and that is going to allow greater use of internal models. And then there has also been a very broad phenomenon of what some people call "shadow insurance," where firms have been taking lower reserves by using affiliate transactions.

So one of the core things that the Fed needs to do, I believe, in its supervision and perhaps in its capital requirements is to make sure that the types of protections that we have seen historically are

not gamed or are not traded away with new regimes that are not time-tested.

Senator WARNER. Well, I want to make sure we get to Senator Scott, so I will just ask, Professor Schwarcz, if you want to just add one other comment. The NAIC witness last week raised similar concerns that there are—I share the fact that they are a very different business than the banking industry. But we have seen insurers start to move to more alternative investment products, use of hedge funds, other kind of things that fall out of the plain vanilla formula. Do you want to make a comment about that? I think that does raise concerns on my——

Mr. SCHWARCZ. Absolutely. I think one of the core lessons of the crisis is that the financial system is constantly evolving, and very sophisticated firms are engaging in transactions that look a lot more like banking. So, for instance, we are seeing some funding agreements that FSOC has pointed out that creates short-term liabilities, securities lending that can create some short-term liabilities and bank-run-like dynamics. We have guaranteed investment contracts that in some ways create guarantees that can create long-term concern and liquidity concerns.

So I think that it is important that we are cognizant of the fact that while the core insurance business is very different than the core banking business, insurers are, at least in many cases, engaging in activities that are closer on the spectrum to banking or in between. And that is why we need to have a flexible and adaptive regulatory system rather than one that embraces very formulaic, quantitative standards.

Senator WARNER. Thank you.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you.

Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman. I was just in a tax working group before I came here, so I think it is a good point that while we examine insurance regulation here and banking, we also keep in mind the unique insurance provisions in our Tax Code and how they impact companies and policyholders. Thank you, panelists, for being a part of this discussion this morning.

I think sometimes it is easy for us here in Washington to get caught up in the alphabet soup of financial regulators and discussions about complex Dodd-Frank regulations and provisions. All of these are very important, but I would like to take a step back and just recall that what we are talking about today really all boils down to how it affects the policyholder.

I learned from my time in the insurance industry of about 25 years that there are a few variables when it comes to products: the terms of the insurance and the price. And I also learned that there are all kinds of people with all kinds of insurance needs. So I think it is important that our discussion focus on the availability and the flexibility of a diverse set of insurance products.

And I worry that if we fail to shape regulation around the bedrock principle of policyholder protection that has served our State-based system so well for so long, we are going to eliminate products from the market or make them so expensive for average folks to afford.

Mr. Bock, do you have any thoughts about this? And can you help me bring this Washingtonspeak down to a kitchen table economics point of view?

Mr. BOCK. Well, let me try to do what others failed to do. Obviously, for our industry, for the property and casualty industry, it is important to protect the policyholder, to keep our promises, and you have seen our capital, our surplus to premium go up. We have more surplus now to be able to take care of our policyholders in this industry than ever before. That is important. Anything that would put that at risk is actually putting our customers at risk, our consumers at risk, because as you did say, it would cause us to have to pass on whatever price it might be—the price of additional efforts in order to raise capital, to raise ourselves to levels that would limit us from doing what we need to do to take care of our customers. So, to me, I fully agree.

The one thing that we are concerned about obviously with all the alphabet soup, as you say, is that in all this we do not think goals are aligned, and for us, in our company, when our goals are aligned, our customers are served, our consumers are taken care of. And regulatory bodies should be no different, and this is an area of our concern. We do not think our regulatory bodies are aligned.

Senator SCOTT. The lack of expertise in some of our regulatory bodies may be part of the reason why they are not aligned.

Mr. BOCK. Absolutely. And we do look to you, we do look to our elected officials to give them the guidance that they need.

Senator SCOTT. Thank you.

Mr. Falzon, obviously Prudential has been designated as a SIFI by the FSOC, which subjects them to additional regulation by the Fed. On Tuesday, I asked Mr. Woodall about Prudential's designation and whether he agreed with me that regulators with experience in an industry should have a greater say in whether to designate a company in that industry. Obviously, Mr. Woodall dissented very forcefully from the Prudential designation decision.

You touched on this during your testimony. Could you elaborate on this? And do you have any concrete ideas for reforming the designation process to give greater weight to regulators with experience in the industry?

Mr. FALZON. We have engaged in the request for commentary on the FSOC process and have made a number of suggestions. In those suggestions, the theme that would run throughout that is increased transparency, increased interaction and dialogue, and clarity around the basis of designation. And we think addressing each of those and the variety of specific initiatives they could do in order to accomplish that would be helpful to coming to the right conclusions, that the transparency and interaction would include the input from experts. And whether the experts are part of that process in the form of voting members or part of that process in the form of expert testimony, we think that that would enhance the overall designation process.

Senator SCOTT. Thank you. One of the points I wanted to convey during this hearing is that as we struggle with the right regulatory environment, the expertise in the industry that you are regulating seems to be incredibly important and oftentimes missing. And if we are going to make sure that the goal, the objective is to protect the

policyholder, perhaps we should start with the policyholder and work our way back to the regulatory environment as opposed to transposing banking regulatory environment over the insurance industry in a way that is inconsistent with the best interests long term of the policyholder.

Thank you.

Senator CRAPO. Well, thank you, Senator Scott, and I can speak for myself that at the level of this Committee and Congress, we are really glad to have someone with expertise in this industry to talk with us and work with us, and we appreciate your contribution.

Senator SCOTT. Thank you. I am glad I have Travis with me, too. Thank you.

[Laughter.]

Senator CRAPO. I have no further questions. Senator Warner, Senator Scott, do you have any further questions?

Senator SCOTT. No, sir. Back to the working group.

Senator CRAPO. All right. Well, we want to thank this panel. I have said this already, but your written testimony as well as your presentations today have been very helpful. We obviously have some very significant issues to deal with, and this Committee is going to be grappling with those issues, and what you have helped us to understand today will be very beneficial in that regard.

Without anything further, this hearing is adjourned.

[Whereupon, at 11 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF ROBERT M. FALZON

EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, PRUDENTIAL FINANCIAL
ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS AND THE AMERICAN INSURANCE ASSOCIATION

APRIL 30, 2015

Chairman Crapo and Ranking Member Warner, my name is Robert Falzon, and I am Executive Vice President and Chief Financial Officer of Prudential Financial. I am testifying today on behalf of the American Council of Life Insurers ("ACLI") and the American Insurance Association ("AIA"). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. ACLI member companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums. The American Insurance Association (AIA) is the leading U.S. property-casualty insurer trade organization, representing approximately 325 insurers that write more than $127 billion in U.S. premiums each year. AIA member companies offer all types of property—casualty insurance, including personal and commercial auto insurance, commercial property and liability coverage for small businesses, workers' compensation, homeowners' insurance, medical malpractice coverage, and product liability insurance.

ACLI and AIA appreciate the opportunity to address the ongoing development of capital rules by the Federal Reserve Board (the "Board") applicable to those insurers that have been designated as systemically important by the Financial Stability Oversight Council ("FSOC") or that own savings and loan associations, the related group insurance capital standard being developed by the International Association of Insurance Supervisors ("IAIS"), and the transparency and fairness of the FSOC designation process.

Prudential Financial is one of the three insurers that has been designated as systemically important by FSOC, and as a consequence my company was intimately involved with the legislation enacted late last year enabling the Board to craft capital standards suitable for an insurance enterprise. In addition, I am personally involved in the overall industry effort to work with the Board to come up with the actual capital rules that will be applied to those insurance groups now subject to the Board's jurisdiction.

The Collins Amendment & The Insurance Capital Standards Clarification Act

Please allow me to thank Chairman Crapo, Ranking Member Warner and the Members of this Subcommittee for your leadership in support of the Insurance Capital Standards Clarification Act of 2014. As you know, this legislation, authored by Senator Susan Collins, Senator Sherrod Brown, Senator Mike Johanns, Representative Gary Miller, and Representative Carolyn McCarthy, was unanimously approved by the Senate and House last year. This essential legislation clarified Federal Reserve Board authority to develop capital standards for insurance companies subject to Board supervision that reflect insurance businesses and risks, rather than defaulting to inappropriate bank standards. The unanimous support for this legislation in both the Senate and House constituted a definitive statement of Congressional intent that insurance capital standards must be appropriately designed and tailored. The legislation was also an important recognition that the business of insurance is substantially and fundamentally different from the business of banking, and that supervision of these different industries, particularly where capital adequacy is being assessed, should account for their different risk profiles, balance sheets, and business models.

Without question, capital standards are stronger when they are appropriately designed for the type of company to which they are applied. Appropriately designed and tailored capital standards further the goals of prudential supervision and provide the highest level of safety and protection for consumers. In the case of insurance, the application of bank standards would have disrupted the operations of well capitalized insurance companies. In fact, capital standards governing banks and bank holding companies should never be applied to insurance entities.

In the near future, we expect that the Board will begin drafting a proposed regulation establishing a consolidated group capital standard for insurers that are savings and loan holding companies, or that have been designated by the FSOC as systemically important. Earlier this year, we met with senior representatives of the Board to stress the importance of moving forward with a proposal that reflects the well established methodologies for measuring the financial strength and resiliency of an insurance group. We have continued our communications with the Board's

staff on the issue since then, and will continue to do so as this process unfolds. Since the passage of the Act, we are encouraged by the Board's approach to the issue and are hopeful that any proposed regulation will reflect the clear Congressional intent behind its passage.

International Insurance Capital Standards

The International Association of Insurance Supervisors (IAIS) is working to develop an international group Insurance Capital Standard (ICS) as part of IAIS work on a proposed Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). ComFrame is a set of international supervisory standards focusing on group-wide supervision of Internationally Active Insurance Groups (IAIGs). Under the current proposed ComFrame definition of an IAIG, there are likely to be approximately 50 IAIGs around the world. IAIGs are defined as companies that operate in three or more countries, generate more than 10 percent of their revenue from outside their home country, and meet significant size requirements.

The U.S. insurance industry is concerned about the haste with which the ICS is being developed, particularly in the context of Congress' passage into law of the Insurance Capital Standards Clarification Act in December 2014. The IAIS timeline must accommodate full implementation of that law and a formal rulemaking process for development of domestic insurance capital standards by the Board.

The IAIS recently announced that it will take a staged or incremental approach to developing the ICS over several years with the ultimate goal of global convergence around one standard in the longer term. This signals a longer, rational and thoughtful process to developing the ICS than originally identified. With that said, we will not grow complacent, we have not claimed victory—we will continue to actively engage our U.S. representatives to the IAIS as well as international supervisors to make sure that they remain true to a more deliberative approach to ICS development—one that reflects a capital/solvency framework that is appropriate for the U.S. insurance market and consumers.

The U.S. representative members of the IAIS will be informed by a deliberative rulemaking process by the Board that draws on the risk-based capital framework currently utilized by the States, and they will bring that experience to bear in the international process. The IAIS timeline should not be elevated above the importance of developing an international standard that is complementary to local capital standards and results in a level competitive playing field that promotes private market expansion around the world. The ICS would clearly benefit from the work of the Board, and the insurance industry supports appropriate adjustments to the IAIS timeline for the ICS to accomplish these objectives. Importantly, the IAIS has slowed its overly aggressive timeline for development of the ICS, which can only be implemented through a State or Federal rulemaking process.

Any ICS must be rooted in principles that are common to insurance in all jurisdictions, but must also be flexible enough to recognize and appropriately reflect existing accounting practices and the need for jurisdictional differences based on market, societal and consumer needs. Such flexibility is an essential precondition to the United States and other jurisdictions' willingness and political ability to adopt it into law and put it into practice.

In fact, Team USA, consisting of the Board, State Insurance Supervisors, and the Treasury Department's Federal Insurance Office (FIO), has been forcefully advocating that any ICS cannot be finalized that does not allow for the foundational elements of the U.S. regulatory system. We understand that the IAIS will begin field testing two different approaches to the ICS this year. One of these approaches was largely developed, advanced and endorsed by all members of Team USA and is more representative of the U.S. regulatory framework. These two approaches will be field tested by more than 25 global firms, including several U.S.-based companies, over the next several years. This is another positive step. We commend the Board, State Insurance Supervisors, and FIO for working together to achieve this outcome.

Another factor slowing the pace of ICS development is a realization by policymakers in markets around the world that life insurers not only meet a tremendous social need for protecting individuals and their families, but also are fundamentally important as one of the few industries that invest for the long term in infrastructure. Those investments are key drivers of global job creation and economic growth. We believe that it is critical for the United States to elevate this issue to the political level of the G20. The balance of regulatory intensity and investment and growth needs to be made at the macro political and economic level and not only by regulators who are not responsible for job creation and economic recovery. In a similar way, property-casualty companies provide the insurance that makes infrastructure development possible, as well as investments that support continued growth. It is critical that capital standards promote those roles to the benefit of consumers and

a healthy economy with robust private insurance markets. We are optimistic that with high level political appreciation for the role that insurers play in the global economy, policies can be developed that begin a virtuous cycle of growth and stability.

Solvency II and the U.S.–EU Regulatory Dialogue Project

The core intent of Solvency II was and is to improve the prudential regulation of the European Common Market in insurance. As we recognize that Solvency II is an internal European undertaking, we have been engaged on "third country" provisions, which are intended to extend the benefits of unilateral recognition to insurers and reinsurers that conduct business into and out of the EU but are headquartered elsewhere.

We have strongly advocated that the U.S. regulatory regime is equivalent in outcome to Solvency II and that this should be recognized by the European Commission. We are pleased that there has been a productive process established between the U.S. Federal and State Governments and the European Commission and the European Member State regulators through their statutory consultative body the European Insurance and Occupational Pension Authority (EIOPA).

This process, called the U.S.–EU Regulatory Dialogue Project, is in its fourth year of a detailed information exchange intended to build greater transatlantic understanding between regulators of the different U.S. and EU approaches to achieving the same regulatory outcomes of stability, consumer protection and fair competition. In our opinion, this regulatory confidence building has been a tremendous success in removing misunderstanding and paving the way for the United States to be deemed either transitionally or permanently equivalent by the European Union.

This positive progress however is not a foregone conclusion and the Dialogue Project process requires continued work by all sides. We believe that the maintenance of a positive relationship between the world's two largest markets is simply too important to be disrupted by perceived differences in regulatory approach. We also commend the State supervisors and FIO for the time and effort they have made to patiently explain the U.S. system and to address potential misperceptions.

The U.S.–EU Dialogue Project has had the ancillary benefit of bringing together U.S. and EU regulators within the IAIS decisionmaking process. We urge this continued expansion of coordination between U.S. and EU regulators within the IAIS to support markets where all competitors are held to the same high standards of solvency, market conduct and consumer protection.

The FSOC Designation Process

While FSOC has made improvements to its designation process, we believe additional reforms are necessary to enhance transparency and ensure a fairer overall designation and de-designation process. Our suggestions for improvement focus on the following: providing better and more transparent procedural safeguards; affording greater weight to the views of an insurer's primary financial regulator; implementing an "activities-based approach" for evaluating the systemic importance of insurers; putting in place a viable process for de-designation; and promulgating the regulations required by Section 170 of the Dodd-Frank Act.

Improve Procedural Safeguards

One of the most important improvements to the FSOC designation process would be to require that a company under consideration be provided with access to the entire FSOC record.

A company that advances to the third and final stage of review has no way of knowing what materials FSOC believes are relevant, whether and in what form the materials it submits are provided to voting members of FSOC, or what materials, in addition to those submitted by the company, FSOC staff and voting members reviewed and relied upon. In other words, a company is not provided with the evidentiary record upon which the voting members will make a proposed or final determination.

In addition, FSOC should have separate staff assigned to its enforcement and adjudicative functions. Council staff who identify and analyze a company's suitability for designation and author the notice of proposed determination and final determination should not also advise Council members in deciding whether to adopt the notice of proposed determination and final determination. Dividing Council staff between enforcement and adjudicative functions would protect the independence of both functions. Communications between Council members and enforcement staff should also be memorialized as part of the agency record and provided to companies under consideration for designation.

For an insurer, we believe an essential part of the designation process must be to afford special weight to the views of the FSOC member with insurance expertise.

FSOC must vote, by two-thirds of the voting members then serving including the affirmative vote of the Chairperson, to issue a final determination. The requirement for a supermajority vote is intended to ensure that designation is reserved for companies that pose the most obvious risk to the financial stability of the United States. Yet, the members of FSOC vote as individuals rather than as representatives of their agencies. Thus, the vote is based upon their own assessment of risks in the financial system rather than the assessment of their respective agencies. Moreover, the voting process gives equal weight to views of all members, regardless of a member's experience in regulating the type of company being considered for designation. In the case of a company primarily engaged in the business of insurance, special weight should be given to the views of the Council member with insurance experience.

Upon receipt of a final designation, a company may seek judicial review before a Federal court. Even this safeguard, however, is subject to limitations. A company has only 30 days in which to file a complaint, and loses the right to do so beyond that date. We believe that timeframe should be extended. Moreover, filing the complaint should carry an automatic stay of supervision by the Federal Reserve Board. While a company is challenging the legitimacy of a designation, it should not be forced to simultaneously establish a comprehensive infrastructure (*e.g.,* systems, procedures, and controls) to comply with Board supervision.

Finally, from a procedural standpoint, we believe FSOC should be prevented from misapplying the "material financial distress" standard for designation. With respect to insurers, it seems clear that FSOC assumed the existence of material financial distress at a company and then concluded that such distress could be transmitted to the broader financial system. Under a material financial distress standard that actually meets the statutory requirements of the Dodd-Frank Act, FSOC would need to employ the 11 statutory factors to first determine whether the company is vulnerable to material financial distress based upon its company-specific risk profile and, if it is, then determine whether the company's failure could threaten the financial stability of the United States. FSOC should not be able to designate a company on an *assumption* it is failing, but instead should designate a company only when a company's specific risk profile—including its leverage, liquidity, risk and maturity alignment, and existing regulatory scrutiny—reasonably support the expectations that the company is vulnerable to financial distress, and then that its distress could threaten the financial stability of the United States. The purpose of designations should be to regulate nonbanking firms that are engaged in risky activities that realistically "could" cause the failure of the firm, not to regulate firms that are not likely to fail.

Afford Greater Weight to the Views of an Insurer's Primary Financial Regulator

In drafting the Dodd-Frank Act, Congress recognized that many nonbank financial companies are subject to supervision and regulation by other financial regulators. Insurance companies, for example, are subject to comprehensive regulation and supervision by State insurance authorities. Thus, Congress directed FSOC to consult with other primary regulators when making a designation determination, and required FSOC to consider "the degree" to which a company is already regulated by another financial regulator. Congress also gave the Federal Reserve Board authority to exempt certain classes or categories of nonbank financial companies from supervision by the Board, and directed the Board to take actions that avoid imposing "duplicative" regulatory requirements on designated nonbank companies.

FSOC's designation of insurance companies shows little deference to these requirements. In the case of MetLife, for example, FSOC discounted State insurance regulation even after the Superintendent of the New York State Department of Financial Services (NYDFS), Benjamin Lawsky, told FSOC that: (1) MetLife does not engage in nontraditional, noninsurance activities that create any appreciable systemic risk; (2) MetLife is already closely and carefully regulated by NYDFS and other regulators; and (3) in the event that MetLife or one or more of its insurance subsidiaries were to fail, NYDFS and other regulators would be able to ensure an orderly resolution. Similarly, in his dissent in the Prudential case, the Council member with insurance experience noted that the scenarios used in the analysis of Prudential were "antithetical" to the insurance regulatory environment and the State insurance company resolution and guaranty fund systems, and all three of Prudential's primary State insurance regulators submitted statements rebutting any argument that Prudential could cause systemic risk.

This lack of deference to an insurer's primary financial regulator is particularly troubling given the fact that insurance, unlike every other segment of the financial service industry, does not have any of its primary regulators as voting members of

FSOC. Moreover, none of the primary regulators of the three insurers that have been designated were "at the table" when FSOC designation decisions were made.

Implement an "Activities-Based" Approach for Insurance

The Dodd-Frank Act gives FSOC two principal powers to address systemic risk. One power is the authority to designate nonbank financial companies for supervision by the Federal Reserve Board. The other power is an "activities-based" authority to recommend more stringent regulation of specific financial activities and practices that could pose systemic risks. FSOC has not been consistent in its exercise of these powers. In the case of the insurance industry, FSOC has actively used its power to designate. In the case of the asset management industry, FSOC has undertaken an analysis of the industry so it can consider the application of more stringent regulation for certain activities or practices of asset managers, and it has not designated any asset management firm to date.

FSOC held a public conference on the asset management industry in order to hear directly from the asset management industry and other stakeholders, including academics and public interest groups, on the industry and its activities.

Furthermore, following its meeting on July 31, 2014, FSOC issued a "readout" stating that FSOC had directed its staff "to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."

In contrast, FSOC has not held any public forum at which stakeholders could discuss the insurance industry and its activities. Instead, FSOC has used its power to designate three insurance companies for supervision by the Federal Reserve Board.

ACLI and AIA support the more reasoned approach that FSOC has taken in connection with the asset management industry and believes that FSOC should be required to use its power to recommend regulation of the specific activities of a potential designee *before* making a designation decision with respect to that company.

FSOC's power to recommend more stringent regulation of specific activities and practices has distinctive public policy advantages over its power to designate individual companies for supervision by the Federal Reserve Board. FSOC's power to recommend primary regulator action brings real focus to the specific activities that may involve potential systemic risk and avoids the competitive harm that an individual company may face following designation. As noted above, in certain markets, such as insurance, designated companies can be placed at a competitive disadvantage to nondesignated companies because of different regulatory requirements. Finally, the power to recommend avoids the "too-big-to-fail" stigma that some have associated with designations.

FSOC's recommendations for more stringent regulation of certain activities and practices must be made to "primary financial regulatory agencies." These agencies are defined in the Dodd-Frank Act to include the SEC for securities firms, the CFTC for commodity firms, and State insurance commissioners for insurance companies. A recommendation made by FSOC is not binding on such agencies, but the Dodd-Frank Act includes a "name and shame" provision that encourages the adoption of a recommendation. That provision requires an agency to notify FSOC within 90 days if it does not intend to follow the recommendation, and FSOC is required to report to Congress on the status of each recommendation.

Permit Companies to Petition for a Designation Review Based on a Change in Operations or Regulation

FSOC is required to review the designation of a company on an annual basis. A company also should have the opportunity to petition for a review based upon a change in its operations, such as the divestiture of certain business lines, or a change in regulation. Moreover, during a review, FSOC should be required to provide a company with an analysis of the factors that would lead FSOC to de-designate a company. This would lead a company to know precisely what changes in its operations or activities are needed to eliminate any potential for the company to pose a threat to the financial stability of the United States.

Promulgate the regulations required by Section 170 of the Dodd-Frank Act

Section 170 of the Dodd-Frank Act directs the Federal Reserve Board, in consultation with FSOC, to issue regulations exempting certain classes or categories of companies from supervision by the Federal Reserve Board. However, to date no such regulations have been issued. This requirement represents yet another tool Congress created to delineate between those entities that pose systemic risk and those that do not. How such regulations might affect insurance companies, if at all, is unknown. But presumably the regulations will shed additional light on what metrics, standards or criteria operate to categorize a company as nonsystemic. The primary goal here should be to clearly inform companies of how to conduct their business

and structure their operations in such a way as to be nonsystemic. Only if that primary goal cannot be met should the focus turn to regulating systemic enterprises.

Conclusion

The insurance industry strongly supports full implementation of the Insurance Capital Standards Clarification Act. In addition, the insurance industry supports a formal rulemaking process with notice and public comment for the development of insurance capital standards to ensure that the Federal Reserve Board has the best information and input from public stakeholders. The goal of this process should be the development of capital standards that are specifically designed and tailored for the insurance business model. Furthermore, this domestic process should not be condensed, abridged, or confused by IAIS standard setting. Because the IAIS would benefit from the work of the Federal Reserve Board, and because the U.S. position is certain to be informed by that work, the IAIS timeline for the development of the ICS must accommodate the U.S. process. This sequencing is essential to good market and regulatory outcomes for U.S. companies and consumers, and also for a healthy outcome to the international discussion.

The insurance industry also supports reform of the FSOC process, including improved procedures for de-designation and increased consideration of the views of primary insurance regulators. These reforms would strengthen the FSOC and its regulatory goals of identifying and diminishing systemic risk.

Chairman Crapo, Ranking Member Warner, thank you for the opportunity to testify before the Subcommittee today.

Testimony of Kurt Bock
Chief Executive Officer of COUNTRY Financial
On Behalf of PCI and NAMIC

Before the United States Senate
Committee on Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance and Investment

Hearing on "Examining Insurance Capital Rules and FSOC Designation"
April 30, 2015

Chairman Crapo, Ranking Member Warner and members of the Subcommittee, my name is Kurt Bock, Chief Executive Officer of COUNTRY Financial, and I appreciate the opportunity to testify today on behalf of the National Association of Mutual Insurance Companies (NAMIC) and the Property Casualty Insurers Association of America (PCI). Our associations together represent more than 2,000 insurance companies – roughly two-thirds of the property-casualty insurance market. These insurers and reinsurers represent a vast diversity of size and business model and provide insurance coverage critical to families and businesses throughout the U.S. and the world.

COUNTRY is a mid-sized financial company from America's heartland that has been awarded A.M. Best's highest rating category ("superior") for over 75 years. We were formed by a group of farmers in 1925 and now provide home, auto, business and life insurance, as well as retirement investments and education funding, to individuals, families, and Main Street businesses. We are very proud that COUNTRY has had the lowest auto complaint ratio with the Illinois Department of Insurance for 11 of the last 12 years and has ranked among the top two home insurers with the lowest complaint ratio for the last 12 years. COUNTRY Financial's top priority is always our consumers, and we assess any regulatory changes or proposals through the lens of our policyholders.

Our trade associations, representing the vast majority of the property-casualty insurance industry, believe that the current U.S. state-based insurance regulatory system is robust and well-positioned to meet the needs of the nation's insurance marketplace. It has helped produce

the strongest, most competitive and largest insurance market in the world. And it has helped our sector improve the quality of life and the safety of the homes, highways and workplaces of all Americans. Finally, our state-based regulatory system is open and transparent to all interested parties, accountable, and able to respond effectively to evolving challenges.

I am appearing before you today to warn that our time-tested and effective system now faces unprecedented challenges, both from international pressures to adopt global bank-like regulatory standards and from increased federal involvement in insurance as the Federal Reserve Board (Federal Reserve) and the Department of Treasury try to navigate their new responsibilities under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the Insurance Capital Standards Clarification Act of 2014.

Having affirmed the primacy of state insurance regulation in both Acts, Congress must now increase its oversight regarding the unprecedented federal and international intrusion into state insurance regulation. Clarity regarding the intended outcomes of federal and international involvement is necessary. Such action should include a clear statement of policy, applicable to federal and international negotiations, that reaffirms and defends the existing state-based system of regulation for all U.S. insurers and insurance groups, that encourages greater collaboration and unity among our U.S. agencies, that supports more transparency and accountability, and that ensures any new regulations are rare and only address documented gaps in protecting U.S. consumers rather than just a forced compromise between state insurance and federal banking or global standards. We appreciate the ongoing discussions of potential reforms in the Committee and COUNTRY Financial and our trades look forward to assisting you in these efforts.

The Current U.S. Insurance Regulatory System

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. I am particularly proud of the role that our industry and COUNTRY Financial have played in helping to bring about safer homes, workplaces and highways—efforts that have saved countless lives and

prevented the waste of huge amounts of resources. And I am equally proud that our financial investment in America's future through the municipal bonds that we buy helps build critical infrastructure that leads to a higher quality of life.

The U.S insurance sector remained strong, stable and safe throughout the last several economic crises. (See Appendix 1). Despite a confluence in the last decade of record storms, market contractions and regulatory changes, property-casualty insurance has had no major recent insolvencies, has achieved record levels of policyholder surplus compared to premium to backstop our promises to policyholders (Appendix 2), and private sector insurance availability and competition is better than ever for consumers (Appendix 3) as demonstrated by the historic decline in the number of consumers having to turn to government residual markets. Compared to federally regulated banks, state regulated property-casualty insurers fared relatively well during the recent financial crisis (Appendix 4). They have suffered significantly fewer insolvencies, and the decline during the crisis in the stock valuations of publicly-held property-casualty insurers was not only far less than for banks but also less than for the New York Stock Exchange composite (Appendix 5). Property-casualty insurers also continue to be far less leveraged than banks and our failures are not correlated with broader economic cycles (Appendices 6 and 7). The local focus of our state-based insurance regulatory system has been extremely supportive of responsive property-casualty insurance markets that address regional needs as well as the specific needs of local insurance customers.

Dodd-Frank created a Federal Insurance Office (FIO) to advise Congress and facilitate a unified voice on international insurance issues, and the Financial Stability Oversight Council (FSOC) to identify and reduce systemic risk. In addition, Congress abolished the Office of Thrift Supervision (OTS), in the process incidentally giving the Federal Reserve new authority over insurance holding companies with thrift subsidiaries. These new agencies and new federal responsibilities are still being sorted out but in some cases concerns are growing that the federal agencies are either veering from the intent of Congress or are being pressured to do so internationally.

In particular, although Congress preserved the Home Owners Loan Act' and a distinct holding company structure to govern savings and loan holding companies differentiating them from bank holding companies, the Federal Reserve has been continuously assessing how to fit systemically important insurance groups and insurance groups with depository institutions into its bank holding company regulatory system. In this effort they must address the conflicting pressures of banking regulation focused on macro-economic stability, holding company source of strength for depositors and federal deposit insurance fund protection contrasted with a completely different insurance business model that does not contribute to systemic risk and is focused on legal entity regulation for consumer protection.

International Standard-Setting for Insurance

The property-casualty industry has serious concerns about recent international standard-setting efforts that have morphed far beyond their original mission to develop best practices or principle-based standards. Instead, these bodies are increasingly trying to extend particular capital standards and accounting practices used by certain regions on a global basis that could significantly undermine the current U.S. insurance regulatory system. While COUNTRY Financial and a majority of the members of our trade associations are domestic, all of the members have felt the impact of the international standards being imported to the U.S. Indeed, the movement toward more formulaic, one-size-fits-all prescriptive standards is accelerating and threatening both international and domestic-only insurers.

International decisions influence the content of regulation in the United States, and also influence the criteria by which the quality of U.S. regulation is assessed by organizations such as the International Monetary Fund (IMF). Standards initially being discussed only for systemically important or internationally active insurance groups are quickly bleeding into the more broadly applicable International Association of Insurance Supervisors (IAIS) International Insurance Core Principles (ICPs), in addition to creating enormous pressure on the state and federal regulators to conform.

U.S. regulators face intense pressure for global convergence from the Financial Stability Board (FSB), a largely opaque consortium primarily composed of international bank regulators, finance ministers and consolidated regulators that advocates one-size-fits-all global standards, as well as the IAIS, which has adopted in its Insurance Core Principles insurance standards based largely on Solvency II – a new top down, bank-like like regulatory system adopted but not yet implemented by the European Union. U.S. state solvency regulation has been extremely successful, due not only to the structure of the regulation but also to its particular focus on protection of insurance consumers rather than investors and lenders.

Changing the existing regulatory paradigm to a centralized banking or Solvency II-like system, as the FSB and IAIS urge, would compromise our current system and lead to harmful consumer protection outcomes that Congress neither envisioned nor intended. Both higher consumer costs and less competition would very likely result.

International Monetary Fund and the FSAP

Following the 2008 financial crisis, all countries participating in the G20 agreed to IMF assessments of their financial sector laws and regulations every five years. These reviews are called the Financial Sector Assessment Program (FSAP) and were designed to create more global consistency in financial regulation. In 2010 the IMF first assessed the insurance laws and regulations in the U.S. to determine their "observance" of the IAIS' ICPs.

After the 2010 FSAP, several new model laws were put in place by the National Association of Insurance Commissioners (NAIC) in response to the recommendations from that report. These included several new requirements for holding companies, including:

- new enterprise risk management requirements;
- additional risk-based capital requirements;
- reduced foreign reinsurance collateral requirements;
- a new corporate governance disclosure; and

- new internal audit function requirements (See Appendix 8 for details).

All of these new models have or will likely become accreditation standards, meaning that each state must adopt them to maintain their accreditation by the NAIC. These new model laws have already changed the fabric of insurance regulation in the U.S.

Despite the NAIC's efforts to develop model laws and movement at the state level to enact the model laws, the IMF returned in 2015 with lower scores for U.S. insurance regulation and more prescriptions for centralized regulation. Ironically, the IMF recognized the general effectiveness of the outcomes of the U.S. state-based regulatory system but criticized it for failing to conform more closely to the IAIS core principles. And unsurprisingly, the report supported a greater federal role in regulation. It is unclear how the new recommendations will be addressed by state regulators, the NAIC, and the Federal Reserve, but it is clear that in the current climate there will be more international pressure on our insurance regulatory system resulting in new requirements, new reporting, and increased costs – with little or no demonstrable benefit and a very real potential for harm.

The International Association of Insurance Supervisors and the ICPs

The IAIS used to be a forum for insurance regulators to discuss best practices, improve cooperation between regulators and inform developing countries that were creating an insurance regulatory system about the important issues to address. More recently IAIS members seeking to globalize their standards or centralize regulation have focused efforts on establishing Insurance Core Principles that are required standards for insurance regulation that members commit to adopt and are graded on their compliance. Beyond the Insurance Core Principles, the IAIS launched a new Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs), "ComFrame." Under current definitions, ComFrame would set a new regulatory scheme for the 50 largest international insurers, making up roughly a quarter of the U.S. property-casualty insurance market. ComFrame began as an attempt to promote

cooperation and coordination among insurance supervisors. It has now become an effort to impose a series of quite specific new regulatory standards on large international insurers regardless of their status as systemically important. There is little doubt that once established, there will be pressure to apply the ComFrame standards more broadly.

It is important to note that the IAIS is not bound by due process and does not formally consider the costs of the changes it makes to international insurance standards relative to the presumed benefits of these changes. With each new or revised ICP or standard, the IAIS adds costs to international regulatory enforcement and compliance with little regard for the impact of these costs on governments, insurers, and consumers. At the IAIS, the U.S. is represented by the Treasury Department through the Federal Insurance Office, the Federal Reserve, and state insurance commissioners; however, these entities do not always speak with a unified voice and are greatly outnumbered by other member countries.

Most of the property-casualty insurance industry believes the chief mission of the IAIS ought to be to facilitate a stronger global insurance regulatory environment through cooperation and coordination rather than attempting to create one-size-fits-all requirements for every country in the world. It is critical that our U.S. representatives cooperate and collaborate to advocate for the strengths of the U.S. system and oppose proposals that would not benefit U.S. consumers. Congress needs to restate this mission by clarifying the desired goals of the federal agencies in working with the state regulators and the U.S. insurance industry and discussing potential commitments to changes in regulation. More specifically, given concerns about the direction of the IAIS discussions on an insurance capital standard that would be applied to insurers that are not systemically important, just internationally active, Congress should direct U.S. representatives to forcefully advocate for the current state-based approach of risk-based capital requirements on a legal entity basis designed for policy holder protection, and not quantitative global capital standard for non-systemic insurance groups that focuses on protection of creditors, shareholders and others, beyond policyholders.

In addition, despite the introduction of bipartisan and bicameral Congressional resolutions and the opposition of state legislators, the IAIS has shut out interested parties from its working meetings. This action was opposed by our state regulators but they were not supported by our federal representatives. The resulting procedures are far less transparent than those of the states and NAIC. This episode serves as an unfortunate example of the lack of coordination between the members of the U.S. regulatory team participating internationally.

Financial Stability Board

Many decisions related to international financial services are being made by an arm of the G-20 known as the FSB. The FSB was established from a group of international central banks and finance ministers. It is housed in Basel, Switzerland, in the Bank for International Settlements, and has been chaired solely by various central banks. Unsurprisingly, the FSB tends to be bank-centric, and it was the FSB that tasked the IAIS with developing the capital standards for both Global Systemically Important Insurers as well as IAIGs. The U.S. is represented on the FSB by the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission. There are no U.S. state insurance regulators or lawmakers represented on the FSB and in fact there is only one FSB member focused primarily on insurance – the IAIS. The FSB decision-making process is largely opaque and there are few opportunities for communicating our members' concerns, or the concerns of interested parties, to the U.S. representatives on the FSB. Consequently, there is ample reason to doubt that the FSB fully understands how its decisions affect insurance markets, or that the critical differences between banks and insurance are fully appreciated.

It is important to ensure that federal agencies representing the U.S. on the FSB and at the IAIS are advancing policy positions that represent the interests of U.S. insurance consumers, insurance markets, insurance regulators, and the U.S. economy in general. To that end, the U.S. should insist on an open and transparent policy development process, and the U.S. representatives who engage with international bodies should share a common agenda and a

common message. That message should include a strong defense of the U.S. insurance market and existing state-based regulatory structure. It should also promote the interests of U.S. insurers and their policyholders. As in the case of U.S. involvement at the IAIS, the FSB represents an opportunity for better coordination between the members of the U.S. regulatory team participating internationally.

The Development of an International Capital Standard

No Identification of Problem; No Flexibility in Key Principles - On October 9, 2013, the IAIS announced that it would develop an Insurance Capital Standard (ICS) by the end of 2016 for all IAIGs, scheduled to be implemented beginning in 2019. The IAIS Executive Committee did not elaborate regarding the problem it was trying to solve or explain why the decisions were made, but insisted on a highly detailed, prescriptive formula for the ICS that would be applied to all countries; that all countries use the same valuation/balance sheet without regard to the costs and implications; and that the capital resources that companies use to meet the obligation be identical even when the capital instruments available to companies vary across countries.

Comparability Not Obtainable - Despite the goals of the IAIS to achieve a comparable ICS for all IAIGs around the globe, the application of the same capital standard to unique companies from very different regulatory environments with very different economic and political objectives will not produce comparable indicators of capital adequacy or solvency. Every country has a unique regulatory system with unique features that influence the solvency of the companies doing business in that regulatory environment. Similarly, every insurance group has unique characteristics that cannot be fully captured in a single one-size-fits-all formula.

Exorbitant Costs; No Identification of Benefits - In its zeal to achieve comparability, the IAIS will succeed only in generating unnecessary costs to governments and insurers. The costs to the U.S. will be significant. Our country will be required to make major changes to its supervisory, corporate law, and accounting systems to accommodate the new group capital requirements.

Because the new standards will likely be derived from existing Solvency II standards, U.S. insurers will be placed at a competitive disadvantage relative to their foreign counterparts in the transition, and U.S. consumers will very likely bear the brunt of higher prices and fewer choices in the market.

A Better Solution - A workable global effort would not create competitive asymmetries between companies domiciled in different, but equally well-supervised, jurisdictions. What is needed is a flexible and dynamic principles-based and outcome-focused assessment that would recognize and improve understanding of diverse, successful approaches to solvency regulation. Under this approach, supervisors could achieve the desired goal of policyholder protection, and for systemically important insurers, the additional goal of insurer solvency, without the costs that would result from implementing new global systems in nearly every country in the world.

Unfortunately, the IAIS does not seem to be heading in this direction. Instead, the IAIS is developing more intensive capital requirements for non-systemically important IAIGs. This approach is based on the European Union model of requiring capital sufficient to prevent failure – that is to protect bondholders and investors, and not the U.S. standard, which is focused on policyholder protections.

Beyond that fundamental disconnect, there are also many more granular, troubling aspects to the approach of the IAIS. While it now recognizes that the ultimate, "fully comparable" ICS cannot be developed by 2019, it continues to push forward for development and implementation of an "interim" ICS by 2019. This may require changing accounting standards and favoring the local approach of one jurisdiction over another, creating further disproportionate costs between companies similarly situated. The potential market disruptions could be unintended, but very significant. Additionally, it appears that the IAIS is moving forward without a full assessment of the impact on consumers and insurance markets. Although the ICS to be proposed by the IAIS is not statutorily mandated and would have to be implemented by the states, the majority of the property-casualty industry is concerned that it would create pressure on the states to harmonize existing state standards to the ICS.

One Voice – Team U.S.A.—On All Issues

The U.S. regulatory team participating internationally needs to seek public input on the international policy issues it addresses internationally with the IMF, the FSB, the IAIS and any other standard-setters whose actions affect U.S. insurance laws and regulations. Drawing on information acquired through consultations with interested members of the public, this team must present a consistent and unified voice both publically and privately. The decisions about international positions should be made in an open, transparent forum that includes due process for all stakeholders impacted by the decisions. This includes both state regulators and state legislators who adopt state insurance laws. The U.S. positions should reflect the basic instruction from Congress to support the existing state-based insurance regulatory system in international negotiations.

In regard to the ICS, the U.S. should be pursuing an outcomes-based, flexible approach that recognizes the successful, state-based U.S. system. All of the U.S. representatives need to set aside concerns about what the FSB or the IAIS will or won't accept and agree on a clear and coherent position from which to negotiate internationally on insurance regulation. The various U.S. representatives engaged in these discussions have taken ad hoc steps to communicate with the industry and U.S. regulators on these capital policy positions, but there remain inconsistencies in the U.S. positions advanced internationally. A better, more systematic process is needed for this major issue and for many other standards under discussion internationally.

The critical importance of a Team USA that advocates positions consistent with effective state-based regulation is not limited to capital standards. The FSB and IAIS are working on a vast array of insurance regulatory topics including governance, remuneration, market conduct, resolution and recovery, and cyber standards. These have a tremendous potential to help or

harm consumers and competitive markets, and our federal representatives should be fully engaged and cooperating with state insurance regulators in these projects. However, Congress can play a key role in helping to ensure that our federal representatives and state regulators are advocating consistent positions internationally on behalf of the U.S. insurance market and the regulatory system that protects its policyholders.

Federal Reserve Insurance Capital Standards

Until 2011, savings and loan holding companies were regulated by the OTS. In 2011, pursuant to the Dodd-Frank Act, the supervisory responsibilities of the OTS were transferred to the Federal Reserve, and savings and loan holding companies (SLHCs) were subjected to much greater risk supervision, liquidity and capital requirements, not just for the thrifts or banks but also the broader holding company. The Federal Reserve also has supervisory authority over entities designed by the FSOC as systemically important. Between its group-level regulation of insurers with thrifts or banks and insurers designated as systemically important, the Federal Reserve has group-wide supervisory authority over more than 30 percent of the insurance industry, measured by premium volume. It should be noted that this supervision is in addition to, not in lieu of, all existing state regulation for these groups and their legal entities.

In the congressional hearings and public forums leading to the enactment of the Insurance Capital Standards Clarification Act of 2014, an oft-repeated theme was that regulators should avoid using a one-size fits all approach to setting capital rules for financial companies under its jurisdiction. This was most typically reflected in the view that insurance companies should not be regulated like banks and subject to rules designed for banking. We agree with this approach, but recommend that the analysis should not end with banking versus insurance when looking at a diverse range of insurance companies and business lines.

While the Federal Reserve has authority with respect to SLHCs and designated systemically important companies, it is important to note that there are distinct differences in these two

categories of companies. SLHCs are subject to Federal Reserve jurisdiction as result of the presence of a depository institution and because Congress abolished the OTS, not because the companies pose any risk to the U.S. financial system. In addition, there are significant differences between property-casualty companies and life insurance companies necessitating very different capital structures and asset holdings. In fact, there are even substantial differences in the liabilities and asset needs facing different types of property-casualty companies (e.g., rate regulated homeowners' insurance versus environmental toxic tort liability).

Last year Congress passed with overwhelming support the Insurance Capital Standards Clarification Act of 2014. This legislation allowed the Federal Reserve to avoid imposing on insurers capital standards designed for bank holding companies. The Federal Reserve is now trying to ramp up its understanding of insurance to evaluate various domestic and international proposals regarding how it should supervise insurance holding companies under its jurisdiction. Numerous staff have spent considerable time and effort examining insurers, asking questions not only about their depository institutions and potential risks to the federal deposit insurance fund, but about many unrelated insurance and commercial activities as well.

Like COUNTRY Financial, some insurers have very small community or trust banks and wonder whether Congress truly intended to create an additional layer of intensive Federal Reserve supervision of insurance for Main Street community operations. We fully respect the integrity of the Federal Reserve in carrying out its new responsibilities, but would suggest that additional clarity from Congress regarding its intent under the Dodd-Frank Act could be helpful.

As the Federal Reserve increases its understanding of insurance and balances its new responsibilities, to what extent does Congress intend for its involvement to be proportional to the risks that insurer-owned banks pose to the federal deposit insurance corporation or broader systemic stability? And to what extent should insurance activities be regulated by our

primary functional regulator rather than by the Federal Reserve? In essence, what is the intent of Congress on state versus federal regulation of Main Street insurers?

We hope that to the extent that the Federal Reserve imposes supervisory requirements on insurance holding companies under its jurisdiction, including capital standards pursuant to the Dodd-Frank Act Collins Amendment and the Insurance Capital Standards Clarification Act, the Federal Reserve will focus on the holding company banking activities and rely to the extent possible on state regulatory standards for holding company insurance operations. In particular it is critical that the Federal Reserve not try to substitute a new capital measurement to replace state risk-based capital requirements and measurements. Rather, the Federal Reserve should recognize the state-based regulation of insurance operations and either exclude the insurance activities or aggregate the current state capital requirements of the insurance legal entities while focusing regulatory oversight on the non-insurance entities, the depository institution and, in the case of insurance systemically important financial institutions (SIFIs), the stability of the U.S. financial system. By doing so, the Federal Reserve would not need to try to replicate decades of sector-specific regulatory experience.

COUNTRY Financial and our trades would appreciate a dialogue that could be helpful to our regulators as well as our customers and look forward to participating as the regulators and Congress seek the right balance of oversight.

FSOC Designation Process

In passing the Dodd-Frank Act, Congress sought to ensure the stability of America's financial markets and reduce the exposure of taxpayers to costly bailouts. To accomplish this, the FSOC must follow the intent of Congress, which was to designate only those financial firms that pose true systemic risk. We are concerned that FSOC has not been sufficiently focused on identifying true systemic risk, and therefore strongly recommend that the Congress exercise robust and effective oversight of the FSOC designation process. This should include providing additional

legislative direction to ensure that relevant provisions of Dodd-Frank are implemented in a manner consistent with the intent of Congress and that the FSOC is properly focused on identifying true systemic risk.

Problems in the FSOC Nonbank Designation Process

The Dodd-Frank Act set forth a list of factors the FSOC is to consider when determining whether a nonbank is systemically important. However, FSOC's designation decisions regarding insurance groups has not provided a meaningful analysis of these factors, focusing instead primarily on issues relating to the size of the company and on hypothetical and arguably implausible scenarios under which material financial stress at the company would pose systemic risk to the economy. By declining to address the statutory systemic risk factors, the FSOC's designation decisions have not clearly established a coherent rationale for the decision based on activities in which the firm engages. This does not foster confidence in the FSOC's decisions. It also leaves all companies in the dark about what activities the FSOC considers systemically risky and thus provides no clear direction to companies on how to reduce systemic risk.

The Government Accountability Office (GAO), in a report released on November 20, 2014, also criticized FSOC for "using only one of two statutory determination standards (a company's financial distress, not its activities)" and noted that "FSOC may not be able to comprehensively ensure that it had identified and designated all companies that may pose a threat to U.S. financial stability."

FSOC's failure to address the ten specific "considerations" set forth in Dodd-Frank is particularly problematic with respect to recent insurer designations. One of those factors is the degree to which the company is already regulated by one or more primary financial regulatory agencies. State insurance regulation has a long-established, excellent record of protecting consumers against insurance insolvencies. Indeed, it could well be argued that its record is superior to that

of numerous federal regulators who have regulated banks, savings and loans, and other financial firms. Despite this, the designations seem to assume that state insurance regulators would be unable or unwilling to respond effectively to problems in insurance companies. For example, the FSOC worried that financial troubles at a life insurer could lead policyholders to seek to surrender their policies in a disorderly manner, but the FSOC failed to acknowledge that state insurance regulators have the ability to impose stays or take other action to manage any such surrender activity. Congress recognized that state regulators have a number of options to mitigate systemic risk, but the FSOC has disregarded those tools. In exercising its oversight responsibilities, Congress should reaffirm its instruction that FSOC consider and provide an in-depth analysis of each of these factors in determining whether an insurer should be designated as systemically important.

FSOC's decisions to designate three insurers as systemically important are particularly disturbing given that they were reached over the strong and substantive objections of both FSOC's Independent Member Having Insurance Expertise and the non-voting State Insurance Commissioner Representative. The FSOC's decision record does not make clear why the strong views of these two insurance experts were disregarded and provides no substantive refutation to the informed and well-reasoned arguments of these experts. We view this as one of the surest signs that the FSOC designation process is flawed and in need of increased congressional oversight and reform. At a minimum, Congress should consider directing the FSOC to provide a well-articulated and substantive discussion of its rationale any time it disregards the expert advice of those on the FSOC who Congress put there to bring insurance expertise to the table.

A byproduct of the lack of clear rationales for FSOC designation decisions is that the FSOC has not provided a roadmap for how companies can take action to eliminate activities that pose systemic risk and thus become eligible to have a designation of systemic importance removed. The ultimate goal of the Dodd-Frank Act was to reduce systemic risk and it created the FSOC primarily to do so. By failing to specifically identify the systemically risky activities required to

be addressed in companies it designates or to provide an "exit ramp" for such companies, the FSOC replaces an effort to reduce systemic risk with just another layer of federal control.

To its credit, FSOC recently adopted several new measures designed to address some concerns. The new measures include: improving engagement with companies being considered for designation; enhancing public transparency; and making the annual review process more meaningful. We applaud FSOC for taking these actions, which we view as improvements to the existing process. Nevertheless, they fall short of fully addressing the shortcomings we, the GAO, and others have identified. Most importantly, they do not bring the FSOC designation process fully into line with that envisioned by Congress and set forth in Dodd-Frank.

In considering how to exercise its oversight responsibilities over FSOC and improve the systemic risk designation process, we urge Congress and FSOC to keep in mind the following basic premises:

Size Alone Does Not Create Systemic Risk. FSOC must not create a new class of "too-big-to-fail" companies, blindly designating companies as systemically important simply because they are large without adequately analyzing other far more significant factors indicative of systemic risk. Few, if any, financial companies are systemically important solely because they are large. Engaging in highly risky activities, coupled with interconnectedness, leverage, concentration and other considerations set forth in Dodd-Frank, is what creates systemic risk. Unless FSOC fully considers and analyzes all of those factors, it cannot gain a holistic view of the true nature of the risks a company does and does not pose.

Goal Should Be to Reduce Systemic Risk. FSOC must recognize that its goal is not to impose punitive regulation on financial companies, but to reduce systemic risk. If FSOC is true to that goal, it will work with companies to consider approaches to reducing systemic risk before, during, and after consideration of a company for designation. To do otherwise fails to provide the protection to the economy that Congress envisioned when it passed Dodd-Frank and

instead only causes significant market distortions and increased costs for consumers with little significant benefit.

Insurance Is Not Systemically Risky. There was widespread recognition during the legislative process that led up to the passage of Dodd-Frank that traditional insurance activities simply are not systemically risky. Property-casualty insurers, in particular, have low leverage, are not interconnected with other financial firms, do not pose a "run-on-the-bank" threat, are highly competitive with low market concentration, have low failure rates, and have their own effective and self-financed resolution system. When one of Dodd-Frank's namesakes, former House Financial Services Committee chair Barney Frank, testified last summer in a hearing assessing the Act, he said that he didn't believe "asset managers or insurance companies that just sell insurance are systemically important." Mr. Frank also said it was never his intention that a nonbank designated by the FSOC should be regulated as a SIFI in perpetuity, and noted that he had sent a letter to FSOC stating that view.

Transparent, Activities-Based Analysis. FSOC needs to make its systemic risk determinations more systematic and transparent. This includes following the mandate of Section 113 of Dodd-Frank to assess the *activities* in which a company engages – not just its size and hypothetical scenarios of financial distress. It also includes identifying activities that pose systemic risk and publicly announcing them *before* designating a company as systemically important. This will allow companies to reduce systemic risk before it becomes necessary for FSOC to consider designation. This would provide much greater confidence to the general public that true systemic risk is being addressed and rooted out of the economy.

Indeed, the GAO noted that "FSOC's public documents have not always fully disclosed the rationales for its determination decisions" and that "the lack of full transparency has resulted in questions about the process and may hinder accountability and public and market confidence in the process." The GAO recommended that "making FSOC's designation process more

systematic and transparent could bolster public and market confidence in the process and also help FSOC achieve its intended goals."

Off-Ramp. Once a company has been designated, a fair process is needed to give the company a reasonable roadmap for eliminating the activities that led to the determination so that the company can be de-designated. There is no process for this now, but this is also essential to achieving the goal of reducing systemic risk.

Deference to Functional Regulators. Although almost all members of FSOC are regulators, no single member has expertise in all sectors of the financial services industry. In keeping with congressional direction in Section 113(a)(2)(H) of Dodd-Frank, FSOC *must* begin to recognize and utilize the expertise of the primary functional regulators and engage in meaningful analysis of how that regulation can or does work to reduce systemic risk. This is especially true with respect to insurance because the vast majority of FSOC members have no background in that industry or its regulation. This means, in part, being more mindful of the strong views of insurance experts on the FSOC, but even more importantly, it means consulting with state insurance regulators before and during the designation process. The non-insurance expert members of FSOC need to devote significant time and attention to the state-based regulatory system and develop a much more sophisticated understanding of it before considering another insurance company for designation.

Congressional Legislation. While increased Congressional oversight of FSOC is important, Congress needs to consider statutory changes to more tightly direct FSOC's decision-making processes. For example, H.R. 1550, introduced by Representatives Dennis Ross (R-FL), and John Delaney (D-MD), would make a good start. The bill would require FSOC to:

- consider the appropriateness of the imposition of prudential standards as opposed to other forms of regulation to mitigate the identified risks;

- at least annually reconsider nonbank SIFI designations and to respond with specificity how the Council assessed any material factors presented by the company to contest such designation;
- revote nonbank SIFI designations every five years at the request of the affected company, including consideration of a plan by the company to reduce its systemic impact;
- notify a nonbank financial company that it has been identified for a potential SIFI designation and to provide with specificity the basis for the consideration, an opportunity to meet with FSOC to discuss FSOC's analysis, and a list of the public sources of information being considered by the Council as part of such analysis;
- before making a designation, vote to approve a resolution that identifies with specificity any risks to the financial stability of the United States FSOC has identified relating to the nonbank financial company;
- provide a potential designee's primary financial regulatory agency at least 180 days from the date of the resolution to respond to FSOC regarding how the risks could be addressed by existing regulation other regulatory action to mitigate the identified risks; and
- every five years assess the impact of designations on SIFIs and the wider economy, including whether the designations are improving the financial stability of the United States.

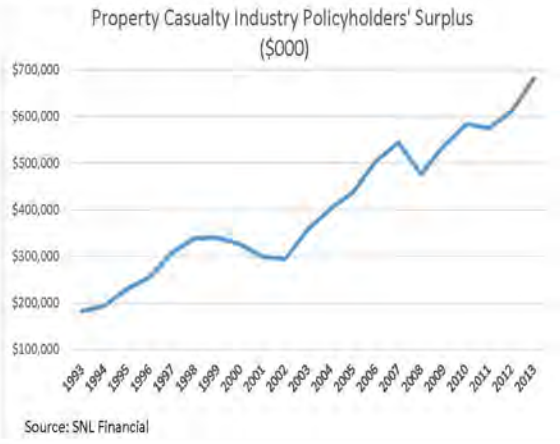
We would further urge that additional requirements for FSOC to give greater deference to functional regulators be included along with requirements to report to Congress on any designations, including detailed descriptions of how FSOC fully followed the requirements of Section 113 of Dodd-Frank.

Conclusion

The stakes in the subjects we have addressed herein could not be higher for consumers and the competitiveness of our markets. Congress has an essential role in overseeing the increasing federal and international intrusion into the well-established state-based system of insurance regulation, encouraging greater collaboration and transparency in standard-setting discussions, and providing clear guidance to federal officials as they interface with a state-based regulatory system and international globalization pressures. Congress should help guide our country's involvement at the IMF, FSB and IAIS to facilitate a stronger global insurance regulatory environment through cooperation, coordination and consistency, as opposed to creating one-size-fits-all standards for every country in the world. New requirements and changes should be based on existing identified gaps in consumer protection. We must avoid a systemically dangerous over-reliance on uniformity, and we must not disregard the fundamental differences in regulatory and legal systems or fail to adequately consider potential costs. Congress can also encourage the regulators not only to meet together as Team USA but to develop a common strategy to support the U.S. overseas in all international insurance regulatory discussions. Domestically, Congress can ensure that federal involvement with insurers is appropriately tailored to specific regulatory objectives (such as protection of a significant thrift or overseeing specifically identified systemically important activities not currently regulated for solvency) and does not undermine the primary mission of state insurance regulation to protect consumers.

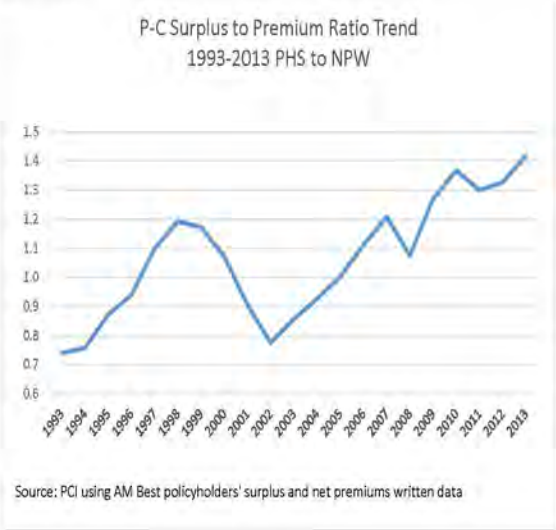
We look forward to working with Congress, federal representatives, and state regulators and lawmakers to ensure the continued support for the time tested state-insurance regulatory model.

Appendix 1



Source: SNL Financial

Appendix 2



Source: PCI using AM Best policyholders' surplus and net premiums written data

Appendix 3

PROPERTY CASUALTY Market Concentration Analysis

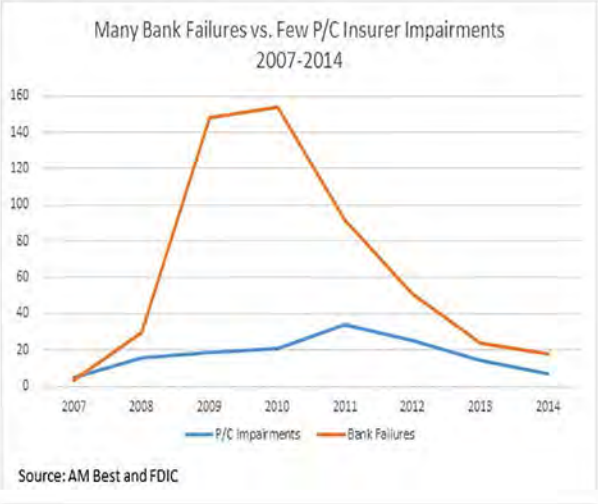
DOJ Considers Score of 1500 - 2500 to Be Moderately Concentrated, But Almost All Insurers Fall Well Below

Herfindahl-Hirschman Index (HHI) based on 2013 U.S. Total (all states and DC)

Line	HHI Indiv. Cos.	Number of Indiv. Cos.
Homeowners	301.9	873
Personal Auto	349.0	877
Commercial Multi-Peril	88.6	800
Workers Compensation	88.9	704
Medical Prof. Liability	216.2	343

Notes:
1. The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.
2. Markets in which the HHI is between 1500 and 2500 points are considered to be moderately concentrated, and those in which the HHI is in excess of 2500 points are considered to be concentrated.
Source: NAIC Annual Statement Database via SNL Financial

Appendix 4

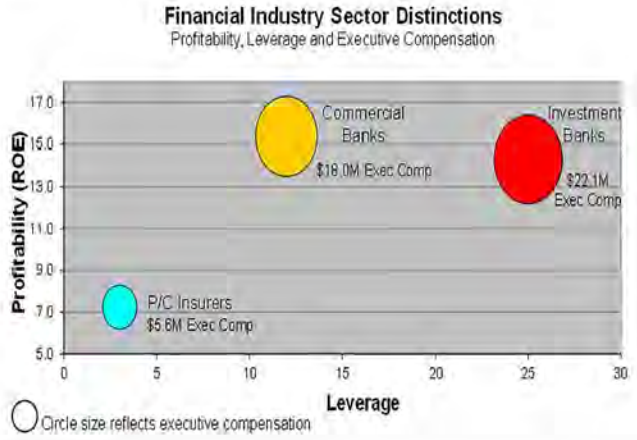


Source: AM Best and FDIC

Appendix 5

Source: GAO analysis of A.M. Best data on the A.M. Best U. S. Life and Property Casualty Indexes and the New York Stock Exchange Composite Index.

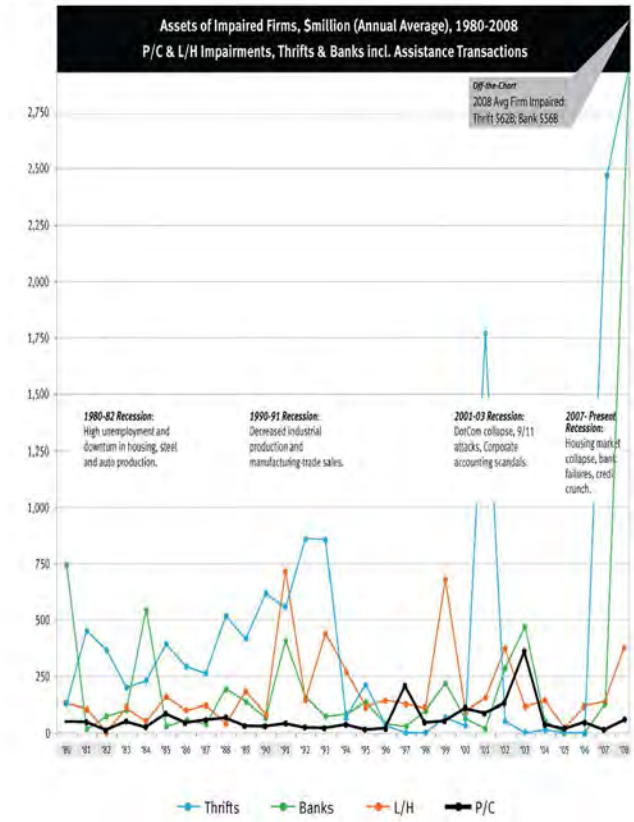
Appendix 6



Source Information:

1. Profitability is based on industry 1998-2007 average annual rate of return; Insurance Information Institute, and Securities Industry and Financial Markets Association.
2. Leverage reflects 2007 Property/Casualty, commercial bank and investment bank results; 2009 *Economic Report of the President* (banks) and PCI calculations of total liabilities as a proportion of net admitted assets using A.M. Best data (insurers). Chart depicts investment banks levered 25 to 1; commercial banks 12 to 1; and PROPERTY CASUALTY insurers 3 to 1.
3. Executive compensation is based on 2004-2008 annual average CEO compensation from the top three firms in 2008 where data are publicly available; Morningstar.com and for State Farm, PROPERTY CASUALTY Annual Statements and Pantagraph.com newspaper article. Please note the commercial banks figure is based on the 2nd, 3rd and 5th largest firms; and the investment banks figure is based on the 2nd - 4th largest firms. In the chart above, the size of each industry's circle represents executive compensation: PROPERTY CASUALTY insurers $5.6 million; commercial banks $18.0 million; and investment banks $22.1 million.

Appendix 7


Assets of Impaired Firms, $million (Annual Average), 1980-2008
P/C & L/H Impairments, Thrifts & Banks incl. Assistance Transactions
Off-the-Chart
2008 Avg Firm Impaired:
Thrift $62B; Bank $56B
2,750
2,500
2,250
2,000
1,750
1,500
1,250
1,000
750
500
250
0
1980-82 Recession:
High unemployment and downturn in housing, steel and auto production.
1990-91 Recession:
Decreased industrial production and manufacturing-trade sales.
2001-03 Recession:
DotCom collapse, 9/11 attacks, Corporate accounting scandals.
2007- Present Recession:
Housing market collapse, bank failures, credit crunch.
'80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08
Thrifts
Banks
L/H
P/C

Appendix 8

U.S. NAIC Model Changes Since 2010 Related to International Pressures

Group Supervision: FSAP Recommendation

- 2010 revisions to the Model Insurance Holding Company System Regulatory Act and Insurance Holding Company System Model Regulation; these are accreditation standards for all states and include the following:
  - Created Supervisory College requirement for international insurers
  - Created Enterprise Risk Reporting Requirement for all insurance groups
  - Added access to Financial Reporting of any affiliates of a group (even non-insurance)
  - Expanded filing requirement for intercompany agreements and amendments
- 2014 additional revisions to the Model Insurance Holding Company System Regulatory Act to create definition, designation and authorities of a group-wide supervisor for international companies; in process to become an accreditation standard for all states
- **48 states have enacted the 2010 model act or have bills awaiting signature with the remaining states to enact by year-end; 7 states have enacted some version of the 2014 model**

Enterprise Risk Assessment: FSAP Recommendation

- 2011, 2012 ORSA Guidance Manual and Risk Management Own Risk and Solvency Assessment Model Act adoption – to require an Enterprise Risk Management function as well as annual assessment and reporting for companies of a size over $500 million premium or insurance groups over $1 billion; in process to become an accreditation standard for all states
- **28 states have enacted the 2012 ORSA model act or have bills awaiting signature with 11 more states pursuing in 2015; the ORSA guidance manual applies automatically to these states**

Reinsurance: EU/US Dialogue Recommendation

- 2011 revisions to Credit for Reinsurance Model Act and Regulations – significantly reducing collateral requirements for foreign reinsurers; an accreditation standard for states
- **At least 28 states have enacted the 2011 revisions to the model act**

Capital Adequacy: FSAP Recommendation

- 2013 added Catastrophe Risk Based Capital Factors for Earthquake and Hurricane risks
- 2014 added Operational Risk Based Capital Factors
- 2013-2014 Investment Risk Based Capital Factors – under evaluation and reassessment
- **All RBC changes will be automatically applied to all states; no adoption necessary**

Corporate Governance: FSAP Recommendation

- 2014 Corporate Governance Annual Disclosure Model Act; in process to become an accreditation standard for all states
- **One state enacted this new model with two awaiting governor signatures**

Internal Audit: FSAP Recommendation

- 2014 Internal Audit Function Requirement added to Model Audit Rule for companies of a size over $500 million premium or insurance groups over $1 billion; in process to become an accreditation standard for all states

PREPARED STATEMENT OF DANIEL SCHWARCZ

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APRIL 30, 2015

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, thank you very much for this opportunity to discuss the Financial Stability Oversight Council's ("FSOC") process for designating nonbank financial companies as systemically significant institutions. In my testimony today, I plan to make two central points regarding this process and its consequences for companies that are engaged primarily in the business of insurance.

First, I will emphasize that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") constructed FSOC's designation process to be flexible and adaptive because systemic risk is itself complicated and evolving. Although this design choice inevitably reduces transparency, FSOC has done a reasonably good job of addressing this concern. For instance, FSOC's development of a quantitative screen in the first stage of its designation process helps assure the vast majority of nonbank financial institutions that they will not be deemed systemically significant. At the same time, FSOC's refusal to rely exclusively on quantitative metrics in its designation process or to define a simple, formulaic "off-ramp" for designated firms preserves its ability to effectively evaluate and monitor the potential systemic importance of individual firms.

After addressing the transparency of FSOC's designation process, I will turn to the consequences of a systemic risk designation for nonbank financial companies that are principally engaged in insurance ("Insurance SIFIs"). Perhaps the most important such consequence is that Insurance SIFIs—in addition to Insurance Savings and Loan Holding Companies [1]—will be subject to consolidated capital rules to be crafted by the Board of Governors of the Federal Reserve System ("Fed"). I will suggest that these rules should focus on the potential ways in which the States' Risk-Based Capital ("RBC") regime fails to fully account for systemic risk concerns. In particular, the consolidated capital regime should use as its starting point firms' consolidated balance sheets, rely on market-based valuations of firms' assets, and generally avoid reliance on firms' internal models in setting capital or reserve requirements.

(1) Transparency in FSOC's Designation Process

One of the central goals of Dodd-Frank is to limit the risk that individual companies can pose to the general economy in times of financial market turbulence. As exemplified by the substantial role of American International Group ("AIG") in the 2008 Global Financial Crisis, the historical assumption that such systemic risk is cabined to banks and their holding companies is inaccurate in today's financial world. Instead, firms engaging in a wide variety of financial activities can, in certain circumstances, contribute to the fragility of the financial system in times of general market stress.

To address this reality, Dodd-Frank empowered FSOC to designate nonbank financial firms as entities that could pose a threat to U.S. financial stability. Rather than requiring FSOC to use specific activity-based or quantitative thresholds in executing this responsibility, Dodd-Frank instructed FSOC to consider 10 broad factors. Tellingly, Dodd Frank also authorized FSOC to consider "any other risk-related factors that the Council deems appropriate."[2] Dodd-Frank thus tasked FSOC—a council of the Nation's leading financial regulators—with employing a broad and evolving approach to identifying systemically significant nonbank financial institutions.

This flexible approach to identifying systemically significant nonbank financial institutions reflects a key lesson of the financial crisis: that systemic risk can arise in new and distinctive guises due to the massive complexity and interconnections that have evolved, and continue to evolve, within our financial system.[3] Just as the errant assumption that only banks could create systemic risk was substantially responsible for the 2008 global financial crisis, any specific quantitative or activity-based definition of systemically significant nonbank financial institutions in Dodd-Frank would undoubtedly have been under-inclusive. This, in turn, would have

[1] Nothing in Dodd-Frank compels the Fed to use the same capital regime for Insurance SIFIs and Insurance Savings and Loan Holding Companies. However, many seem to anticipate that the Fed will design a single capital regime for both entities, and then apply a capital surcharge to Insurance SIFIs.

[2] Dodd-Frank § 113(a).

[3] See generally Daniel Schwarcz & Steven Schwarcz, Regulating Systemic Risk in Insurance, 81 U. Chi. L. Rev. 1569 (2014).

incentivized financial firms to take on risks that were not captured by the applicable statutory definition but where extreme losses could have been externalized on to the broader financial system and the general public.

As with all broad legal standards, the flexibility of the FSOC designation scheme as established in Dodd-Frank inevitably creates potential concerns regarding its transparency. Any legal standard that relies on expert decisionmakers to apply a broad multifactor test will necessarily sacrifice predictability and transparency in favor of flexibility and adaptability. This is particularly true in a domain such as systemic risk, which is highly technical, constantly evolving, and not fully understood by the academic or regulatory communities.

To help address these inevitable transparency concerns, FSOC engaged in a prolonged process of rulemaking to more specifically describe its criteria for determining which nonbank financial firms might pose systemic risks to the financial system.[4] FSOC's Final Rule and Interpretive Guidance defined three potential "channels"[5] through which a nonbank financial firm might transmit systemic risk and established a six-part analytical framework[6] to guide its assessment of individual firms. At the same time, FSOC specifically declined commentators' requests to establish a simple formula that would link the transmission channels to the analytical framework or that would determine how the six-factor analytical framework would be weighted in a final determination. Such an approach, FSOC noted, would be inconsistent with the qualitative nature of many of Dodd-Frank's statutory considerations and with robust assessment of individual financial firms' unique risk profiles.

Nonetheless cognizant of continuing transparency concerns, FSOC did develop a formulaic quantitative test to screen out only a small subset of all nonbank financial firms for potential systemic risk designation. Under this screen (which occurs at "stage one" of FSOC's designation process), firms are generally identified for more searching quantitative and qualitative assessment by FSOC[7] if their total consolidated assets surpass $50 billion and they satisfy one of five additional quantitative standards.[8] The effect of this quantitative screen is to provide substantial certainty to the vast majority of nonbank financial institutions that they will not be designated as systemically significant institutions.[9] At the same time, this approach appropriately reflects the reality—illustrated by the crisis and embedded within Dodd-Frank—that the potential for a firm to pose a systemic risk to the larger financial system cannot currently "be reduced to a formula."[10]

In recent months, FSOC has responded to continued concerns regarding the transparency of its process by adopting additional reforms suggested by various stakeholders. Among other things, these reforms will inform firms earlier in FSOC's process if they are being considered for designation and will allow those firms to submit relevant information to the Council at that point. It will also provide firms that have been designated as systemically significant with an enhanced opportunity to participate in the Council's annual reevaluation of that designation.

To be sure, none of this is to suggest that FSOC could not further improve the transparency of its operations. In particular, FSOC's public basis for designating nonbank financial firms as SIFIs could more clearly articulate the relative importance of the identified factors in explaining the Council's reasoning.[11] Additionally, FSOC could more clearly develop a process for allowing a SIFI to seek the Council's

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[4] See 77 Fed. Reg. 21,637 (Apr. 11, 2012). FSOC issued an advance notice of proposed rulemaking in 2010, a first notice of proposed rulemaking in early 2011, a second notice of proposed rulemaking in late 2011, and a Final Rule and Interpretive Guidance in 2012.

[5] These are (i) direct exposure of other firms to the systemic firm, (ii) abrupt liquidation of the systemic firm's assets, and (iii) the disruption of a critical function or service provided by the systemic firm.

[6] This framework focuses on (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny.

[7] The final rule established two post-screen stages of review. In the first (*i.e.,* "stage two"), the Council considers a broad range of quantitative and qualitative information that is available through existing public and regulatory sources. As originally described in the final rule, firms being reviewed during this stage would not be notified of this fact. In the final evaluation stage (*i.e.,* "stage three"), firms that FSOC continued to believe could pose a systemic risk would be subject to a more detailed review in which they would be invited to submit relevant materials.

[8] These quantitative metrics "represent the framework categories that are more readily quantified: size, interconnectedness, leverage, and liquidity risk and maturity mismatch." *Id.* at 21,642.

[9] FSOC did reserve its discretion to evaluate a financial firm as posing potential systemic risks even if it was screened out in Stage One.

[10] *Id.*

[11] Government Accountability Office, Financial Stability Oversight Council, Further Actions Could Improve the Nonbank Designation Process (Nov. 2014).

opinion regarding whether specific transactions or alterations to the firm's risk profile would allow it to shed its designation as a SIFI.

Nonetheless, in my view, FSOC has done a reasonable job of promoting the transparency of its designation process given the inherently multi-factored and complex nature of its responsibility. It has also rightly resisted calls to develop simple rules defining systemically risky nonbank financial firms or a formulaic "off-road" for systemic risk designation. The nature of systemic risk is too fluid, complex, and poorly understood to allow for such simple formulas. By using clear quantitative metrics only to narrow the field of potential systemically risky nonbank financial institutions, while promoting greater participation and transparency among stakeholders in the post-screen assessment process, FSOC has struck a reasonable balance between transparency, on the one hand, and flexibility and adaptability, on the other.

(2) Consolidated Capital Rules for Insurance SIFIs

Under Dodd-Frank, those nonbank financial firms that are deemed systemically significant by FSOC are subject to enhanced prudential rules and supervision by the Fed. Perhaps the most important element of this regime is the application of new risk-based capital standards on a consolidated basis, which Dodd-Frank directs the Fed to develop. The Insurance Capital Standards Clarification Act of 2014 authorized the Fed to tailor these capital standards to the distinctive risks posed by insurers, which are different than the risks posed by banks. But, at the present time, the Fed has not made clear how precisely it intends to use this authority.

In my view, the Fed should design capital standards for Insurance SIFIs that focus on the potential ways in which the policyholder-protection design of State RBC rules may fail to fully account for systemic risk concerns.[12] As I have emphasized on multiple occasions in prior congressional testimony,[13] the regulatory objectives of any risk-based capital regime have important implications for how that regime should be constructed. For that reason, capital regimes focused on systemic risk can, and should, be designed differently than capital regimes focused on policyholder protection.

Given this perspective, I believe that the Fed should consider implementing a capital regime for insurance SIFIs that is consistent with three broad principles. First, that regime should use as its starting point the consolidated balance sheet of the firm.[14] The current State-based RBC regime focuses exclusively on the balance sheets of individual insurance entities. Although this regime generally works well to promote policyholder protection, it has important limitations when it comes to regulating systemic risk.[15] This is most obvious with respect to AIG's use of a noninsurance subsidiary to issue Credit Default Swaps prior to the 2008 crisis. But it was also importantly illustrated by AIG's use of a complex securities lending program to "transform insurance company assets into residential mortgage-backed securities and collateralized debt obligations, ultimately losing at least $21 billion and threatening the solvency of the life insurance companies."[16] More recently, the Daniel Schwarcz, Testimony before the House Housing and Insurance Subcommittee regarding entity-based focus of the RBC regime has allowed insurance companies to utilize complex transactions with "captive" affiliates that may create systemic risks.[17]

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[12] In a Report of the NAIC and the Federal Reserve Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage (2002), a working group of insurance and banking regulators explained the core differences between risk-based capital rules in insurance and banking by noting that "Insurance company regulators place particular emphasis on consumer (policyholder) protection" while "banking regulators focus on depositor protection and the financial stability of regulated entities on a going concern basis."

[13] *See, e.g.,* Daniel Schwarcz, Testimony before the Senate Subcommittee on Financial Institutions and Consumer Protection regarding "Finding the Right Capital Regulation for Insurers" (March 11, 2014); "Legislative Proposals to Reform Domestic Insurance Policy" (May 20, 2014); Daniel Schwarcz, Testimony before the House Subcommittee on Insurance, Housing and Community Opportunity regarding "Insurance Oversight and Legislative Proposals" (Nov. 16, 2011).

[14] Consistent with the IAIS's proposed approach, this balance sheet could then be broken down into three components: insurance, banking, and noninsurance financial and material nonfinancial activities. *See* International Association of Insurance Commissioners, Basic Capital Requirements for Global Systemically Important Insurers (July, 2014).

[15] *See* generally Daniel Schwarcz, A Critical Take on State-Based Group Regulation of Insurers, 5 U. Cal. Irv. L. Rev. (forthcoming, 2015), *available at http://ssrn.com/abstract=2593897.*

[16] Robert L. McDonald & Anna L. Paulson, AIG in Hindsight (April, 2015), NBER Working Paper No. w21108, *available at SSRN: http://ssrn.com/abstract=2596437.*

[17] See generally Ralph S. J. Koijen & Motohiro Yogo, Shadow Insurance (February 18, 2015), Swiss Finance Institute Research Paper No. 14–64, *available at http://ssrn.com/abstract=2320921;* Federal Insurance Office, How to Modernize and Improve the System of In-

Continued

Second, the Fed should seriously consider designing its capital regime for insurance SIFIs to require valuation of assets at market rates. Market-based valuations are more relevant than accounting values when it comes to systemic risk regulation, because it is precisely in times of potential systemic risk transmission that liabilities previously perceived to be long-term can become short-term. To the extent this occurs, then systemic firms may find themselves compelled to sell their assets at prevailing market rates. Market valuation of assets is also more consistent with emerging international norms, thus tending to promote cross-jurisdictional comparability, which is important from a systemic risk perspective. Although market valuation does create potential concerns regarding artificial capital fluctuations that could possibly contribute to fire-sale dynamics, these issues could conceivably be dealt with by adjusting required capital levels in times of economic stress.

Third, the Fed should not allow firms to use their own internal models to determine adequate capital levels and it should also proceed with caution in accepting State Principles-Based Reserving (PBR) reforms that will allow insurers greater freedom to use internal models to set their reserves. A central lesson of the 2008 global financial crisis is that firms' internal models can often be overly optimistic, which should not be surprising given the incentives firms have to maintain lower capital levels and increased leverage. Moreover, in many cases it is simply not realistic to rely on regulators to police firms' internal models due to the complexity of these models and the imbalance of resources available to regulators and private firms.[18]

These principles are broadly consistent with elements of the group-wide, consolidated capital requirements for systemically significant insurers that are being developed by the International Association of Insurance Supervisors (IAIS). Moreover, the IAIS has made substantial progress in recent years in crafting and testing the technical features of this framework. Of course, the Fed should remain cognizant of this country's unique insurance regulatory scheme in determining how the IAIS's capital standards should apply to insurance SIFIs in the United States. But it should also seriously consider adopting elements of this scheme that would provide a more macroprudential perspective than the State RBC regime, which focuses on policyholder-protection. For this reason, I believe that the Fed should continue to be an active participant in the IAIS's development of consolidated capital standards, and should draw on these developments in implementing a consolidated capital requirement for insurance SIFIs in the United States.

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surance Regulation in the United States (2014); New York State Department of Financial Services, Shining a Light on Shadow Insurance: A Little-Known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk (June 2013).

[18] Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States (2014).

RESPONSE TO WRITTEN QUESTION OF KURT BOCK FROM SENATOR VITTER

Q.1. Mr. Bock, in your statement you stated, "We have no transactional deposits or loans. Despite this minimal banking footprint, COUNTRY is now subject to Federal Reserve regulation, including detailed discovery questionnaires and regular visits by examiners that seek to learn all aspects of our business."

How much time and resources has your company used to comply with these new regulations? Do you believe that this allocation of resources has affected the ability of COUNTRY to grow at its maximum rate?

A.1. Since the beginning of our regulation under the Federal Reserve, COUNTRY Financial has had significantly increased administrative burdens on our compliance and regulatory staff. For example, 25 percent of COUNTRY's regulatory and compliance staff time is now spent communicating with the Federal Reserve even though COUNTRY's depository institution is only $30.5 million in assets—less than 0.2 percent of our holding company. In addition, COUNTRY has had to engage both inside and outside counsel in interpreting and responding to requests for information or interpretation of rules. We have also added documentation and reporting requirements, which are in excess and duplicative to our current OCC and State regulatory requirements.

While this reallocation of resources has not stopped COUNTRY from continuing to grow, the added burden has further stretched our risk management and regulatory compliance areas and taken senior executive attention away from other important strategic areas within the property casualty and financial services markets. The overall impact from new regulation has been added administrative costs, which the organization has largely absorbed within our existing structures, with marginal, if any benefit to the policyholder.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

AMERICAN ACADEMY *of* ACTUARIES

Objective. Independent. Effective.

Testimony of Elizabeth Brill, MAAA, FSA
Chairperson, Solvency Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries

Submitted for the Record

U.S. Senate Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment Hearing Entitled
"Examining Insurance Capital Rules and FSOC Process"
April 30, 2015

Chairman Crapo, Ranking Member Warner, and distinguished Members of the Subcommittee:

On behalf of the American Academy of Actuaries'[1] Solvency Committee, I appreciate the opportunity to provide this written testimony for your Subcommittee's April 30 hearing: "Examining Insurance Capital Rules and FSOC Process." The state of the U.S. insurance sector is strong, in no small part due to the effective regulation and oversight based on sound solvency and actuarial principles. Our testimony will focus on the Academy's Solvency Committee's perspectives on recent domestic and international efforts to regulate insurers' capital and solvency in order to promote financial stability.

Domestic Efforts

Insurance Capital Standards Clarification Act of 2014

First, we would like to thank the Senate for passing the *Insurance Capital Standards Clarification Act of 2014* during the 113th Congress. The statute provides the Board of Governors of the Federal Reserve System with the much needed authority to differentiate regulatory capital requirements between banks and insurers.

Insurance entities should be regulated distinct from other financial institutions, such as banks. Insurance companies operate under different regulatory systems and accounting constructs than

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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other financial institutions. The business models for insurance companies and other financial institutions have important differences in terms of the needs of consumers, the nature of risks transferred, and the timing and certainty of generating profits. Assigning risks to insurers that are not necessarily significant to them could drive changes to their product offerings, impact policyholders in the long-term by impeding competition and creating affordability and accessibility problems, and lead to actions that increase the economic risks to insurers and their policyholders. Furthermore, some risks could be more significant for insurers than other financial institutions, particularly for liabilities that rely on changes to interest rates. As such, applying the same regulations or capital requirements to insurers and other financial institutions, including banks, is not appropriate.

We hope the Subcommittee will work in an expeditious manner to ensure that the Board of Governors of the Federal Reserve System can properly implement this law and the regulations accurately reflect the risks and business models associated with U.S. insurance companies.

Basic Solvency Principles for Capital Standards

Although U.S. insurers are regulated at the state level, the National Association of Insurance Commissioners (NAIC) and the Board of Governors of the Federal Reserve System are individually developing insurance regulations for large U.S. insurers to meet certain group capital requirements. To help guide these regulators, the Academy's Solvency Committee has created a comprehensive set of basic principles that we believe are essential to the development of effective group solvency and capital standards for insurers. Adhering to these principles will help policymakers and regulators create insurance capital standards that are appropriate for the insurance business model and do not negatively impact U.S insurance markets or consumers. These principles include:

1. A group solvency regime should be clear regarding its regulatory purpose and goals. For example, the purpose could be to protect policyholders, enhance financial stability, ensure a competitive marketplace, provide a level playing field, identify weakly capitalized companies, rank well-capitalized insurers, improve risk management practices and procedures, or some combination of the above. The regulatory purpose and goals will aid in the development of a standard itself, the associated regulatory actions, and priorities.

2. Any metrics, information, or other output of a group solvency standard should be useful to all relevant parties, including regulators, management, shareholders, and rating agencies.

3. A group solvency regime should promote responsible risk management in the regulated group and encourage risk-based regulation. For example, a solvency regime should recognize risk-mitigation activities, such as asset/liability matching, hedging, and reinsurance. Actuarial functions are critical in the risk management process and their role should be well defined, as it is in the U.S. reserving and solvency framework. Actuaries can and should identify where factor-based systems could miss emerging risks, set reasonable boundaries around estimates and modeling, and, as appropriate, render actuarial opinions.

4. Methods should recognize and take into consideration the local jurisdictional environments under which members of an insurer group operates, including the local regulatory regime, product market, and economic, legal, political, and tax conditions.

5. A group solvency standard should be compatible across accounting regimes, given the political uncertainties in achieving uniform standards.

6. A group solvency standard should minimize pro-cyclical volatility so as to avoid unintended consequences on insurance groups, insurance markets, and the broader financial markets.

7. A group solvency standard should present a realistic view of an insurance group's financial position and exposures to risk over an agreed-upon time frame.

8. All assumptions used in any capital or solvency model should be internally consistent.

9. It is more important to focus on the total asset requirement than the level of required reserves or capital on a separate basis. The focus should be on holding adequate total assets to meet obligations as they come due. Whether a jurisdictional standard requires the allocation of these assets to liabilities versus capital/surplus should be irrelevant to the overall solvency regime.

10. It must be demonstrated that the capital held is accessible, including in times of financial or economic stress, to the entity facing the risk for which the capital is required.

Last year, the American Academy of Actuaries' Vice President of the Risk Management and Financial Reporting Council, William Hines, provided written testimony[2] on the challenges associated with developing entity-level capital requirements for insurers to the Senate Banking Subcommittee on Financial Institutions and Consumer Protection for the Mar. 11, 2014 hearing on "Finding the Right Capital Regulation for Insurers." This testimony contained an overview of the NAIC's risk-based capital (RBC) requirements, which are currently in effect in the United States.

International Efforts

In addition to the domestic efforts discussed above, the International Association of Insurance Supervisors (IAIS) is developing group solvency and capital standards that could have a profound effect on internationally active insurance groups (IAIGs), including several U.S. insurers. As such, these international capital standards must be created in a careful, transparent, and meaningful manner. Failure to do so may undermine the ability of U.S. insurers to operate effectively and efficiently and could affect the financial stability of U.S. insurance industry.

The Academy's Solvency Committee strongly believes that any international regulations for insurance capital standards must be consistent with the principles for insurance group solvency and capital standards developed by our committee, discussed above. To provide the

[2] http://actuary.org/files/RMFRC_HouseTestimonyHines_031114.pdf.

Subcommittee with a more complete picture of the potential impacts of the IAIS's proposed group solvency and capital standards, please find a summary of the Academy's Solvency Committee's response[3] to the IAIS on its *Risk-based Global Insurance Capital Standard* (ICS) public consultation document, dated Dec. 17, 2014, below.

Comparability

The IAIS's ICS should aim to be compatible across varying jurisdictional accounting regimes (i.e., between countries, states, and other international standards) without requiring a common valuation methodology for determining capital standards. Developing consistent valuation principles is likely to be very challenging and such principles are unnecessary to achieve a risk-based, globally comparable ICS. We note that the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been unable to converge on accounting standards for insurance contracts, as developing a common balance sheet across jurisdictions is fraught with significant challenges. Furthermore, while we agree that it is important for regulators to be able to assess the risks faced by IAIGs, it is unclear whether a single capital ratio or a single risk factor for a similarly labeled product can result in true comparability across national boundaries or different insurance products. For example, the risk in auto insurance in a country with national health care and low incidence of civil litigation is different from the risk in auto insurance in a country without national health care and high levels of claims filed.

Minimize Pro-Cyclical Volatility

The ICS should minimize pro-cyclical volatility so as to avoid unintended and harmful consequences on regulated insurance groups, insurance markets, and the broader financial markets. For example, the business models for U.S. insurers writing long-term business often do not rely on a market-adjusted approach. If such an approach inconsistently adjusts the value of assets and liabilities for changes in credit spreads then, to the extent that the cash flows offset, this would create artificial changes in the capital calculations that are not accurate and could distort and/or hide the real risks that an IAIG might face.

ICS as a Minimum Threshold

The ICS should be a minimum threshold for regulatory intervention. Functionally, a minimum threshold for intervention identifies groups that are financially troubled versus those that are financially sound. By definition, the "minimum threshold" for intervention will be a smaller amount of capital than any additional amount above the threshold that is needed to ensure that a company's capital is "prudent" or "strong." Implementing "target" capital levels above the minimum threshold will make comparisons between insurers and jurisdictions more difficult—particularly considering the differences among insurance markets, products, and lines of business globally—which works against the overarching goal of comparability.

[3] http://actuary.org/files/Solvency_Committee_ICS_Consultation_Response_Final_020615_0.pdf

We note that the ICS does not need to serve as the sole capital requirement in every jurisdiction. Some jurisdictions could impose more stringent group capital requirements and others also may impose capital requirements on a legal entity basis. If it is designed appropriately as a regulatory minimum, the ICS need not override these other requirements. Instead, the ICS can serve as a group-level, globally comparable floor on capital. Local requirements that are more sensitive to the particular features of each jurisdiction can define the amount of any capital that should be held above the floor.

Availability of Capital in Time of Stress

It is important that the ICS is developed in a way that ensures assets are both accessible and available during a stressed situation. If capital is held in the location where the risk resides, then regulators and policyholders can be assured that it will be accessible in a stressed situation. In contrast, if capital is in a different location, then it may not be of use for addressing a stressed situation.[4] This can include situations such as funds subject to currency restrictions and funds held in one jurisdiction, where the regulator in that jurisdiction is unwilling or unable to allow funds to be used in other jurisdictions unless full payment to policyholders or creditors in their jurisdiction is assured.

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Thank you for this opportunity to provide our views on proposed insurance capital rules. Actuaries have worked for many years with insurance and other financial sector policymakers to help develop prudent rules and regulations that address insurer solvency, including capital requirements. Actuarial expertise remains crucial to the creation of international and domestic insurance regulatory and capital standards.

If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

[4] Note that this requires "location" to be defined in terms of regulatory authority, which may include both geographic and sector components.

STATEMENT BEFORE THE U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT HEARING ON "EXAMINING INSURANCE CAPITAL RULES AND FSOC PROCESS" April 30, 2015

Founded in 1931, the National Association of Professional Insurance Agents (PIA) is a national trade association that represents independent insurance agencies and their employees who sell and service all kinds of insurance, but specialize in coverage of automobiles, homes, and businesses. PIA represents independent insurance agents in all 50 states, Puerto Rico, and the District of Columbia. They operate cutting-edge agencies and treat their customers like neighbors, providing personal support and service. PIA members are *Local Agents Serving Main Street America℠*.

Introduction

While perhaps not contemplated at the time, the 2010 passage of the Dodd-Frank Financial Reform Act has had a profound impact on insurance regulation. Under the Dodd-Frank Act, the Financial Stability Oversight Council (FSOC) has the power to designate "systemically important financial institutions" (SIFIs). Designated institutions are subject to regulation and supervision by the Federal Reserve Board. Currently, three insurance companies hold a SIFI designation. Dodd-Frank also transferred regulatory authority over savings and loan holding companies (SLHCs) to the Federal Reserve. This affected a number of insurance companies that are organized as SLHCs. Between SLHCs and SIFIs, the Federal Reserve oversees between one-quarter and one-third of insurance industry assets.

PIA acknowledges the regulatory role that the Federal Reserve Board plays as a consolidated supervisor, but maintains concerns about transparency in the FSOC decision-making process and safeguarding the important part state regulation plays in maintaining competitive markets and protecting consumers.

Concerns Regarding Transparency in the FSOC Decision-making Process

The built-in checks and balances of the state-based regulatory system ensure transparency and accountability. PIA believes the same standards should apply to federal offices and commissions, such as the FSOC; the Federal Insurance Office (FIO); and international organizations, such as the International Association of Insurance Supervisors (IAIS), in which the FIO and Federal Reserve are involved. PIA supports efforts to increase transparency and cooperation, and to ensure that state insurance regulation is afforded appropriate deference in any federal or international decision-making process. PIA supports legislation that would require consultation with Congress, the insurance industry, and consumers with respect to domestic and international insurance standards, negotiations, regulations, or frameworks.

Another area where increased transparency is needed is in the designation and regulation of SIFIs. Currently, three insurance companies are designated as SIFIs. Troublingly, the SIFI designations occurred before the increased regulations that designated companies would face were fully established.

To that end, PIA supported the December 2014 passage of the Insurance Capital Standards Clarification Act (P.L. 113-279). PIA appreciates Congresses bipartisan actions to ensure that insurance companies can be regulated based on their unique risk profiles. With the passage of P.L. 113-279, the Federal Reserve should focus on working with the public to draft proper standards for insurance companies that are now under its supervision.

Furthermore, Congress must work with the FSOC to establish a process by which SIFI designations can be removed. Dodd-Frank did not intend for SIFI designations to be permanent and unless a process is established for removal SIFI designations are effectively permanent. Failing to establish a clear exit path for SIFIs could have an adverse effect on the competitiveness and stability of state insurance markets.

Safeguarding State Regulation

For over 150 years the state-based system of insurance regulation has worked, successfully protecting consumers and creating a competitive and diverse U.S. insurance market. PIA supports a deliberative, cooperative, and consultative approach to insurance regulation between state and federal officials. Overlapping state, federal, or international regulations will generate an additional burden on the industry, raising consumer costs with no coordinating increase in consumer protections.

PIA has endorsed S. 798, the Policyholder Protection Act, which would better empower state insurance regulators to protect policyholders in their state by ensuring that insurance companies structured under larger financial firms are not held financially responsible for an affiliated bank's failure or financial crisis. Furthermore, S. 798 ensures that state regulators, and not the Federal Deposit Insurance Corporation (FDIC), have the power to appropriately manage a troubled insurer for the best interest of policyholders.

Conclusion

PIA supports state insurance regulators as the primary regulators of insurance. State regulation has served the insurance industry and consumers well for over one hundred years. Any attempt to increase federal regulation of insurance is inappropriate and would negatively impact policyholders. PIA urges Congress to ensure that the FSOC and the Federal Reserve operate in a transparent manner in consultation with state regulators. PIA looks forward to continuing our engagement with Congress on these important issues in the months ahead and thanks the committee for holding this hearing today.