American Insurance Association

THE FINANCIAL SERVICES ROUNDTABLE

Financing America's Economy

Statement by

Leigh Ann Pusey

President & CEO

American Insurance Association

in coordination with

Financial Services Roundtable

before the

Committee on Financial Services

Subcommittee on Insurance, Housing and Community Opportunity

United States House of Representatives

July 28, 2011

Good morning. Chairman Biggert, Ranking Member Gutierrez and other members of the Committee. Thank you for the opportunity to testify on behalf of the American Insurance Association (AIA), in coordination with the Financial Services Roundtable (Roundtable), on key issues facing the insurance industry in the wake of the global financial crisis. My name is Leigh Ann Pusey, and I am the President and Chief Executive Officer of AIA.

AIA represents approximately 300 of the nation's leading insurers that write more than $117 billion in premiums each year. Our 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. The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer.

Our member companies, as well as the members of the Roundtable, have a significant interest in the insurance issues being discussed before the Committee today, and the policy implications of those issues. While we are active in the implementation of many of these policy discussions, I would like to use my time today to focus on a few key priorities that are emerging from the confluence of regulatory reform discussions occurring at the international, federal, and state levels. Further, within these priorities, I would like to highlight the important role that the Federal Insurance Office (FIO), created under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), can play in keeping U.S. insurers competitive, preserving the viability of the U.S. insurance regulatory system, and furthering the growth of free and open insurance markets around the world. My focus on the FIO's key role, particularly in the international arena, is intended to complement the good work of the state regulators and of the National Association of Insurance Commissioners (NAIC). They have been instrumental in explaining the strengths of U.S. financial regulation of insurers. My recommendations today are intended to emphasize the important unifying mission that is outlined for the FIO in the Dodd-Frank Act. If the FIO functions as statutorily intended, the U.S. government and the state regulators will be able to present a national voice on international insurance matters.

In this context, I would like to spend the balance of my time today on three international regulatory priorities and a domestic regulatory priority for AIA and the Roundtable. First, while the domestic implementation of the Dodd-Frank Act is at the forefront of our agenda and occupies a great deal of time and resources, we have a joint stake in ensuring that the process for designating, supervising and resolving so-called "global systemically important financial institutions" – or G-SIFIs – is fair, open, transparent and, above all, does not overtake U.S. regulatory efforts to implement parallel provisions of the Dodd-Frank Act.

Second, we share common ground in ensuring that our state-based insurance regulatory system is viewed as equivalent to the European Union's Solvency II initiative, even if the standards that are utilized are not identical.

Third, we have a mutual interest in broadening market access, reducing trade barriers, and ensuring that regulatory initiatives do not impair private markets.

Finally, we believe that new restrictions in the Dodd-Frank Act, such as the Volcker Rule, should address gaps in current regulation and perceived high-risk activities; and not supplant existing bank or insurance regulation.

THE FINANCIAL CRISIS AND ITS GLOBAL IMPLICATIONS FOR INSURANCE

It is critical to note the insurance industry emerged from the recent financial crisis safe and strong. The resilience of insurance throughout the crisis is a testament to the insurance industry business model and its supporting regulatory structure – a combination that has yielded low-leveraged businesses that maintain conservative investments and are focused on safety and soundness. Accordingly, it is imperative to maintaining the strength of our business that regulators – both here and abroad – appreciate the unique nature of the industry when developing new rules.

AIA has led U.S. property-casualty industry efforts to engage at the international level amidst wide-ranging proposed global financial standards intended to prevent or mitigate the next financial crisis. For many years, we have worked cooperatively with the International Association of Insurance Supervisors (IAIS), the NAIC, the Organization for Economic Cooperation and Development (OECD), Treasury, Congress, and European Union instrumentalities on a number of important international insurance regulatory and trade fronts.

This overarching global debate over emerging financial regulation impacts all companies, whether or not they are engaged in markets outside the U.S. The plain truth is that such regulation – done hastily or without due regard to the insurance business model and national regulatory standards that embrace that model - may increase regulatory risk at the expense of private markets. We have grave concerns that the consequences of misguided regulation at an international level could yield: (a) less competition for U.S. insurers; (b) an erosion of sound, flexible regulatory standards; (c) private markets with a declining number of consumer product and company choices; and (d) duplicative, contradictory regulatory standards with the potential for regulatory gaps and confusion. Under a worst case scenario, significant shifts in the regulatory framework could make it difficult for insurers to enter or remain in insurance markets, threaten the solvency of companies by siphoning away additional capital, reduce insurance availability, or push more consumers into insurance residual markets.

Solvency II

In the U.S., the NAIC launched its Solvency Modernization Initiative (SMI) in 2008. The SMI covers five broad areas: Statutory Accounting, Reinsurance, Capital Requirements, Group Supervision, and Corporate Governance/Risk Management.

At the global level, regulatory framework changes are being debated in a variety of arenas, but have been driven by the EU's Solvency II initiative – an effort that began prior to the global financial crisis, but which shifted direction following the crisis. Solvency II is not simply a financial regulatory initiative, but a comprehensive restructuring of capital requirements, risk management measures, disclosure and reporting standards, and group-wide requirements and supervision. Many of the elements at the core of Solvency II have also migrated to the IAIS in the form of proposed new IAIS Insurance Core Principles (ICPs), which could provide extensive new authority to every insurance supervisor at the national level in countries that adopt the ICPs in legislative form. This may lead to the same types of adverse regulatory consequences that we could face if Solvency II concerns are not resolved.

The major work product under both the SMI and Solvency II has been developed in the area of group supervision. Domestically, the NAIC has focused on revisions to the model insurance holding company law and regulation, which the NAIC wants to use to provide U.S. insurance regulators with more information about the activities and risks of the broader group outside of the insurance entity. The group supervision standards here and abroad reflect the differences in regulatory approach between the U.S. and the EU. Solvency II also contains an external component – the third-country equivalence process – that has been the principal source of pressure on the U.S. and the state-based insurance regulatory system. Under Solvency II, non-EU countries have been invited to become "equivalent" jurisdictions in terms of their regulatory treatment of reinsurance, group solvency calculation, and group supervision. The consequences of a negative equivalence determination, including having to meet solvency requirements absent the capital from U.S. operations, are potentially severe both for U.S. insurers doing business in European Economic Area (EEA) countries and for EEA-based insurers with U.S. operations. The European Commission earlier announced that the United States would not be included in the first wave of countries assessed for equivalence. However, any implications of a negative equivalence determination might be suspended for up to 5 years, but subject to specified transition measures. During this period, the U.S. will be evaluated as to its progress towards convergence with the Solvency II approach.

The pressure being applied through the Solvency II equivalence process is being reinforced by the International Monetary Fund (IMF), which conducts periodic examinations of national regulatory systems, effectively grading those systems under its Financial Sector Assessment Program (FSAP), using the ICPs as global insurance regulatory measures. The U.S. insurance regulatory system is purportedly scheduled for an FSAP evaluation in 2012.

AIA's concerns with the Solvency II initiative stem from three principal sources: (a) the competitive consequences of a negative third-country equivalence determination for those companies with U.S. insurance operations: (b) potentially unworkable financial regulatory standards to be adopted in the U.S. as a result of the Solvency II process; and (c) new layers of added regulatory burden that may further stress the ability for insurers to do business. This regulation can take many forms, including unnecessarily high capital requirements and new reporting mandates, controls over internal operations of well-functioning insurers, and other supervisory measures that could add dramatically to costs while adding little to consumer benefits. Often, these mandates arise out of the failure to recognize the unique, strong and successful business model of insurance, which differs significantly from other sectors.

Global Systemically Important Financial Institutions

Separate and apart from Solvency II and similar initiatives, the crisis itself generated the debate about systemic risk and the heightened supervision that should apply to financial institutions that present such a threat. The debate in the U.S. yielded the Dodd-Frank Act, which addresses four different regulatory aspects of systemic risk: (1) monitoring the activities of financial institutions; (2) the process of designating “systemically important” financial institutions (SIFIs) for heightened federal prudential supervision; (3) the prudential regulatory standards applicable to SIFIs; and (4) the orderly resolution of failing SIFIs.

At the international level, the Financial Stability Board (FSB) was designated by the G-20 to coordinate global financial services regulatory activities to prevent future crises. The FSB has directed IAIS to report on which insurers should be designated as G-SIFIs. IAIS has also incorporated the notion of systemic risk into its new ICPs. To respond to the FSB, IAIS has proposed a data collection program to determine the extent to which insurers may be engaged in non-core activities.

There are a number of dangers associated with the premature designation of G-SIFIs. First, for companies that are screened under this process, any public mention of a screened company or confidential data could compromise the company’s competitive position and risk the public disclosure of financially-sensitive information. Further, to the extent that the company is misidentified as a G-SIFI, the business reputation of the company could be put at risk. Second, to the extent that the G-SIFI process outpaces the substantive implementation of the parallel Dodd-Frank Act provisions in the U.S., the outcome of the international determination could unduly and unfairly influence the SIFI determinations here. Third, the factors utilized and the standards developed could vary, meaning that an insurance company could be scrutinized differently in the U.S. and internationally. Inconsistencies could be exacerbated, as legislatures and regulators adopt varied standards in different nations. The process is intended to regulate shadow financial activities that amass and concentrate risk across financial sectors in those companies that engage in those unregulated activities, not those that spread risk and diversify exposure according to business models and regulation that prevent customer runs on the institutions.

Trade and Market Access

As important as they are, Solvency II and the G-SIFI process are not the only international challenges for U.S. insurers. Barriers to market access, usually through regulation, continue to be a major issue for insurers. Annually, U.S. property-casualty insurers are deprived of nearly $40 billion annually in premium, and related jobs, due to foreign barriers to trade, according to the U.S. International Trade Commission in its 2009 report, Property and Casualty Insurance Services: Competitive Conditions in Foreign Markets.

Examples of regulatory barriers include undue difficulty in opening local offices, controls on geographic expansion, and restrictions on product offering. One example is a government limit on the amount of foreign reinsurance. Yet another example is the constant danger of government-backed insurers unfairly profiting from cultural advantages and/or not being subject to regulation of the kind imposed on insurance companies.

We are strong supporters of the three pending free trade agreements. They include good language on regulatory transparency, consultation, and unfair competition from government-controlled insurers. Once in effect, they should open important markets with large growth opportunities for U.S. insurers.

<u>THE FEDERAL INSURANCE OFFICE AND U.S. GOVERNMENT PARTICIPATION INTERNATIONALLY</u>

In each of these discussions – whether they involve Solvency II, the G-SIFI process, market access, or other critical international insurance issues - it is vitally important for the FIO to be at the table alongside other key representatives providing a unified national voice. Congress envisioned this role for the FIO when it authorized the office "to coordinate Federal efforts and develop Federal policy" on prudential international insurance matters, represent the U.S. before the IAIS, assist the Treasury in negotiating bi-lateral or multi-lateral insurance agreements on prudential issues, and to make recommendations to the FSOC regarding SIFI designations involving insurers. (See 31 U.S.C. § 301 note – Federal Insurance Office Act of 2010 [§ 313(c)]). The Dodd-Frank Act has outlined a complimentary role for the FIO on the international stage, serving as a bridge to the state-based regulatory system.

<u>VOLCKER RULE</u>

We believe that Congress did not intend Bank-Owned Life Insurance (BOLI) contracts to be subject to the restrictions and prohibitions of the Volcker Rule. While this exclusion of BOLI contracts from the reach of the Volcker Rule is clear for BOLI contracts supported by an insurer's general account or by a separate account of the insurer that is registered with the SEC, the analysis with respect to other BOLI (*e.g.*, private placement separate account BOLI products) may be less clear. With respect to such products, we believe that any similarity between BOLI and traditional hedge funds and private equity funds is largely restricted to the fact that all rely on the exemptions under 3(c)(1) or 3(c)(7) of the Investment Company Act. Banking entities purchase BOLI insurance policies as a tax effective means to manage the risks associated with employee benefit obligations. Applicable banking supervisory guidance prohibits the purchase of BOLI for speculative purposes[1] and establishes a number of requirements that must be fulfilled by the purchasing bank entity, including rigorous, continual oversight of such policies by the banking entity's senior management. The guidance also requires that the assets in a BOLI separate account be invested in bank-eligible securities, with an exception for certain non-bank-eligible investments that act as a hedge against existing obligations of the banking entity. Insurance and tax laws also dictate requirements affecting this product. Further, the insurance and tax law requirements applicable to a BOLI separate account mean that a banking entity does not, and cannot, own or control the assets in the separate account and cannot make investment decisions regarding the individual assets in a separate account.

The BOLI insurance structure is dependent upon an insurance company establishing a "separate account" on its books to support each BOLI policy. Insurance company separate accounts are used to hold portfolios of securities that are dedicated to supporting specific variable insurance contracts (while all other insurance company assets not held in such separate accounts are held in the "general account" and support the insurance company's general insurance and other liabilities). The separate account structure is attractive because assets held in a separate account are not available to satisfy the general creditors of the insurance company. In

[1] Interagency Statement on the Purchase and Risk Management of Life Insurance (2004) (the "Interagency Guidance") (generally imposing restrictions on banks and savings associations with respect to the purchase and use of life insurance; specifically requiring, *inter alia*, that banks and savings associations not purchase life insurance for speculation and that banks and savings associations have a comprehensive risk management process for purchasing and holding life insurance).

the event of an insurance company failure, any assets in a separate account supporting a BOLI policy cannot be used to satisfy general creditors' claims against the insurance company. To achieve the tax deferral benefit for the increase in value of the assets in a separate account supporting a BOLI policy, the purchasing banking entity may not exercise investment control over the assets in the separate account, and the variable insurance policies are structured to prevent investment control by the policyholder. The courts however, have determined that the separate account itself is an "investment company" and therefore the separate account either must be registered as such with the SEC or rely on an exemption from registration under the Investment Company Act. The separate account that supports a BOLI policy will generally rely on either the 3(c)(1) or 3(c)(7) exemption under the Investment Company Act, and hence the separate account technically meets the definition of a hedge fund or private equity fund for purposes of the Volcker Rule.

Beyond the separate account's reliance on the 3(c)(1) or 3(c)(7) exemptions, however, BOLI bears no resemblance to the traditional hedge funds or private equity funds that the Volcker Rule is intended to police.

First, as noted, existing bank regulatory guidance prohibits the purchase of BOLI policies for speculative purposes.[2] It also prohibits depository institutions from holding life insurance in excess of their risk of loss or cost to be recovered, requires investments in separate accounts to comply with the limits on bank eligible investments (with the minor exception for certain equity investments reflecting a very high degree of correlation used to hedge specific equity-linked obligations under an employee benefit plan), and limits the cash surrender value of BOLI to be

[2] Interagency Guidance at 2.

25% or less of capital.[3] Management must approve the purchase of BOLI policies and exercise regular oversight over their operation, performance and fulfillment of bank regulatory requirements.[4]

Insurance law provides that a banking entity purchasing an insurance policy supported by a separate account does not have a legal ownership interest in the separate account; rather the assets of the separate account are considered assets of the insurance company (and, as noted above, the assets are insulated from claims of the insurance company's general creditors).

Finally, under applicable tax law, once a BOLI policy is established, a policyholder cannot exercise investment discretion over the assets in the separate account; if a bank entity policyholder did so, it would be subject to severe negative tax consequences (basically by forfeiting the economic benefit of the policy).[5] The fact that the BOLI policyholder does not exercise investment discretion over the underlying assets supporting the policy makes it difficult, if not impossible, for the policyholder to take on excess risk through the policy itself, which stands as further evidence that BOLI lacks the attributes of a mechanism for evading the Volcker Rule.

In sum, because BOLI accounts do not have any of the attributes that give rise to the same concerns as the hedge funds and private equity funds that the Volcker Rule was meant to restrict, neither the insurance company separate accounts that support BOLI variable insurance contracts nor the insurance contracts themselves should be deemed hedge funds or private equity funds for purposes of the Volcker Rule.

---

[3] *See generally* Interagency Guidance.
[4] *Id.*
[5] *Id.* at 13.

CONCLUSION

The insurance industry emerged from the financial crisis in a strong position with capacity to expand and there is rapidly growing demand for more insurance from many parts of the world. Today, despite the industry's outlook, we face regulatory issues on the international stage that may challenge our way of doing business and the regulatory structure that defines that business model. Now, more than ever, we need the combined strength of the U.S. government and state regulators, working together, to allow the U.S. industry to compete on a level playing field globally and to promote new market opportunities. Thank you again for the opportunity to testify, and I would be happy to answer any questions.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Leigh Ann Pusey	American Insurance Association and FSR
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: Leigh Ann Pusey	

Please attach a copy of this form to your written testimony.