STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

SUBCOMITTEE ON HOUSING AND INSURANCE

OF THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

ON

THE FEDERAL INSURANCE OFFICE'S REPORT ON MODERNIZING INSURANCE REGULATION

February 4, 2014

Statement Made by
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Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee, my name is Gary Hughes, and I am Executive Vice President and General Counsel of the American Council of Life Insurers ("ACLI"). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. These companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums.

ACLI appreciates the opportunity to provide you with its views on the report of the Federal Insurance Office ("FIO") entitled, *"How to Modernize and Improve the System of Insurance Regulation in the United States."* We believe the report presents a generally fair and balanced picture of the present state-based insurance regulatory system and the challenges it faces. In addition to serving as a comprehensive outline of insurance regulation in the U.S., the report highlights a number of issues that are of importance to the ACLI and its member companies, particularly those issues dealing with emerging capital standards in the U.S. and abroad.

Regulatory Change Affecting Life Insurance Companies

The focus of our testimony today is on regulatory change affecting the life insurance industry, the challenges this change presents to insurance companies and the role of the FIO in this context. During the pendency of the Dodd-Frank Act, ACLI advocated for the creation of the FIO. As regulatory initiatives unfold both here and abroad, we believe more strongly than ever that a unified, effective federal voice – working collaboratively with state insurance regulators – is essential to ensure that the U.S. insurance regulatory structure is one that is effective, fair and fosters a healthy and vibrant U.S. insurance marketplace for all companies regardless of corporate form or ownership structure.

Life insurance regulation is experiencing unprecedented and rapid change. The Dodd-Frank Act resulted in the Federal Reserve Board assuming a significant regulatory role with respect to those life insurers that are designated as systemically important as well as those controlling thrifts. At the same time, the Financial Stability Board ("FSB") is pressing the International Association of Insurance Supervisors ("IAIS") to impose group capital and supervisory standards on internationally active life insurance groups. Taken together, these initiatives directly affect approximately 60% of the direct premiums of ACLI member life insurance companies. Put differently, in the very near term a large segment of the life insurance industry will have aspects of its capital structure either dictated or materially influenced by entities other than state insurance regulators.

Add to this the fact that the European Union ("EU") is scheduled to implement its own modernization of insurance capital standards through Solvency II. And of course the states are contemplating how best to respond to these pressures from at home and abroad. Simply put, life insurance regulation in the U.S. can no longer be viewed as a purely domestic matter. If the capital standards developed by the states, the Federal Reserve, the IAIS and the EU are not generally consistent, the resulting competitive disparities will disrupt the U.S. and global life insurance marketplace and present significant opportunity for regulatory arbitrage.

Our perspective on the future of insurance regulation and on the importance of working constructively with the IAIS and other international standard-setting bodies may be somewhat unique among those testifying today, but understanding the diversity of our membership will illustrate why we believe this is critical and why we believe the FIO, as outlined in its report, has an important role to play in this regard. Two of our member companies have been designated as Systemically Important Financial Institutions ("SIFIs"). One additional company is under review for possible designation. Twelve of our member life insurers own thrifts and, like SIFIs, will be subject to whatever prudential standards the Federal Reserve decides to impose. At a minimum, we believe eighteen of our member companies are Internationally Active Insurance Groups (three of whom have been designated as Global Systemically Important Insurers) and at some point may be subject to the group capital and group supervision standards developed by the IAIS with direction from the FSB. Fifty-five of our member companies with major operations in the U.S. and representing 22% of total U.S. assets have foreign parents and consequently must also comply with the capital and supervisory requirements of their home countries. We also have a number of large and small member companies that do not fall into any of these categories but are legitimately concerned that whatever standards are developed and applied to the above companies may eventually migrate to them.

As an industry that until very recently had its core solvency standards set and administered exclusively by the states, post Dodd-Frank we have experienced a general lack of understanding of our industry by federal regulators and policymakers now involved in our business. This lack of understanding is most evident with respect to the unique characteristics of a life insurers' financial structure and the tools state insurance regulators employ to assure company solvency (e.g., insurance statutory accounting versus GAAP accounting). While the Federal Reserve and other federal regulatory bodies continue efforts to enhance their understanding of the more technical underpinnings of our business, the knowledge gap remains a significant impediment to dealing effectively with issues such the appropriate calibration of new capital standards. All too often, federal regulators tend to view these issues through the lens of those with whom they are most familiar - - commercial banks. As we have pointed out repeatedly, one cannot appropriately apply bank capital standards to a life insurance company. To do so would substantially and unnecessarily disrupt insurers' fundamental business model, including the products they make available to provide consumers with life and longevity protection and retirement security.

We believe the FIO will be invaluable in helping fill the life insurance knowledge gap in Washington given the fact that a fundamental part of the office's statutory mission is to be the federal repository of information on insurance regulation. Over time, the FIO will be a more and more valuable resource for other federal regulatory agencies that now have some interest or responsibility with respect to the insurance industry and its regulation. The office will also be well positioned to interact with the NAIC, the states, the FSB, the IAIS, the EU and other international standard-setting bodies as global capital and supervisory standards evolve. And that evolution must occur on a rational and consistent basis in order to avoid major disruption and competitive inequities in the U.S and global markets. That will not happen absent strong advocacy by the FIO, the states and the industry working in concert and toward common objectives.

The states and the current insurance regulatory system served the industry well during the recent financial crisis. Indeed, insurers fared better than most other segments of financial services. That fact alone, however, does not lead to the conclusion that it is in the best interests of state insurance regulators and the U.S. insurance industry to simply stand pat and oppose federal and international initiatives to change the current insurance regulatory system. It would certainly be desirable if the rest of the world coalesced around the U.S. insurance regulatory model. But in light of Dodd-Frank and ongoing global regulatory initiatives, significant change to our insurance regulatory system is inevitable. Today's reality is that mere defense of the status quo is no longer a viable option. We look forward to the FIO being a constructive part of the global dialogue on insurance regulation, and we strongly encourage the FIO to coordinate closely with state insurance regulators as this process moves forward.

Federal Reserve Holding Company Capital Requirements

One aspect of evolving capital standards is of immediate concern to life insurers. As this Subcommittee is aware and as noted above, a number of life insurers are facing the application of holding company capital standards by the Federal Reserve due to their status as depository institution holding companies or designation as non-bank SIFIs. It is imperative that any holding company capital requirements applied to a life insurance enterprise be based on life insurer business models and life insurer risk-based capital principles, and not on a capital regime developed for and appropriate to commercial banks.

As we have noted repeatedly to Congress and various federal agencies, the life insurance business is fundamentally different then the banking business. Life insurance companies have significantly different business and risk profiles and capital structures than those of banks. Life insurers provide coverage to customers for their long-term risks, and their regulation requires them to match those long-term, illiquid liabilities with appropriate assets to ensure that those liabilities can be met. Current life insurer capital requirements directly reflect the level to which an insurer has matched the duration of its assets to the duration of its liabilities. This business model is fundamentally different than that of banks, where assets and liabilities are not matched and where the institutions are more dependent on short-term, on-demand funding, and are thus potentially subject to a "run" in periods of stress. Banking capital requirements implicitly assume this inherent mismatch.

The business models, risk profiles and capital structures of life insurers and banks are so divergent that it would be incongruous to attempt the application of a single, one-size-fits-all capital standard to both. Unfortunately that is the scenario we continue to face due the Federal Reserve's interpretation of certain provisions of the Dodd-Frank Act. The issue here is not whether these particular life insurance companies oppose being subject to enhanced prudential standards. They have accepted the fact that they will be. The issue is whether it makes any sense whatsoever to impose ill-fitting, unsuitable capital standards to these enterprises and in so doing disrupt their business. The whole purpose of these provisions of the Dodd-Frank Act is to stabilize the U.S. financial system. Disrupting the operations of well-run life insurance companies is completely at odds with that purpose and should not under any circumstances be permitted to occur.

I would like to express our appreciation to Congressman Gary Miller and Congresswoman Carolyn McCarthy for introducing H.R. 2140, a bill that would amend the problematic provision of the Dodd-Frank Act and allow the Federal Reserve to develop and implement appropriate, insurance-centric capital standards for those life insurers under its jurisdiction. Similar legislation has been introduced in the Senate by your colleagues Senators Brown and Johanns, and we look forward to working with both houses of Congress on these important pieces of legislation.

Uniformity of Insurance Regulation

We fully agree with a central theme of the FIO report regarding the need for greater uniformity in state insurance regulation. Lack of uniformity was the primary impetus for the ACLI some 15 years ago to redouble its efforts to bring uniformity to the state system and embrace the concept of an optional federal charter. And as the report notes, Congress has entertained measures over the years to incent the states to regulate on a more uniform basis in areas such as market conduct, producer licensing, reinsurance and receivership. Of course, a regulatory construct with 56 separate jurisdictions presents inherent challenges in this regard. While the states have achieved a high degree of uniformity with respect to solvency standards through the National Association of Insurance Commissioners ("NAIC") Financial Regulation Standards Accreditation Program, uniformity in other areas is still lacking. This leads to inefficiency and unnecessary costs that are ultimately passed along to consumers. ACLI remains open to congressional initiatives that would foster a more uniform and consequently more efficient system of insurance regulation.

NAIC Governance

We noted with interest the recommendation in the FIO report calling for "an independent, third-party review mechanism" to oversee the NAIC's financial accreditation program. The accreditation program is intended to provide uniform insurer solvency oversight in all jurisdictions and, as noted above, has largely achieved its desired goal. The program is one of a number of activities of the NAIC intended to make regulation more uniform between and among states, and to be clear, the industry has historically encouraged these initiatives in the interests of regulatory efficiency. However, as the number and importance of these programs has grown, it has become increasingly clear that some form of administrative due process and accountability is necessary. Certain standards in the NAIC's accreditation program essentially have the force and effect of law without any further meaningful action by the states, thus sidestepping otherwise applicable state administrative procedure statutes. No other state or federal body that functions in these capacities does so without predictable, formally stated and statutorily mandated administrative due process. The NAIC's role in the development of model laws and regulations that are in turn passed along to the states for implementation is not similarly problematic, since in those instances state administrative procedure acts will be triggered and will provide necessary due process and accountability.

This is not an easy matter to address given the unusual relationship between the NAIC, state insurance regulators and the insurance companies the states regulate. The NAIC is a membership organization comprised of state insurance commissioners. Insurance companies are not members of the NAIC nor do they have administrative rights with respect to the organization. But these companies are directly and significantly affected by decisions made by the NAIC in those instances in which the states have delegated responsibilities to the NAIC. ACLI has broached this concern with the NAIC and intends to work with the NAIC and the states to address the issue.

Captive Reinsurance Transactions

The FIO report discusses the issue of captive reinsurance transactions, and this is a matter of particular significance to life insurers. These arrangements are typically used to finance a portion of the statutory reserves companies are required to set aside when they issue term life insurance or universal life insurance with secondary guarantees. While we do not agree with some of the pejorative language in the report describing these transactions and their operation, we do agree with the report's recommendations that captive reinsurance arrangements be subject to uniform standards to enhance transparency as well as uniform standards for evaluating the assets backing these arrangements.

For well over a year, the ACLI has been working with the states to address issues surrounding the regulation of captives. Last February we provided the NAIC with extensive suggestions for making captive transactions more transparent. We have also provided the NAIC with detailed suggestions for qualitative guidelines designed to enable regulators in all jurisdictions to evaluate proposed and ongoing captive arrangements on a consistent and uniform basis. In addition, we are currently working with the NAIC on the development of uniform quantitative standards that regulators can use to assure that captive reinsurers have assets that appropriately back both reserves and capital.

Captive reinsurance is an example of the challenges state insurance regulators are experiencing in today's environment. Not all states view captives and their regulation the same, and consequently there is not yet agreement among regulators regarding how the oversight of these arrangements should be handled. As the FIO report notes, it is often difficult to get multiple jurisdictions to agree on a common approach to regulatory issues. And while there is a clear consensus among life insurance companies on how the regulation of captives could be enhanced, there is not unanimity.

Unfortunately, slow movement on a final regulatory outcome on captives is giving rise to unprecedented scrutiny of these arrangements by a variety of nontraditional entities. In addition to the interest in captives expressed by the FIO, the following groups have involved themselves in the issue: the Federal Reserve; individual Federal Reserve banks; the Financial Stability Oversight Council; the Office of Financial Research, the Securities & Exchange Commission; the Federal Housing Finance Agency; and the FSB. In the final analysis, only the states have the statutory authority to address how the regulation of domestic captives will be addressed. But because we now exist in a global environment, the time it takes to resolve these types of issues becomes a much more important consideration. If regulators and standard setters other than the states perceive undue delay in addressing significant issues, they can now be expected to insert themselves into the details of how our business is regulated.

We are confident the states will take the steps necessary to improve the transparency and uniformity of the way in which capitve reinsurance transactions are regulated, and we encourage them to act as expeditiously as possible to bring this matter to an appropriate conclusion. We also encourage the FIO to be supportive of the states as this work moves forward.

Agent and Broker Licensing

Making the licensing process for insurance agents and brokers more efficient has long been a goal of the ACLI and its member companies. A particular concern has been the implementation of an efficient state system enabling agents and brokers to hold multi-state licenses. We applaud the House for passing H.R. 1155, the National Association of Registered Agents and Brokers Reform Act of 2013. This bill would provide a framework for uniformity and efficiency in agent and broker licensing requirements. A similar measure (S. 534) has passed the Senate Banking Committee, and we look forward to working with both houses of Congress to complete work on this initiative.

Reinsurance Collateral

The FIO report recommends that the Treasury Department and the United States Trade Representative pursue a bilateral or multilateral agreement among countries that the Dodd-Frank Act called a "covered agreement." Negotiating such an agreement with one or more countries could be the first step in a process to make state laws on reinsurance collateral more uniform. Such uniformity would be based on the framework and language unanimously endorsed by the NAIC. We support that recommendation. We also support the efforts of state insurance regulators, within the U.S.- EU Dialogue Project and under the FIO's leadership, to achieve a consistent approach within each jurisdiction and to examine further constructive improvements to each jurisdiction's treatment of reinsurance and reinsurers.

Conclusion

The FIO report is a balanced and thoughtful critique of the insurance regulatory framework, and we hope it serves as a catalyst for constructive discussion on how that framework can be improved. Given the rapid and unprecedented change under way with respect to how insurance will be regulated in the United States and around the globe, we continue to believe the FIO is well positioned to play a critical role in advocating for a regulatory structure that fosters a competitive and vibrant life insurance marketplace. We encourage the FIO to strengthen its relationship with the states to assure that emerging capital standards both here and abroad are firmly grounded in proven insurance-centric principles and treat all companies fairly regardless of their corporate or ownership structures. And we encourage the FIO in the strongest terms to work with the House and Senate to pass urgently needed legislation amending the Dodd-Frank Act to permit the Federal Reserve to impose insurance-oriented holding company standards on those life insurance enterprises under its jurisdiction.