Testimony of the
National Association of Insurance Commissioners

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Community Opportunity
Committee on Financial Services
United States House of Representatives

Regarding:
"Insurance Oversight: Policy Implications for U.S. Consumers,
Businesses and Jobs"

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Introduction

Chairman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee, thank you for the opportunity to testify today. My name is Susan Voss, and I am Commissioner of Insurance for the State of Iowa. I am here as President of the National Association of Insurance Commissioners (NAIC), and I present this testimony on behalf of that organization. Specifically, I am here to provide an overview of recent insurance regulatory activities, including the NAIC's continued response to the recent financial crisis.

The past few years have seen an understandable flurry of activity in the financial regulatory arena. Lawmakers and regulators here and abroad have engaged in the monumental task of enhancing authorities to better monitor and police financial markets, curtail activities that pose risks to the broader financial system, and address "too big to fail" financial institutions. In addition to interacting with our federal and state counterparts charged with implementing reform for banking and securities entities, insurance regulators have recognized that regulatory enhancements can and should be made to ensure that the positive track record of state-based insurance regulation continues in an increasingly complex and global marketplace. I am happy to be before you today to describe various ways in which the states have stepped up to these challenges.

My testimony today will focus on three broad areas. First, I will explain how state insurance regulators are working with federal legislators and regulators on the federal activities undertaken in response to the financial crisis; namely, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Next, I will discuss separate activities that the NAIC has undertaken in response to that crisis. Finally, I will highlight some processes that we are engaged in with an eye toward the future of insurance regulation around the world.

Responding to the Dodd-Frank Act

At its core, the Dodd-Frank Act acknowledges the differences between insurance and other financial products, as well as the strength of the state-based insurance regulatory system. Title II of that statute authorizes the Federal Deposit Insurance Corporation (FDIC) to resolve systemically risky companies that are in financial distress, but requires that insurance companies be resolved pursuant to state law. Title V creates a Federal Insurance Office (FIO) to provide the federal government with information regarding insurance and to negotiate certain international agreements, but preserves the states' authority to regulate and supervise insurance. The Act authorizes implementation of a Volcker Rule that seeks to curb proprietary trading at banks and non-bank systemically important financial institutions (SIFIs), but provides an exception for insurance company investments for general accounts. Title X creates a bureau of consumer financial protection, but excludes insurance from its jurisdiction and ensures that the power of protecting insurance policyholders remains with the states.

To date, the state insurance regulators through the NAIC have provided input on four main areas of Dodd-Frank implementation: 1) the Financial Stability Oversight Council (FSOC); 2) Orderly Resolution; 3) Derivatives Regulation; and 4) Surplus Lines and Reinsurance. We are also monitoring three other areas very closely: 1) the implementation of the Volcker Rule; 2) the Federal Reserve's new authorities to oversee SIFIs and Thrift Holding Companies; and 3) the development of the Federal Insurance Office.

<u>Financial Stability Oversight Council</u>

The state regulators are represented on FSOC through John Huff, who was appointed through the NAIC to serve as a non-voting member on the panel. As you know, FSOC has the authority to designate non-bank financial institutions, including insurance companies, for heightened supervision by the Federal Reserve. Through Director Huff, the NAIC has been working to educate all FSOC members on the fact that core insurance activities are different from other types of financial activities and don't pose systemic risk. At the same time, we also recognize that unregulated affiliates or other large scale non-insurance related activities could pose such risks and might create a basis for such designation.

This effort has been complicated by the scarcity of insurance representation on the Council up until very recently. Although FSOC is required to consult with the functional regulators of any institutions being considered for systemic oversight, at that point in the process critical decisions about insurance will have already been made. There is ongoing work to develop appropriate criteria, and judgments about the insurance industry are being made that would benefit from more input from insurance regulators. The NAIC remains hopeful that this challenge will improve with the addition of one of our former colleagues, Mike McRaith, as FIO Director, as well as with the addition of recently-nominated Roy Woodall as the insurance expert and only voting member on insurance issues on FSOC. However, it is important to note that Director Huff will remain the sole active insurance regulator on FSOC, and his need to consult with his fellow insurance regulators on confidential issues impacting insurance remains a concern for the state regulators.

Orderly Resolution

The NAIC has been actively engaged with the FDIC on its new orderly resolution authorities under Title II. The NAIC's Dodd-Frank Receivership Implementation Working Group is composed of insurance receivership regulatory experts and is charged with examining the impact this new regime may have on existing state insurance receivership processes. As part of this effort, we are considering a new draft chapter to be added to the NAIC Receivers' Handbook: "Procedures for Prompt Initiation of State Receivership under Dodd-Frank." It is believed that this addition will establish procedures at the state level to ensure the state receivership mechanism will respond effectively to a receivership arising from a systemic failure.

The Dodd-Frank Receivership Implementation Working Group also assists the NAIC in responding to specific rules proposed under Title II that could have implications for insurance; actions that afford us the opportunity to strengthen our already positive relationship with the FDIC. We have commented on proposals that could potentially enable the FDIC to take a lien on insurance company assets if that agency had to exercise its authority with respect to the company's non-insurance affiliate or parent. Regulators have also requested that the FDIC allow for the resolution of any mutual insurance holding companies pursuant to state insurance receivership law, even though the statute is murky in this regard. While we hope there is never an occasion where the FDIC has to exercise its authorities on a company with insurance operations, our good working relationship with this agency will be critical to ensuring that policyholders are protected during such an event.

Derivatives

The NAIC has actively responded to rules proposed by the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) regarding their new authorities to regulate the over-the-counter derivatives market. Our position on this matter has been governed by two guiding principles: 1) any rules issued by the SEC and CFTC should not conflict with the insurance regulatory regime; and 2) such rules should not create an unlevel playing field between insurers and non-insurers.

The NAIC has asked the SEC and CFTC to further refine its rules regarding the definition of "swap dealer" to ensure that it does not inadvertently capture insurers absent any indication that they are truly engaging in traditional dealer-like activities. We've also called for changes to the definition of "major swap participant" so that it reflects the differences between insurers and other financial entities, including the fact that insurers use derivatives primarily for hedging against commercial risks.

A very important recently proposed rule involves the additional definitions of swaps and security-based swaps; under Dodd-Frank, these items could conceivably include certain insurance products though we do not believe this was Congress' intent. Since enactment of the statute, the NAIC has sought clarification from the SEC and CFTC that these definitions do not include insurance products sold by a regulated insurance company. We believe that we have made significant progress with the agencies in this regard, but we are of the view that certain changes still need to be made to exclude all regulated insurance products. We recently provided comments to the SEC and CFTC and hope to work with them as they continue to refine the rule.

Surplus Lines and Reinsurance

The Dodd-Frank Act also included provisions relating to the regulation of nonadmitted, or "surplus lines," insurance. Most of those provisions became effective just days ago and states continue efforts to implement changes consistent with the law while ensuring equitable distribution of premium taxes. The risk of losing valuable surplus lines premium tax revenues to the "home state" of a policyholder on multi-state risk is a powerful incentive as state legislatures meet to consider this issue. Regulators agree it is imperative to preserve the ability of states to receive surplus lines premium taxes to the same extent we do today; that is, regulators want to ensure states continue to receive taxes based on the risk or exposure located in a given state.

In August of last year, the NAIC established a task force under its executive committee to examine the various structures for implementing a state-based solution to these new surplus lines provisions. After considering a formal interstate compact approach, the task force opted to develop an interstate agreement, presently known as the Nonadmitted Insurance Multi-State Agreement (NIMA), which states could enter into through enabling legislation and other statutory changes.

NIMA does not transfer broad supervisory authority to a single compacting entity, but it does provide for a single point of tax filing – the main concern of surplus lines brokers. As of the one-year anniversary of the enactment of the Dodd-Frank Act, ten states and Puerto Rico had joined NIMA, but other states have sought alternative solutions to the challenges brought on by the new law. A similar number of states have passed a compact approach to comply with Dodd-Frank, while other states have given their insurance commissioners the authority to join a solution that is in the best interest of their respective states. We expect that over time, given state legislative calendars and other issues, states may gravitate toward a solution that represents the largest percentage of premium taxes to help preserve their level of income. In the meantime, brokers' lives are simplified in that they only have to file tax with the "home state," and there are simplified eligibility standards. Whichever solution is chosen, it is clear that a significant number of states have acted quickly in the 330 days they were given before their systems were preempted by Dodd-Frank.

The same title of the Dodd-Frank Act also made significant changes in the area of reinsurance, which the NAIC coordinates and monitors through the Reinsurance Task Force of its Financial Condition (E) Committee. At present, the task force continues its work to implement a reinsurance regulatory modernization framework that is intended to facilitate cross-border reinsurance transactions and enhance competition within the U.S. market, while ensuring that U.S. insurers and policyholders are adequately protected against the risk of insolvency. The task force is considering amendments to the applicable NAIC state model law and regulation, and plans to implement these reforms prior to year-end. These reforms will put in place a method by which states may relax collateral requirements for foreign reinsurers if appropriate.

“Volcker Rule” and New Federal Reserve Authorities

The Volcker Rule prohibits insured depository institutions and their affiliates from engaging in proprietary trading, and also requires additional capital requirements and quantitative limits for non-bank financial institutions designated by FSOC for heightened supervision. The Dodd-Frank Act provides that the implementation of the Volcker Rule should “accommodate the business of insurance,” and the NAIC is closely monitoring the implementation of this rule to ensure that the agencies do so.

In January, FSOC issued a study regarding the implementation of the Volcker Rule by the federal financial agencies; on insurance, that report is generally consistent with the wording of Dodd-Frank. The study recommended that insurance investments for the general account should be permitted even if they otherwise might be considered “proprietary trading” under the statute, provided that such investments are compliant with state investment laws and such investments do not threaten an affiliated bank or the financial stability of the United States. However, the study also recommended that the agencies consider, among other items:

1. The timing and approach to the assessment of insurance company investment laws in determining whether such laws adequately protect a given institution or the financial stability of the United States;
2. How to handle investments made by foreign insurance companies; and
3. Whether separate account investments should be treated as being made on behalf of customers (another permitted activity under the Volcker Rule).

The NAIC is waiting to see how such issues and others are resolved in the proposed rule before determining an appropriate response.

In addition, the Federal Reserve will regulate any SIFIs designated by FSOC and will be the consolidated regulator for any thrift holding company groups. While it is still unclear how the Fed will regulate such companies, we are monitoring work done in this area to see whether such activity will have any impact on the states' risk-based capital system and any other aspects of the insurance regulatory regime. We have had a good relationship with the Federal Reserve to date, and look forward to working with them on this issue.

Federal Insurance Office

The final area of the Dodd-Frank Act that I would like to discuss today is the Federal Insurance Office. FIO will impact all lines of insurance except health, long-term care (aside from those policies paired with life or annuity components), and crop insurance. However, it does not possess general supervisory or regulatory authority over the business of insurance.

FIO will have the authority to work with the U.S. Treasury Department and the Office of the U.S. Trade Representative (USTR) on negotiating international "covered agreements" for the recognition of prudential measures governing the business of insurance and reinsurance. Such agreements must achieve a level of protection for insurance consumers that is substantially equivalent to the level of protection achieved under state regulation. FIO is authorized to preempt state laws once such covered agreements are completed – but only to the extent that a state law treats a non-U.S. insurer less favorably than a U.S. insurer. Furthermore, FIO is prohibited from preempting state laws and regulations governing solvency and consumer protection.

The FIO Director will also advise the Treasury Secretary on major domestic and international insurance policy issues. To that end, the NAIC supported the office's membership to the International Association of Insurance Supervisors (IAIS). FIO will also be authorized to collect information on insurance at the federal level but is required to get this information from the states and other sources, such as the NAIC.

The Dodd-Frank Act requires FIO to issue a report on insurance regulation by January 2011. The report will include legislative recommendations and look at the potential for federal regulation of insurance. We hope the report will be honest and factual, but we continue to believe there is an inherent conflict in an office of the Treasury Department studying ways to further empower itself. While the national state-based system of insurance regulation has successfully protected the interest of consumers for decades, state regulators recognize that, like any regulatory system, it is not perfect and we are open to hearing any suggestions FIO may have for improvements. To date, the NAIC has had a good relationship with FIO, and we look forward to continuing that relationship going forward and working with our friend and former colleague, Mike McRaith.

Independent Insurance Regulatory Developments

Representatives from the NAIC have frequently testified before the House Financial Services Committee on our continuing efforts to improve the state-based system of regulation; this work was underway well before the financial crisis. The checks and balances inherent to our multi-state oversight are important to ensuring robust regulations in a variety of dimensions and from a variety of perspectives. In that vein, state regulators have worked through the NAIC to enrich our regime and ensure that insurance consumers will continue to be afforded the highest level of protection. Regulators have made enhancements to group supervision, lessened reliance on credit rating agencies, examined methods to improve solvency protection, and played a key role in activities on the international level.

Enhancements to Group Supervision

The financial crisis certainly underscored a need for state insurance regulators to enhance and improve group supervision. From our experiences in dealing with situations where an insurance company was either held by or was an affiliate of a business governed by another regulator agency, we learned that it is not enough to focus solely on transactions with insurance companies; we need to look through our "windows" and understand the contagions that could impact insurers. However, we must still have an appreciation of the "walls" in place when examining material exchanges between the insurers and other parts of the group – our ability to ring fence insurers to protect the assets supporting policyholder obligations.

In December of last year, the NAIC adopted revisions to the *Insurance Holding Company System Model Act* and the *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions*. These revisions are intended to provide regulators the ability to better assess the enterprise risk within a holding company system and its impact on an insurer within the group. Ultimately, this enhanced “windows and walls” approach should provide greater and much needed breadth and scope to solvency regulation while maintaining the highest level of policyholder protection.

The concepts addressed in the enhanced “windows and walls” approach provide for a number of improvements. We have expanded the disclosure requirements to any entity within the insurance holding company system that could pose reputational or financial risk to the insurer and clarified that the insurance regulator has the right to access information on any entity of a holding company system when desired. We have included official recognition of regulators' participation in "supervisory colleges" for groups with international activities and established the funding mechanism for such participation. We have made a number of enhancements in corporate governance, including introducing high level responsibilities of the Board of Directors and senior management. Finally, additional requirements have been added to the terms and conditions of affiliated cost-sharing and management services agreements in order to assist regulators in determining whether transactions are fair and equitable to insurers.

<u>Reliance on Credit Rating Agencies</u>

The financial crisis also revealed that insurance market participants and regulators overly relied on credit ratings issued by the Nationally Recognized Statistical Rating Organizations (NRSROs). In an effort to reduce our reliance on these rating agencies, the NAIC acted to more closely align the capital requirements for residential mortgage-backed securities (RMBS) and for commercial mortgage-backed securities (CMBS) with appropriate economic expectations. These two asset classes represent over $300 billion in carrying value of invested assets for the U.S. insurance industry.

The NAIC developed alternative methodologies for evaluating CMBS and RMBS investments, and the new process results in a more accurate reflection of the risk of loss for each specific insurer that is then mapped to a risk-based capital factor. At the conclusion of our most recent year of effort in this regard, the NAIC made available projected expected losses on a list of approximately 19,500 residential mortgage-backed securities and 5,200 commercial mortgage-backed securities to insurers, the Federal Reserve and other federal agencies. While the NAIC continues to use the NRSROs for other asset classes, our Valuation of Securities Task Force, as well as our Rating Agency Working Group, are monitoring these other asset classes to determine whether continued reliance is appropriate.

Additional Transparency to Securities Lending

Perhaps our greatest single source of concern for insurance regulators during the financial crisis was over securities lending activities by AIG; work that was separate from the non-insurance problems at the AIG Financial Products Division overseas. U.S. insurance regulators had discovered the change in AIG's management of the securities lending program in 2007 during a regular financial examination, and immediately began working with the company to wind down the activity and provide additional public disclosure of the structure and risks facing the program.

In the time since the AIG Securities Lending discovery, insurance regulators have taken a number of actions to ensure transparency in any such activities at insurance companies in the future. We improved the guidance for such activity in 2008, as well as annual financial statement disclosure requirements in order to obtain summary information on the duration of when related collateral is required to be returned to the counterparty. This allows regulators to more readily identify if an insurer's securities lending program could cause excessive liquidity strains under stressed scenarios. Furthermore, the NAIC adopted a new Schedule DL in 2010 to strengthen transparency in securities lending agreements utilized by insurers by requiring detailed disclosure of the program's collateral instruments.

Looking Forward: The Future of Insurance Regulation

Solvency Modernization Initiative

In June 2008, state insurance regulators began the Solvency Modernization Initiative; a critical self-examination of the U.S. insurance solvency system. While this system had helped protect the relative stability of the insurance sector during the financial crisis, the success of the past does not necessarily prepare us for the challenges of the future. Under SMI, we are examining international developments regarding insurance supervision, banking supervision, and international accounting standards in order to consider their potential use in U.S. insurance regulation. We believe that, ultimately, this open and transparent process will drive changes to our overall regulatory system. We must learn from international developments and collaborate where appropriate, but we cannot abdicate our responsibility for U.S. insurance consumers and companies.

The SMI project is focused on several major areas, such as outlining high-level corporate governance principles and determining the appropriate methodology to evaluate adherence with such principles. We are also reviewing IAIS principles and standards related to corporate governance as part of this effort. From this work, we hope to identify future initiatives to improve our regulatory solvency system.

Furthermore, we are also considering ways in which to improve risk-based capital standards in order to ensure they adequately capture the appropriate risks to U.S. insurers. In the area of statutory accounting and financial reporting, we remain committed to implementing a principles-based methodology to reserving requirements. Finally, we continue to maintain statutory accounting for regulatory purposes and consider what the impacts international accounting standards may have here. Though implementation of all of these changes will take time, we anticipate that all major policy decisions in SMI will be adopted by December of next year.

<u>International Efforts</u>

Of course, insurance markets have evolved over the years to become increasingly global, interconnected, and convergent, and this trend will undoubtedly continue in the years to come. Insurance regulators around the world have found that it is vital to constantly improve their level of cooperation, coordination and collaboration.

The NAIC is devoting significant resources and energy to international standard setting. In particular, we are actively working on revisions of the IAIS Insurance Core Principles (ICPs), which form the basis for the International Monetary Fund's Financial Sector Assessment Program (FSAP). State insurance regulators are also advocating enhanced coordination through supervisory colleges and through the new Supervisory Forum, which we chair at the IAIS. The objective of the Supervisory Forum is to strengthen the effectiveness of insurance supervision and to foster convergence of supervisory practices through the exchange of real-world experiences. In some respects, this initiative is modeled after the multi-jurisdictional coordination framework that exists in the United States.

The NAIC and the state regulators also welcome the objectives of the IAIS's Common Framework for the Supervision of Internationally Active Insurance Groups, or ComFrame, and are participating in its development process. This project aims to make group-wide supervision of internationally active insurance groups more effective, to foster cooperation and coordination among supervisors around the world and to close regulatory gaps. The ultimate role of ComFrame is under discussion and will continue to develop; however, the intent is given by its name – a common framework – one that lays out how supervisors around the globe can work together to supervise internationally active insurance groups. ComFrame should neither be a platform for pushing a global capital standard for insurance, nor create prescriptive ways to promote a particular means for solvency standards, nor create additional layers of regulation. If done right, ComFrame has the potential to create a multijurisdictional approach to supervision that emphasizes robust oversight and cooperation while maintaining the proper balance between home and host jurisdictions.

In addition to these activities, U.S. state insurance regulators continue to participate in supervisory colleges for insurance-related entities around the world. As NAIC President, I participate in the Insurance and Private Pensions Committee (IPPC) of the Organization for Economic Cooperation and Development (OECD). Finally, the NAIC serves as technical experts to USTR officials regarding multi-lateral trade agreements through the World Trade Organization, including the General Agreement on Trade in Services and regional and bilateral trade negotiations.

Notwithstanding these international developments and their increasing impact on NAIC and state regulation, as we talk about international convergence, we must keep in mind that there are different regulatory systems and approaches around the globe, so convergence must be a discussion about arriving at common outcomes and not necessarily universal standards or structures. An area where this is particularly important is in looking at Solvency II in Europe and their equivalency process. U.S. state insurance regulators support Europe's efforts to modernize their solvency regime through the Solvency II project. While we intend to monitor the development of Solvency II and participate in ongoing discussions with our foreign counterparts, we do not intend to adopt Solvency II. However, there may be elements of Solvency II that we can learn from and consider incorporating into our system as appropriate, which is why it has been examined as part of our SMI process.

Solvency II looks to determine if other countries, including the U.S., offer "equivalent" levels of regulation compared to what it envisions. The U.S. has a strong system of insurance solvency supervision that helped the world's largest insurance market weather the worst financial crisis in decades. While we have a different legal and regulatory structure here in the U.S., we believe our system is at least equivalent to Solvency II on an outcomes basis. We therefore have been urging Europe to view equivalence as an outcomes-focused process and find the U.S. equivalent so as to avoid putting U.S. or European insurers at a competitive disadvantage.

Imposing jurisdictional or regional concepts unilaterally is counterproductive, but clearly all regulators have a vested interest in harmonizing our systems where appropriate in order to seek a more stable and competitive marketplace for companies and consumers. In my view, global convergence should heavily focus on information sharing, and should include mechanisms for peer review. Again, the key to addressing international insurance issues is to improve coordination, cooperation and communication among supervisors.

Conclusion

In conclusion, insurance oversight in the U.S. is strong and continues to improve. Following the financial crisis that had such devastating impacts to other financial sectors, insurance regulators have taken steps to address an evolving landscape and ensure continued protection of the American consumer. I think that after review, you will agree that states have made great strides in developing tools that can be leveraged to realize the efficiencies necessary for a competitive environment, while preserving states' front-line strength of solvency regulation and consumer protection. Thank you for this opportunity to testify, and I look forward to your questions.