Testimony of the Property Casualty Insurers Association of America (PCI)

The Impact of Dodd-Frank's Insurance Regulations on Consumers, Job Creators and the Economy

Subcommittee on Insurance, Housing and Community Development
Committee on Financial Services
United States House of Representatives
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The Property Casualty Insurers Association of America (PCI) commends the Subcommittee for holding this important hearing to examine the impact of the Dodd-Frank Act (DFA) on the insurance industry. PCI appreciates the opportunity to provide our thoughts on the Act's impact on the property casualty insurance industry in particular. PCI is composed of more than 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write over $189 billion in annual premium, 39.2 percent of the nation's property casualty insurance. Member companies write 45.5 percent of the U.S. automobile insurance market, 32 percent of the homeowners market, 37.3 percent of the commercial property and liability market, and 40.6 percent of the private workers compensation market.

Extensive post-crisis analysis by international and national insurance regulators and policy experts have consistently found that traditional insurance activities do not create systemic risk, did not cause the recent economic crisis, and that the U.S. industry generally has been and continues to be regulated successfully for solvency at the state level. Even after paying for two of the highest catastrophe loss years in history and suffering the greatest market crash in half a century, there were very few property casualty (P/C) insolvencies. The industry's credit ratings have remained stable and insurers' underwriting obligations are backed by historically strong surplus and surplus to premium ratios.

Home, auto, and business insurers generally present relatively low systemic risk because they generate relatively little counterparty risk and their liabilities in almost all cases are independent of economic cycles or other potential systemic failures. With respect to liabilities, P/C products tend to be mandatory with inelastic demand, so P/C revenues are relatively unaffected by outside systemic impacts. Recessions or third party failures do not significantly increase auto accidents, workers' injuries, or house fires. Insurance contracts are not typically subject to further hedging or risk arbitrage (unlike mortgage underwriting or financial guarantees that may be subjected to numerous cycles of securitization and further third party financial guarantees or risk betting). While some portions of primary risks are passed on to reinsurers, the risks are not further multiplied or leveraged, and the primary company almost always remains obligated and retains a portion of the underlying risk.

With respect to assets, P/C insurers do not hold other people's money, so there is no vulnerability towards a "run on the bank." Moreover, their underwriting obligations are supported by their own assets (unlike depository institutions, investment funds, or retirement accounts) as regulators permit less leveraging than for other insurance or financial companies. Ultimately, while the economy is highly dependent on the P/C industry, the industry's risks are independent and relatively walled off from systemic impairments.

For these reasons, DFA largely focused on other financial firms that pose far more systemic risk than insurers. Nevertheless, DFA did have some significant impacts on insurers, some of which were positive but some for which PCI recommends that the Subcommittee consider legislative remedies.

The Subcommittee should monitor carefully all DFA regulatory developments affecting insurers (as indeed it is doing through this hearing) to avoid unjustified, costly, and duplicative insurance regulatory requirements. It is important to remember that regulation carries costs – costs to government and costs to industries that must comply with government regulations. Average regulatory compliance costs grew 36% for small insurers from 2008-2010. By the third quarter of 2011, there were nearly 11,000 bills affecting insurers and 18,850 insurance statutes, regulations, and bulletins. With over 8000 pages of new regulations from DFA alone, insurers, like other financial firms, are struggling to monitor, understand, and work towards compliance with all the new government mandates. For example, PCI has numerous insurance members with small thrifts that just received several hundred pages of proposed capital rules from the federal banking agencies. Just the management and legal staff required to understand these new rules is taking significant unmeasured time and resources away from new business and development and growth. These industry costs will inevitably have an impact on the cost of products for consumers and could also have a negative impact on employment in the insurance industry as well. Especially at this time, when our nation faces significant economic challenges and unacceptably high levels of unemployment, the Federal government should not increase economic burdens on consumers by imposing new financial regulatory burdens without demonstrating significant need or gaps.

Systemic Risk Determinations

DFA gave the Federal Reserve Board the power to impose heightened prudential standards on firms that the Financial Stability Oversight Council (FSOC) finds to be systemically risky. Because it is now well-established that traditional property casualty insurance activities are not systemically risky, Dodd-Frank should exempt such activities from federal systemic risk regulation. Nevertheless, we are pleased that the FSOC's final rule governing systemic risk determinations makes it relatively unlikely that companies predominantly engaged in the property casualty insurance business will be so designated. We are hopeful that the FSOC will continue to recognize the wisdom of that approach over time, but continue to believe that the statute should not grant FSOC the power to impose heightened prudential standards on state-regulated insurers. Again, the imposition of unnecessary and duplicative federal solvency regulations on insurers serves no useful purpose and threatens to drive up the cost of insurance for consumers.

State Insurer Resolution Authority

The Dodd-Frank Act grants federal regulators the authority to resolve failing financial companies. However, insurance companies are already subject to existing state solvency guaranty funds that protect consumers. In the last 40 years, our property-casualty guaranty system has paid out roughly $21 billion to consumer/policyholders on behalf of insolvent insurers – a clear indication that the current state-based system works to protect insurance consumers. While Dodd-Frank properly reserved to the states the authority to resolve failing insurance companies, the Act needs tightening in several ways to ensure that federal regulators do not have the power to intrude improperly on state authority to resolve insurers.

Insurer Assessments. Dodd-Frank also unfairly asks certain insurers to help defray the costs of federal resolutions of other non-insurer financial firms. As noted above, insurers are already required to pay into state insurance resolution funds to help ensure that policyholders of other failed insurers are honored. The imposition of federal resolution assessments on insurers imposes the potential for double assessments on insurers. Because insurers already pay at the state level for resolution costs within the insurance sector, they should not pay a second time at the federal level for resolution costs *outside* of the insurance sector. Doing so creates inequity, as the Act does not require non-insurance entities to pay for insurer resolution costs. Dodd-Frank does require the FDIC to use a risk-matrix in determining how to assess financial companies, and that matrix does include consideration of an insurer's payments of assessments into state guaranty funds. The matrix, however, does not prevent the FDIC (a federal bank regulator) from imposing a double resolution assessment on state-regulated insurers. The most unfair impact of double assessments would be on small businesses and individual insurance consumers, who would ultimately bear a high portion of the cost. PCI therefore recommends that the Subcommittee consider legislation that would expressly bar the FDIC from imposing assessments on insurers to pay for the resolution of systemically important firms.

Liens on Insurer Assets. Section 204(d)(4) of the Act permits the Federal Deposit Insurance Corporation (FDIC) to take a lien on the assets of a covered financial company or its subsidiaries, but fails to exclude companies and subsidiaries that are insurance companies. This creates the potential for the FDIC to take a lien against insurance company assets to help shore up an affiliated non-insurance company. State insurance regulators comprehensively regulate insurer investments to ensure that adequate capital and surplus is available to keep the insurer solvent and able to pay claims to policyholders. By giving the FDIC authority to take a lien against insurer assets without even consulting with state insurance regulators, the Act creates the potential for federal regulators to imperil the ability of insurers to honor claims to policyholders, giving priority to claimants who are not policyholders. PCI recommends that the Subcommittee consider remedial legislation to eliminate this threat to insurance consumers.

Volcker Rule

While the DFA's Volcker rule was intended to restrict the ability of banks to engage in proprietary trading, the statutory language applies to all affiliates within a holding company that includes a depository institution. Absent an insurer exemption, this would preclude insurers affiliated with a depository institution within a holding company from carrying out common investment activities.

Congress recognized that insurer investment activities are already heavily regulated and closely supervised by state insurance regulators, whose job it is to ensure that insurers licensed in their states remain solvent and able to pay claims. These strict state insurance investment laws prohibit insurers from making investments that are detrimental to the interests of policyholders. Congress therefore included in the Volcker Rule an exemption for investments by a regulated insurance company or its affiliates for the general account of the insurance company. The exemption is predicated on a requirement that the investments be in compliance with all applicable state insurance investment laws and regulations, and that the federal banking agencies do not jointly determine that the existing state investment laws and regulations are insufficient to protect the safety and soundness of the banking entity or the nation's financial stability. The exemption does not extend, however, to an insurer's non-insurance affiliates.

The Federal Reserve Board and other agencies charged with promulgating the Volcker Rule have crafted a proposed rule that, *with one exception*, appropriately allows insurers to continue their state regulated investment activities. The exception relates to insurer investments in hedge funds and private equity funds ("covered funds" under DFA). While the DFA statutory language in no way limits the insurance carve-out for covered funds investment, the proposed Volcker rule fails to include the insurance exemption in the covered funds restrictions, creating a significant ambiguity between the statute and proposed rule and the possibility that insurers could be prohibited from making such investments or be subject to federal capital requirements if they do.

Federal Insurance Office (FIO)

Dodd-Frank created, for the first time, a federal office in the U.S. government charged with the responsibility of monitoring the insurance industry and making recommendations to Congress. PCI supported the creation of the Federal Insurance Office (FIO) with an appropriately focused mission. FIO has a highly qualified director in Michael McRaith, who is assembling an experienced and knowledgeable staff. PCI has worked cooperatively and constructively with FIO as it seeks to discharge its duties, but we do urge the Subcommittee to monitor FIO's activities closely over time to guard against tendencies toward "mission creep" that might tempt future leaders of that office to stray from FIO's statutorily assigned tasks.

International Focus. One of FIO's most important statutory roles is in coordinating the federal government's policy on international insurance matters, including U.S. representation in the International Association of Insurance Supervisors (IAIS) and other international fora. The insurance marketplace, and its regulation, are becoming increasingly global. FIO's new international role, if exercised in careful coordination with state regulators and insurers, can now help the U.S. speak with a single strong voice in international fora. We see this as the area in which the FIO can make its greatest impact and contribution.

One of the greatest challenges to the insurance marketplace is the unprecedented proliferation of international discussions on insurance regulatory standards, including those engaged in by the G-20, the Financial Stability Board (FSB) and the IAIS, as well as increasingly important trade negotiations with individual countries and international organizations such as the Organization for Economic Cooperation and Development (OECD). There is an increasingly strong movement to standardize insurance supervision throughout the globe. PCI supports consideration of international prudential standards where convergence helps consumers and strengthens the competitiveness of the marketplace. However, the insurance international standard-setting this process is currently being driven largely by non-U.S. regulatory staff that in some cases want to export their regulatory inefficiencies, forcing the U.S. to converge toward their systems and standards without proper regard for the needs and culture of the U.S. market. FIO's new strong voice in these discussions can now help to ensure that the strengths and differences of the U.S. insurance market will be recognized.

Subpoena Power. PCI is also concerned about the Dodd-Frank Act's grant of subpoena power to the FIO. Dodd-Frank gave FIO exceedingly broad subpoena powers that are inappropriate for a non-regulator. In fact, the powers are much broader than those most other Treasury agencies have. Treasury's usual subpoena powers generally fall into three categories: (1) formal administrative proceedings; (2) criminal or civil investigations and enforcement of laws/regulations; and (3) Inspector General investigative powers.[1] The subpoena power granted in 31 U.S.C. Section 313(e)(6) does not fit into any of these categories, thereby establishing a troubling precedent for government information demands.

Although Dodd-Frank Section 313(e)(4) instructs FIO to coordinate with state and other federal agencies before seeking data from insurers, FIO's subpoena power is not otherwise constrained beyond a requirement that FIO must believe that the information it wants is relevant to its mission. No suspicion of criminal or civil violations of a law or regulation is required. No formal administrative proceeding must be initiated. Because FIO is not a regulator, FIO cannot issue a subpoena in furtherance of a regulatory function, such as a financial examination. The state insurance departments, however, are regulators and already have the legal power to obtain information and data from insurers, either by subpoena or otherwise (*See, e.g.*, NAIC Model Law on Examinations, NAIC Insurer Receivership Model Act; NAIC Unfair Trade Practices Model Act). In addition to subpoena power, state regulators have an even bigger stick to get information – the ability to withhold or revoke licenses or to take other disciplinary action against uncooperative insurers.

PCI's concern is that future FIO directors may not always coordinate with the state insurance regulators and could subpoena information that insurers are providing or have already

[1] U. S. Department of Justice, Office of Legal Policy, *Report to Congress on the Use of Administrative Subpoena Authorities by Executive Branch Agencies and Entities*, (2001).

provided to the state insurance regulators and significantly increase our administrative expenses and burdens. In addition, because the Office of Financial Research (OFR) is required to obtain any information it needs on insurers from FIO, PCI is concerned that a lack of coordination could further exacerbate marketplace administrative expenses and burdens. The best process for getting federal agencies information about the insurance industry and specific companies is for FIO to use the power already given to it by Dodd-Frank to request it from the states (and then share it with OFR) and take advantage of the inherent regulatory authority the states have to compel production. Taking this approach would in no way inhibit FIO's ability to fulfill its functions. To help ensure that this more constructive approach is utilized, and to avoid unnecessary and costly subpoenas on insurers, PCI urges the Subcommittee to consider legislation that would remove FIO's subpoena power.

Confidentiality. Dodd-Frank gave FIO the authority to monitor all aspects of the insurance industry, including the ability to gather information about the industry consistent with FIO's statutory functions. However, the Act, did not adequately acknowledge the role that state regulators play in regulating individual companies and the industry.

The Act included a very well-intentioned provision meant to ensure that the confidentiality of non-publicly available data submitted to the FIO would be protected. PCI is concerned, however, that a provision protecting privileged information *submitted to* the FIO might not be tight enough to ensure that this information will continue to enjoy privilege if FIO were to share it with other federal agencies, such as the OFR or the FSOC, or with state insurance regulators. In addition, there is no guarantee that privileged information submitted to state regulators would retain that privilege when state regulators share it with FIO. PCI recommends that the Subcommittee consider legislation that would tighten these confidentiality protections and clarify that all privileged information flowing to or from FIO regarding insurers will not lose its privilege merely because it is being legitimately shared among various agencies and regulators. This is similar in concept to provisions of the National Association of Insurance Commissioners' (NAIC) Insurance Holding Company Model Act, which provides that privileged information shared by state insurance regulators with other state, federal or international regulators does not lose confidentiality protections.

Source of Strength Rule

DFA also requires insurers to serve as a source of strength for affiliated banks. This runs counter to the general requirement state regulators observe that insurers existing in a holding company should be "walled off" from non-insurer affiliates to ensure that regulatory capital required to support the underwriting obligations of the insurer cannot be compromised. It is unfortunate that the Congress failed to address this concern adequately in DFA, and we urge the Committee to monitor this issue closely and to consider remedial legislation to prevent the exercise of DFA powers that could threaten insurers and their consumers.

Lender Placed Insurance

DFA also created the new Bureau of Consumer Financial Protection (CFPB), which poses some potential threats to insurers. Although the business of insurance is generally outside of the CFPB's jurisdiction, agency activities have appeared increasingly hostile to lender-placed insurance, which is coverage purchased by lenders to cover (usually temporarily) properties for which owners have failed to maintain property insurance required by their mortgages. Lender-placed coverage is a critical element of commercial and residential lending and thus to the real estate market. Unwarranted regulatory and legal hostility towards it can threaten to undermine the much-needed recovery of the U.S. real estate markets. DFA includes new amendments to the Real Estate Settlement Procedures Act (RESPA) providing strict new procedures under which lender-placed coverage can be utilized, but expressly states that the CFPB has no authority to regulate lender-placed insurance rates.

PCI is concerned that some state and federal regulators have taken an overly hostile view towards lender-placed insurance. Given that product's importance to healthy credit markets and to the recovery of the housing market, regulators must be careful not to delay that recovery by taking imprudent actions on lender-placed insurance issues. PCI member companies are working cooperatively and constructively with regulators to address consumer concerns in that market, but regulators must keep a level head to avoid doing further damage to the nation's fragile housing market. PCI recommends that the Subcommittee monitor developments in this area carefully to ensure that this critical insurance market is not unduly hindered.

Nonadmitted and Reinsurance Reform Act

DFA included bi-partisan and industry supported provisions for the modernization of the regulatory system of the nonadmitted insurance market, commonly referred to as surplus lines. Through the NRRA, a national framework was established to bring about greater consistency and efficiency to the taxation and regulation of surplus lines insurance that would bring benefit to insurance consumers, insurers, and brokers alike. However, to fully achieve the benefits of the NRRA, individual state legislatures and regulators must consistently adopt and implement the letter and spirit of the law. PCI recommends that the Subcommittee monitor developments in this matter to ensure that this critical insurance market fully realizes the intended changes, including consistent implementation of uniform standards for surplus lines eligibility.

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Again, PCI appreciates the opportunity to share our views and we stand ready to assist the Subcommittee as it fulfills its responsibility to address issues related to implementation of the Dodd-Frank Act and its impact on insurers.