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Hearing entitled "The Federal Insurance Office's Report on Modernizing Insurance Regulation"

House Financial Services Subcommittee on Housing and Insurance
February 4, 2014

Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for inviting me to testify today on the Federal Insurance Office's report (Report) entitled "How To Modernize And Improve The System Of Insurance Regulation In The United States." The Report was released on December 12, 2013 and is available through the web site of the U.S. Department of the Treasury.

My name is Michael McRaith, and I am the Director of the Federal Insurance Office (FIO) in the U.S. Department of the Treasury.

The Report establishes a framework for the United States to build on the existing federal and state regulatory structure. While states generally perform consumer protection functions, many insurance regulatory issues of uniformity and national interest justify federal engagement. The insurance sector in the United States is both vast and essential, and long-standing prudential and marketplace issues may require a federal solution.

By any measure, insurance is a significant sector in the U.S. economy, providing not only essential asset protection tools for families and businesses, but also serving as a critical participant in the capital markets and financial service industries. In 2012, insurance premiums in the life and health (L/H) and property and casualty (P/C) insurance sectors totaled more than $1.1 trillion, or approximately 7% of gross domestic product. In the United States, insurers directly employ approximately 2.3 million people, or 1.7% of non-farm payrolls. More than 2.3 million licensed insurance agents and brokers hold more than 6 million licenses. Moreover, as of year-end 2012, the L/H and P/C sectors reported $7.3 trillion in total assets, $6.8 trillion of which were invested assets.

The penetration of the private insurance market is commonly measured as the ratio of premium to a nation's gross domestic product, a metric which demonstrates that developing economies provide fertile growth opportunities for U.S.-based insurers. By premium volume, the United States remains the world's largest insurance market: from 2008 to 2012, premium volume grew by $30.2 billion, but declined as a percentage of the U.S. gross domestic product (GDP) from 8.73% to 8.1%. At the same time, emerging and developed economies overseas have seen dramatic spikes in premium volume. From 2008 to 2012, China's premium volume, for example, increased by $105 billion, even though volume declined as a percentage of GDP (3.11% to 2.94%). Brazil's premium volume increased by nearly $35 billion and as a percentage of GDP (2.87% to 3.65%). South Korea's premium volume increased – by $42 billion – and as a percentage of GDP (2.27 to 3.02). With fast-paced international growth, insurance supervisors in countries around the world are pushing for improved consistency of supervisory standards to understand better the operations, solvency, and risk management of firms operating in their markets. Improved consistency of supervisory standards will benefit U.S.-based insurers that operate globally.

Notwithstanding the role the federal government has had in some areas of insurance, through FIO, the United States now has an office that holds, among others, the authority to –

- monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system;
- monitor the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products; and
- coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors and assisting the Secretary in negotiating covered agreements.

The states remain the primary regulators of individually licensed entities engaged in the business of insurance, but the federal government also has insurance oversight and supervisory responsibilities. The Federal Reserve Board (Board) serves as the consolidated supervisor of a savings and loan holding company that owns an insurer, and an insurer subject to Board supervision following designation by the Financial Stability Oversight Council (Council).

FIO Modernization Report

The Dodd-Frank Consumer Protection and Wall Street Reform Act directed FIO to, among other things, conduct a study and submit a report to Congress on how to modernize and improve the system of insurance regulation in the United States. As required by statute, the Report is based on and guided by six explicit considerations and factors.

In developing the study, beginning in late 2011, FIO consulted extensively with interested parties from across the national and international insurance sector. FIO published a notice in the Federal Register on October 17, 2011, to solicit comments on the statutory factors and considerations. Nearly 150 written comments were provided in reply to that notice, all of which are available online at treasury.gov/initiatives/fio. Additional direct consultations occurred with nearly 40 different insurance sector stakeholders, including state insurance regulators, representatives of the industry and policyholders, advocates, and academics. On December 9, 2011, FIO hosted a conference at Treasury with representatives of the broad diversity within the insurance sector. Through 2012 and 2013, FIO continued to study the issues and consult with interested parties. The Report reflects many of the issues and topics raised by stakeholders throughout the consultation process, including through written comments, at the Treasury conference, and also through FIO's direct engagement with federal, state and international supervisors.

For purposes of the Report, FIO's analysis began with the predicate to address the world as it is, not as it was or as one might wish it were. Since President Theodore Roosevelt's annual message to Congress in 1904, the debate about reforming the U.S. system of insurance regulation has foundered on the binary contentions that the business of insurance must be subject to either state or federal authority. That debate is a relic of a bygone era.

The federal government has played a role in insurance for years. In addition to market support programs like the Federal Crop Insurance Corporation and the Terrorism Risk Insurance Program, federal agencies like the Securities and Exchange Commission and the Federal Deposit Insurance Corporation have insurance responsibilities.

Further, the financial crisis illustrated the deficiencies in a state-based, solo entity approach to the supervision of insurance holding companies, and the potential threat to the national financial system of large, complex and internationally active financial firms. Thus, national and international financial stability initiatives, as well as the expanding international insurance marketplace, have driven regulatory change both in the United States and abroad. Indeed, although the states remain the primary regulators of individually licensed entities engaged in the business of insurance, the federal government now has explicit statutory roles insurance oversight and supervision (*e.g.*, Board supervision of insurance companies designated by the Council).

FIO Modernization Report – Analysis

FIO's Report determines that the U.S. should build on the existing hybrid model of insurance regulation, incorporating both federal and state oversight. The question is not whether federal involvement in insurance regulation is necessary, but where and how that involvement should be calibrated. A federal role in insurance regulation would improve uniformity of regulation, address the realities of globally active, diversified insurance firms, and better serve national interests.

The business of insurance is primarily regulated at the state level, and while proponents of the current system reasonably assert that the system works well, the absence of uniformity in the U.S. insurance regulatory system creates inefficiencies and burdens for consumers, U.S.-based insurers, and international market participants. This hybrid framework not only reflects today's reality, but also provides a foundation for Congress and other policymakers to address areas for improvement in the existing hybrid model of insurance regulation.

In particular, the Report identifies the following areas for modernization and improvement:

Areas of Near-Term Reform for the States

Capital Adequacy and Safety/Soundness

1) *For material solvency oversight decisions of a discretionary nature, states should develop and implement a process that obligates the appropriate state regulator to first obtain the consent of regulators from other states in which the subject insurer operates.*

2) *To improve consistency of solvency oversight, states should establish an independent, third-party review mechanism for the National Association of Insurance Commissioners Financial Regulation Standards Accreditation Program.*

3) *States should develop a uniform and transparent solvency oversight regime for the transfer of risk to reinsurance captives.*

4) *State-based solvency oversight and capital adequacy regimes should converge toward best practices and uniform standards.*

5) *States should move forward cautiously with the implementation of principles-based reserving and condition it upon: (1) the establishment of consistent, binding guidelines to govern regulatory practices that determine whether a domestic insurer complies with accounting and solvency requirements; and (2) attracting and retaining supervisory resources and developing uniform guidelines to monitor supervisory review of principles-based reserving.*

6) *States should develop corporate governance principles that impose character and fitness expectations on directors and officers appropriate to the size and complexity of the insurer.*

7) *In the absence of direct federal authority over an insurance group holding company, states should continue to develop approaches to group supervision and address the shortcomings of solo entity supervision.*

8) *State regulators should build toward effective group supervision by continued attention to supervisory colleges.*

<u>Reform of Insurer Resolution Practices</u>

9) *States should: (1) adopt a uniform approach to address the closing out and netting of qualified contracts with counterparties; and (2) develop requirements for transparent financial reporting regarding the administration of a receivership estate.*

10) *States should adopt and implement uniform policyholder recovery rules so that policyholders, irrespective of where they reside, receive the same maximum benefits from guaranty funds.*

<u>Marketplace Regulation</u>

11) *States should assess whether or in what manner marital status is an appropriate underwriting or rating consideration.*

12) *State-based insurance product approval processes should be improved by securing the participation of every state in the Interstate Insurance Product Regulation Commission (IIPRC) and by expanding the products subject to approval by the IIPRC. State regulators should pursue the development of nationally standardized forms and terms, or an interstate compact, to further streamline and improve the regulation of commercial lines.*

13) *In order to fairly protect consumers in all parts of the United States, every state should adopt and enforce the National Association of Insurance Commissioners Suitability in Annuities Transactions Model Regulation.*

14) *States should reform market conduct examination and oversight practices and: (1) require state regulators to perform market conduct examinations consistent with the National Association of Insurance Commissioners Market Regulation Handbook; (2) seek information from other regulators before issuing a request to an insurer; (3) develop standards and protocols for contract market conduct examiners; and (4) develop a list of approved contract examiners based on objective qualification standards.*

15) *States should monitor the impact of different rate regulation regimes on various markets in order to identify rate-related regulatory practices that best foster competitive markets for personal lines insurance consumers.*

16) *States should develop standards for the appropriate use of data for the pricing of personal lines insurance.*

17) *States should extend regulatory oversight to vendors that provide insurance score products to insurers.*

18) *States should identify, adopt, and implement best practices to mitigate losses from natural catastrophes.*

Areas for Direct Federal Involvement in Regulation

1) *Federal standards and oversight for mortgage insurers should be developed and implemented.*

2) *To afford nationally uniform treatment of reinsurers, FIO recommends that Treasury and the United States Trade Representative pursue a covered agreement for reinsurance collateral requirements based on the National Association of Insurance Commissioners Credit for Reinsurance Model Law and Regulation.*

3) *FIO should engage in supervisory colleges to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers.*

4) *The National Association of Registered Agents and Brokers Reform Act of 2013 should be adopted and its implementation monitored by FIO.*

5) *FIO will convene and work with federal agencies, state regulators and other interested parties to develop personal auto insurance policies for U.S. military personnel enforceable across state lines.*

6) *FIO will work with state regulators to establish pilot programs for rate regulation that seek to maximize the number of insurers offering personal lines products.*

7) *FIO will study and report on the manner in which personal information is used for insurance pricing and coverage purposes.*

8) *FIO will consult with Tribal leaders to identify alternatives to improve the accessibility and affordability of insurance on sovereign Native American and Tribal lands.*

9) *FIO will continue to monitor state progress on implementation of Subtitle B of Title V of the Dodd-Frank Act, which requires states to simplify the collection of surplus lines taxes, and determine whether federal action may be warranted in the near term.*

FIO Modernization Report – Conclusions

In short, the Report concludes that the states generally provide effective consumer protection. The ability of an insurer to pay a policy obligation is the bedrock of state solvency oversight. However, the Report also identifies issues for improvement that have received attention from the states, some for years. For example, state-based market conduct examinations and product approval processes have long been unduly burdensome, costly and redundant, but states have been unable to resolve these challenges with uniform practices. Another example is the proliferation of special purpose vehicles serving as life reinsurance captives, developments which have led to state-by-state variances and raises serious questions about the state-based solvency regime. Nevertheless, the states have not developed a consensus approach to resolving this issue and, as a result, are far from developing a uniform implementation approach. States have also failed to address—much less resolve—the use of data mining technology by insurers offering personal lines insurance products. These are a few examples of long-standing issues in need of a solution: the *status quo* will not resolve the problems of inefficiency, redundancy, or lack of uniformity.

As detailed in the Report, a number of recommendations call for direct federal involvement. For example, the financial crisis demonstrated the importance of the housing finance system to the U.S. national economy. Nevertheless, private mortgage insurers are subject to state regulatory regimes that differ in supervision and in levels of enforcement. Several private mortgage insurers failed or suffered potential financial distress, and the costs of default and foreclosure were shifted to lenders, the government-sponsored enterprises, and ultimately the taxpayer. The Report calls for federal supervision of the private mortgage industry, both in terms of standard-setting and the enforcement of those standards. Under this recommendation, however, it is conceived that a state would still be permitted to impose and retain premium taxes and would retain the authority to license and supervise the conduct of agents and brokers. While the federal government has an unambiguous leadership role in international standard-setting activities, other recommendations call for a direct FIO role in coordinating solutions to existing problems, such as personal auto policies for members of the armed forces, and pilot programs to decrease rate regulation in order to promote competitive markets. In the area of collateral required of non-U.S. reinsurers, the Report recommends the negotiation of an agreement to impose national uniformity in a global market.

The Report outlines FIO's ongoing work to modernize and improve the U.S. system of insurance regulation. Working with all aspects of the insurance sector, including federal supervisors, the states, consumers, and industry, FIO will monitor and report publicly on progress made to effectuate the recommendations. FIO's Report is only one milestone –status reports will be forthcoming. Whether, and to what extent, necessary improvements will require federal involvement or Congressional action will depend upon the subject matter, circumstances, and ability and willingness of states to resolve the underlying issue. Finally, the Report provides a pragmatic, fact-based framework to move the United States forward and to preserve the U.S. global leadership position in the insurance sector.

Thank you, Chairman Neugebauer, for the invitation to discuss FIO's Report on how to modernize and improve the system of insurance regulation in the United States. I look forward to answering your questions.