EMBARGOED FOR DELIVERY

Written Testimony of Michael T. McRaith
House Committee on Financial Services
Subcommittee on Housing and Insurance
“Assessing the U.S. - EU Covered Agreement”
February 16, 2017

Chairman Duffy, Ranking Member Cleaver, members of the Committee, thank you for inviting me to testify about “Assessing the U.S. - EU Covered Agreement."

I previously served as the Illinois Director of Insurance from 2005- 2011, and as the Director of the Federal Insurance Office (FIO) at the U.S. Department of the Treasury from 2011 until January 20, 2017. While serving as the FIO Director, among other things, I coordinated and developed Federal policy on prudential aspects of international insurance matters and served as Treasury's lead negotiator for the “Bilateral Agreement Between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance” (Covered Agreement).

Including today, I have been privileged to testify before Committees of the United States Congress on 20 occasions. I first testified on June 20, 2006, on behalf of the National Association of Insurance Commissioners (NAIC) in the U.S. Senate Committee on the Judiciary, and offered testimony in support of the limited anti-trust exemption in the McCarran-Ferguson Act. As in that first hearing, and in every hearing since, I reiterate today my respect and support for the U.S. integrated system of insurance oversight wherein the states remain the primary regulators of the business of insurance.

Most states have diverse insurance markets in which multi-national insurers of great size, scale and complexity compete against insurers that operate only in one state, or in only one region of one state. As the Director of Insurance in Illinois, I witnessed firsthand the importance of these insurers — regardless of size or geographic reach — to consumers, to local and state economies, to employees, and to our national interests. Insurance agents, brokers and companies are an essential feature of every American community.

Competitive insurance markets offer critical benefits to working families and small businesses. Products and services offered by America’s insurers allow families to protect and accumulate property, to transfer wealth between generations, and to ensure a financially secure retirement. Insurance is a necessary component of America’s promise of economic fairness and opportunity.

Indeed, Treasury and USTR’s Covered Agreement negotiating authority recognizes the global interests of the U.S. insurance sector and the implications of those interests for the American insurance industry and consumers. For these reasons, among others, Treasury and the United States Trade Representative (USTR) jointly negotiated and agreed upon the Covered Agreement with the European Union (EU).

Covered Agreement – Background

The prudential insurance matters resolved by the Covered Agreement are neither new nor surprising. Reform of the U.S. state reinsurance laws was first debated by state regulators in 1999, if not earlier, well more than a decade before state regulators unanimously adopted modernized model laws and regulations in November 2011.

However, despite energetic efforts by the state regulators through the NAIC, only 32 states have adopted some version of reinsurance reforms. Both the content and the implementation of that reform varies across those 32 states. For this reason, among others, state regulators, through the NAIC, opted in 2016 to promote consistency in solvency oversight by adopting reinsurance reforms as an NAIC accreditation standard, effective January 1, 2019. By virtue of this NAIC decision, all states will adopt a law or regulation substantially similar to the NAIC model law and regulation by January 1, 2019, or confront the loss of NAIC accredited status.

While the NAIC spent years sorting through alternative approaches to reforms of state-based credit for reinsurance laws, the European Union (EU) spent years developing its Solvency II insurance supervisory regime. Solvency II was first anticipated more than 10 years before its implementation on January 1, 2016. The EU and its member states should be congratulated on the successful technical development and implementation of Solvency II, an EU-wide system of insurance oversight that reflects a high level of professional and political accomplishment.

Almost from the earliest days of the development of Solvency II, U.S. insurance sector participants, including state regulators, were aware that Solvency II could require the EU to evaluate whether non-EU insurers and reinsurers operating in the EU market were domiciled in “equivalent” jurisdictions. An “equivalent” jurisdiction is one, such as Switzerland, which supervises its insurers consistent with Solvency II practices and standards, i.e. global group capital, reporting and governance.

Solvency II and its supervisory approach matter because, in terms of premium volume, the EU’s consolidated insurance market is the largest in the world. However, as the world’s largest single nation insurance market, U.S. insurance authorities have repeatedly refused to submit to the formal EU Solvency II equivalence process. The United States has long-held that the United States substantively and structurally regulates its insurance sector as the United States determines appropriate, just as the EU determines how to supervise the insurance sector within the EU.

However, the United States has also long known that failure to resolve the Solvency II “equivalence” issue could result in: (1) U.S. reinsurers losing opportunities in the EU reinsurance market, and (2) U.S. primary insurers being forced to satisfy Solvency II global group capital, reporting and governance criteria that are far different, and far more costly, than current regulatory practices in the United States. In the absence of a resolution, U.S. insurers operating in the EU face potentially billions of dollars in Solvency II compliance costs.

As the EU moved to implement Solvency II and U.S. insurance stakeholders learned more about the potential negative impact on U.S. reinsurers and insurers, state regulators continued the massive (albeit piecemeal) effort to reform reinsurance oversight, an initiative that should be applauded for its embrace of a risk-based framework. Nevertheless, in exchange for this reform, state regulators received nothing of benefit for U.S.-based insurers and reinsurers operating in the EU. Nothing.

After difficult and contentious negotiations that began in early 2016, the Covered Agreement will resolve these long-standing issues. The Covered Agreement will remove excessive unnecessary regulation of the global reinsurance industry in both markets, open the EU reinsurance market to U.S. reinsurers, and relieve U.S. primary insurers of potentially billions of dollars in Solvency II compliance costs.

While providing a balanced outcome with an equally meaningful outcome for the EU, the Covered Agreement puts America’s interests first. U.S. consumers, industry and the U.S. national economy will benefit because of the Covered Agreement.

Covered Agreement Negotiations — Process and Transparency

U.S. state regulators, most of whom are appointed and serve at the will of a state Governor, have never before been directly included in the negotiating delegation for a U.S. international agreement. In recognition of the unique role of the states in insurance sector oversight, and even though not required by law, the Covered Agreement negotiation process created an unprecedented mechanism for state regulator participation.

Treasury and USTR asked the state regulators to establish a small covered agreement task force of commissioners, and allowed the state regulators to determine the size and membership of the task force.

State regulators were invited to, and did, participate in every Covered Agreement negotiating session.

State regulators were invited to, and did, share perspectives, technical insights, and ask questions during U.S. delegation preparations in advance of any Covered Agreement negotiating session.

State regulators were consulted throughout the Covered Agreement negotiation process, including during any Covered Agreement negotiating session. During the Covered Agreement negotiations, a state regulator sat at the table with the U.S. delegation and frequently provided technical insights.

Through a confidential web portal established for purposes of Covered Agreement negotiations, state regulators received all documents offered by the EU shortly after those documents were received by Treasury and USTR.

Through the same confidential web portal, state regulators received all U.S. Covered Agreement documents before those documents were provided to the EU.

Before any U.S. Covered Agreement document was provided to the EU, state regulators were invited to, and did, participate in a telephone call with Treasury and USTR to provide feedback and insight, and to ask questions. These telephone calls frequently offered important insights and perspectives that were incorporated into, or addressed in, the U.S. Covered Agreement document before that document was provided to the EU.

Prior to my departure from Treasury, both Treasury and USTR expressed appreciation to Wisconsin Commissioner Nickel and his colleagues from California,Texas, Missouri, Florida, Vermont, Tennessee, Kentucky, Maine and Montana for their constructive input and insights provided throughout the Covered Agreement negotiation. These regulators, including Commissioner Nickel, should be commended for contributing substantial time and energy to the Covered Agreement negotiations even while tending to the business of insurance in their home states and to the various NAIC activities in which they are engaged.

In addition, throughout the Covered Agreement negotiations, Treasury and USTR consulted extensively with the four Committees of jurisdiction in Congress. These consultations occurred in person and by telephone, and occurred before negotiations

began, before and after each negotiating session, and before the negotiations and the Covered Agreement were finalized.

Treasury and USTR also extensively consulted with private sector stakeholders, particularly those U.S. insurers and reinsurers with operations in the EU.

Treasury and USTR also worked closely with the entire U.S. Covered Agreement negotiating delegation which, in addition to Treasury and USTR and the state regulators, also included the Departments of Commerce and State, and the Board of Governors of the Federal Reserve System.

This extensive transparency and stakeholder engagement supported and informed the joint Treasury and USTR effort throughout the Covered Agreement negotiations.

Credit for Reinsurance Reform — Removing Excessive Regulation of a Global Industry

The reinsurance industry largely manages risk on a global basis. The reason is obvious: in order to avoid concentration of risk from natural catastrophes, or from a mass epidemic, reinsurers spread capital to different areas and continents. Insurance supervisors support this approach in order to promote affordable and reliable reinsurance markets and, in turn, to promote the affordability and accessibility of insurance products to working families and small businesses throughout the United States.

The Covered Agreement will support the U.S. state-based initiative to reform reinsurance regulation. In fact, the 32 U.S. states that have adopted reinsurance collateral reform already provided collateral relief to 31 non-U.S. reinsurers. Of those 31, 30 now hold 10% or 20% of the collateral required under prior state laws. The state regulators' adoption of the NAIC Model Law and Regulation as an accreditation standard, effective January 1, 2019, means that all states would be expected to adopt a substantially similar reform in the next two years.

If domiciled in a non-equivalent country, a reinsurer operating in the EU could be subject to EU member state laws that require collateral or a local presence. U.S. reinsurers were experiencing this burden in full force: at least two EU member states, with more in process, required that U.S. reinsurers either establish a subsidiary or operate in the EU member state only without the use of brokers. Beginning in mid-2016, U.S. reinsurers were losing existing EU clients and missing new opportunities in the EU.

The Covered Agreement eliminates collateral and local presence requirements for EU reinsurers operating in the United States and U.S. reinsurers operating in the EU, thereby eliminating excessive reinsurance regulation in both markets and establishing a new paradigm for oversight of this essential global industry.

If the Covered Agreement conditions are met, current collateral requirements for EU-based reinsurers will be eliminated within 60 months from the date the Covered Agreement enters into force or, perhaps, as early as mid-2023. U.S states, therefore, have sufficient time within the NAIC's existing plan for accreditation (i.e. January 1, 2019), to conform all state laws to the terms of the Covered Agreement, thereby rendering unlikely the need for FIO preemption of state law.

In addition, if the Covered Agreement conditions are met, current local presence requirements for U.S. reinsurers in the EU (or EU reinsurers in the United States) will be eliminated within two years from the date of signature. Due to the successful conclusion of the Covered Agreement negotiations, EU member states that were imposing local presence requirements on U.S. reinsurers have already agreed to forbear from enforcing compliance.

In addition, by imposing meaningful reporting requirements coupled with the potential for re-imposition of local presence or collateral requirements, the Covered Agreement enhances the protections available to primary insurers and consumers in both the EU and the United States. For example, a reinsurer must confirm in writing that it consents to the jurisdiction of the courts where the primary insurer is domiciled, and must consent in writing to pay all final and enforceable judgments wherever enforcement of that judgment is sought. Also, reinsurers must maintain a practice of prompt payment, and can be required to report to the ceding insurer's supervisor semi-annually with an updated list of all disputed and overdue reinsurance claims outstanding for 90 days or more.

These protections, and the myriad others contained in the Covered Agreement, apply to U.S. reinsurers operating in the EU and to EU reinsurers operating in the United States. In exchange for these enhanced consumer protections, the EU and U.S. reinsurance markets will be open to non-domestic competition in an unprecedented manner, thereby providing free market opportunities that will meaningfully benefit ceding insurers and insurance consumers.

Finally, and importantly, the Covered Agreement provides that U.S. state law and regulation (and EU law and regulation) can revert to its prior form if the Covered Agreement is terminated. Termination of the Covered Agreement will allow for the "snap back" of collateral or local presence requirements, precluding the prospect that the EU or United States could benefit from the Covered Agreement despite failing to comply with its own obligations. *See* Article 3, paragraph 9.

Group Supervision — EU – U.S. Mutual Respect Finalized

The Covered Agreement describes group supervision practices in a manner that accommodates the distinctly different approaches of the United States and the EU. Notably, the group supervision practices of the Covered Agreement apply only to those insurers operating in both the EU and the United States.

Through the Covered Agreement, the EU and the United States acknowledge that supervisors of the jurisdiction in which the insurer or reinsurer is domiciled are the only supervisors with authority to supervise the insurer or reinsurer at the global group level.

The Covered Agreement does not require either the United States or the EU to change group supervision practices. The Covered Agreement does, however, ensure that EU and U.S. regulators can continue with those jurisdiction-specific practices that protect consumers and promote financial stability.

The Covered Agreement group supervision practices memorialize the mutual respect shared by the EU and the United States, and comprise explicit recognition that neither the EU nor the United States will change insurance oversight systems and structures just because of the other. As a factual matter, supervisors in both jurisdictions have adopted, or pursued, practices that originated with the other. For example, U.S. state regulators began development of an Own Risk Solvency Assessment (ORSA) based on the idea as it originated with the EU. Over time, U.S. state regulators adopted the ORSA but in a U.S.-specific way. At the same time, EU supervisors have studied the U.S. state regulators' approach to the collection, compilation and publication of insurance industry data, and are developing a manner and system of insurer reporting that, while different from the U.S. state approach, is premised upon U.S. state-based concepts and practices.

Beginning in 2014, U.S. state insurance regulators, through the NAIC, began development of a group capital calculation for U.S. insurers and reinsurers. This initiative reflects a growing awareness among international insurance supervisors, including at the U.S. state level, that a common group capital standard for multi-national insurers will allow for non-domestic insurance regulators to protect consumers and promote financial stability within their jurisdictions. Although the NAIC group capital initiative has been under development for over two years, it remains in the early phases as state regulators evaluate alternative approaches both to the scope and the technique for the calculation.

It is clear, however, that the NAIC's group capital calculation will not amount to a group capital requirement, and will not require capital to be held by U.S.-based insurers and reinsurers in any place other than the insurance legal entities over which state regulators have authority. The Covered Agreement confirms these two facts, and provides U.S. state regulators with flexibility to build the U.S. group capital calculation on specifications that they determine appropriate. *See* Article 4, paragraph h.

To repeat for clarity, the Covered Agreement only requires that U.S. state regulators proceed with group capital work already underway at the NAIC, and does not specify how that work should conclude. To be abundantly clear, the Covered Agreement would not require that U.S. state regulators develop an approach that requires capital to be held outside of an insurance legal entity, and the reference to "corrective, preventive, or otherwise responsive measures" merely restates existing state-based insurance holding company laws. Indeed, to repeat again for clarity, the Covered Agreement further limits the application of the state regulators' group capital calculation to a much smaller group of U.S. insurers and reinsurers (i.e. only those operating in the EU) than presently contemplated by the state regulators.

Importantly, just as the United States sought respect for the U.S. approach to its group capital calculation, the Covered Agreement is also drafted in a manner that accommodates and expresses respect for the EU approach to a global group capital requirement.

The Covered Agreement limits the application of the EU's Solvency II global group supervision practices to the operations and activities of U.S. insurers that occur in or originate from the EU. While the same limitation of U.S. law also applies to EU insurers operating in the U.S. market, it is the limitation on the application of Solvency II that saves U.S. insurers potentially billions of dollars in additional compliance costs. The savings for U.S. insurers and reinsurers will benefit U.S. insurance consumers through increased affordability, increased insurer investment in the U.S., and more efficient use of the capital that would otherwise be tied to Solvency II compliance.

The Covered Agreement will provide insurers and reinsurers that operate in both the United States and the EU the long-sought clarity and certainty with respect to the relationship between the two different supervisory approaches. The Covered Agreement incorporates, and memorializes, shared mutual respect between the EU and the United States, and will close with finality issues between the United States and the EU that have been pending for more than a decade.

Reinsurance and Group Supervision Issues Resolved with Finality

Neither the United States nor the EU can benefit from the terms of the Covered Agreement without also providing to the other the benefits of the Covered Agreement. In other words, the provisions of the Covered Agreement are cross-conditional. If the United States fails to perform on the reinsurance reforms, then the EU need not comply with the group supervision practices. If the EU does not comply with the group supervision practices, then the United States need not comply with the reinsurance reforms.

The cross-conditional nature of the Covered Agreement incentivizes supervisors in both the EU and the United States to comply with the terms. For this reason, among others, the Covered Agreement does not need to be clarified with further written materials. This would be a fool's errand. The Covered Agreement terms, painstakingly negotiated, are abundantly clear, even if not written to resolve every stakeholder's nuanced fantasies.

To the extent that the EU and the United States have questions about interpretation or implementation in the coming years, the Covered Agreement establishes a Joint Committee to address and resolve any open question. This Joint Committee mechanism, not unlike those established to implement other international agreements, would allow for both broad and targeted subjects to be addressed in a collaborative manner, again a reflection of the shared substantial and mutual benefits of the Covered Agreement.

If both the EU and the United States comply with the Covered Agreement terms, then the Covered Agreement becomes permanent and final. *See* Article 10, paragraph 1.

Federal Insurance Office

After the financial devastation wrought by the financial crisis, and in recognition of the central role of a U.S. insurer in that devastation, Title V of the Dodd-Frank Consumer Protection and Wall Street Reform Act established FIO to complement the work of the states with respect to the U.S. insurance regulatory system.

FIO, an office within Treasury, has statutory authority to represent the United States on prudential aspects of international matters. In doing so, FIO has worked closely with the professionals at the Board of Governors of the Federal Reserve System, state regulators, and staff at the NAIC. By working with our U.S. and international counterparts, FIO built consensus in the development of international standards that incorporates views accommodating the substance and structure of the U.S. insurance regulatory system.

FIO's collaborative domestic and global leadership has served the best interests of U.S. insurance consumers, industry, and the U.S. economy. Make no mistake — U.S. leadership in the global insurance sector is more important and necessary now than at any time before.

This is a time of rapid globalization within the insurance sector as developing economies around the world seek private capital and insurance products to provide the same benefits to their populations that the industry provides in the United States. These are profoundly meaningful opportunities for organic growth for U.S.-based insurers and reinsurers. As each year passes, these reasons for U.S. global engagement and leadership become more obvious and more important.

FIO has afforded the United States insurance sector its most coordinated, forceful and effective global representation. Choosing otherwise puts American interests far in the rear. The debate of whether the U.S. federal government, including FIO, should have a role in U.S. insurance sector oversight is a bygone relic, a debate from another era, and fails to recognize that the U.S. insurance industry, in all of its diversity, deserves prominent U.S. leadership on important global insurance matters. To the extent the debate remains, the actual salient question is whether the United States prefers to lead or to follow.

If the United States does not engage, or lead, then the United States cedes the development of regulatory concepts to other jurisdictions. The global insurance community will not wait for the United States if we repeatedly re-hash the currently unchallenged merits of the McCarran-Ferguson Act.

Further, FIO has played an essential role in domestic oversight of the insurance sector. FIO has published 16 reports, including on topics relating to insurance consumer matters. This work highlights the state-by-state differences and the impact of those differences on the insurance industry and the American people. Industry and consumers have a shared interest in efficient, well-regulated and competitive markets, and FIO’s reports on the domestic and global industry should continue to facilitate policymaker analyses.

Too often some posit that the choice between consumer protections and industry interests is binary, a zero sum proposition. FIO’s reports, and FIO’s engagement on broader domestic issues of insurance public policy, have been premised upon a balanced and factual dialogue that improves insurance sector oversight.

FIO has also engaged domestically in a broad range of matters, including retirement security, resilience to severe weather events, cyber-security, implementation and interpretation of the 2015 terrorism risk insurance program, as well as nuts and bolts insurance projects such as flood insurance and long-term care insurance.

As an industry of $8.5 trillion in assets (2015 total) in the United States, and a critical tool for all aspects of American personal and commercial activity, the insurance industry deserves a prominent place in Treasury, and the U.S. Executive Branch of government. FIO's statutory authorities serve as a perfect complement to the limitations of state regulatory authority. To view FIO differently diminishes the importance the insurance sector in the United States and minimizes the significance of the insurance issues confronting the American people. In other words, without threatening the regulatory role of the states, Federal leadership, including through Congress, will continue to be necessary to address important insurance issues of national and global interest.

Conclusion

Treasury and USTR pursued a Covered Agreement that would memorialize the obvious prerogative of the United States to determine the substance and structure of U.S. insurance oversight. In addition, Treasury and USTR sought a Covered Agreement that would provide meaningful benefits for U.S. insurers, reinsurers, consumers, and for the U.S. economy.

At every point in the Covered Agreement negotiation, Treasury and USTR prioritized the best interests of U.S. consumers, U.S. insurers and the U.S. economy. While providing equally meaningful benefits for the EU, this Covered Agreement achieves every U.S. goal.

Chairman Duffy, Ranking Member Cleaver, thank you for the courtesy and respect that you showed to me throughout my FIO tenure. I valued the chance to work with this Committee and its excellent staff, including your predecessors, and always benefited from our interaction.

Thank you for your attention. I look forward to your questions