

Testimony of the
National Association of Insurance Commissioners

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Sponsored Enterprises
Committee on Financial Services
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Regarding:
“Insurance Holding Company Group Supervision”

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On Behalf of the National Association of Insurance Commissioners

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Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for inviting me to testify before the Subcommittee.

My name is Ann Frohman. I am the Director of Insurance for the State of Nebraska. I am testifying today on behalf of the National Association of Insurance Commissioners (NAIC). I am pleased to be here to discuss state insurance regulators' activities in the area of group supervision of insurance holding companies.

NAIC Financial Regulation Standards and Accreditation Program

Before delving into the specifics of holding company and group supervision, I must first highlight a program that supports much of this system. State regulators, working through the NAIC, have developed a comprehensive system of baseline prudential standards and practices necessary for supervising the insurance sector. This system, the NAIC Financial Regulation Standards and Accreditation Program ("Accreditation Program"), was developed with regulators, legislators, consumers and industry input to ensure that all states maintain a strong and consistent baseline of financial regulation and regulatory practices. All 50 states are now accredited, and maintaining accreditation requires periodic assessments of compliance that ensure that the laws and rules necessary for accreditation are not just on the books, but followed and enforced.

Failing accreditation can have adverse consequences for a state regulator, as financial examinations performed by a non-accredited state will be rejected by other states. This subjects insurance companies to financial examination by other insurance departments, and thereby threatens the insurance industry in a state, as insurance companies consider relocating to an accredited state to reduce the cost and number of examinations.

As we discuss holding company supervision below, we will reference numerous tools, practices,

and model laws, many of which are necessary for maintaining accreditation.

U.S. Supervisory Monitoring Approaches for Groups

As insurance companies have grown increasingly complex, spanning multiple state jurisdictions and organized with multiple affiliates, state regulators and the NAIC have had to develop tools and processes for ensuring an effective and coordinated approach to group supervision. State insurance regulators monitor insurance groups using three critical mechanisms: Reporting, Financial Analysis and Examination.

Reporting

Regular reporting of certain holding company information is statutorily required and involves a magnitude of data collection activities, including:

- Information concerning the parent company, its subsidiaries and its affiliates;
- Organizational charts and details of affiliated transactions;
- Corporate restructuring and acquisitions/dispositions;
- Whether a foreign person or entity directly or indirectly has control of 10 percent or more of the reporting insurer;
- Whether the insurer is part of a bank holding company regulated by the Federal Reserve Board;
- Whether the insurer is affiliated with one or more banks, thrifts or securities firms, and, if so, the name of the applicable federal financial regulatory services agency regulating the company of affiliation;
- Information on direct premiums written internationally;
- Reinsurance agreements (assumed or ceded) with international insurers affiliates;
- Combined and/or consolidated financial filings; and
- Audited financial statements.

Holding company reporting requests can be *ad hoc* as well, based on need and events.

Other regulators may also require additional reporting, such as what occurs with publicly traded holding companies, and the states typically have access to this information. Nearly 1,800 U.S. insurers who write approximately two-thirds of the domestic industry's

direct premium are affiliated with over 180 publicly traded holding companies that are required to file extensive public disclosures with the Securities and Exchange Commission (SEC).

Financial Analysis (Off-Site Inspection)

Group holding company analysis is a standard part of the insurance regulator's quarterly financial analysis process. It includes analysis of the upstream and downstream holding company entities (both financial and non-financial) as well as of the group structure, affiliated relationships, financial condition and management. It utilizes publicly available information, such as SEC filings or international filings, as well as non-public holding company information specifically requested from the insurer. Since state insurance regulators are charged with protecting the policyholders of insurance entities, the focus of group analysis has been on ownership and other business transactions that involve the insurance entities.

Examination

Risk-focused examination considers holding company risks and their prospective implications on the domestic insurer/group. For multiple insurance entities within the same group, U.S. state insurance regulators encourage the use of group examinations to maximize resources and create efficiencies.

Overall, the U.S. has strong experience with cross-border supervision and coordination activities with troubled companies. In fact, a key strength of the state insurance regulatory system is that multiple jurisdictions provide peer review. For example, in addition to the NAIC's Financial Analysis Working Group (FAWG) activities – a quarterly forum for regulator discussions and collaboration on potentially troubled insurers/groups, which Commissioner Dilweg will discuss in more detail – states conduct quarterly analysis on non-domiciliary insurers/groups. There is also routine coordination with “lead state” regulators of groups.

States also coordinate frequently with other functional regulators, such as the Office of Thrift Supervision (OTS), Federal Reserve Board (FRB), Office of the Comptroller of the Currency

(OCC), Federal Deposit Insurance Corporation (FDIC), U.S. Department of Agriculture (USDA) and Centers for Medicare and Medicaid Services (CMS). An example of this coordination can be witnessed in the NAIC quarterly meetings with federal banking and thrift regulatory agencies.

The Insurance Holding Company System Regulatory Act

U.S. statutory holding company laws in general apply to individual insurance companies, and not to holding companies. Therefore, all states and the District of Columbia have adopted language substantially similar to the NAIC's *Insurance Holding Company System Regulatory Act* (Model #440 or "the Holding Company Act") and its related Regulation (Model #450) regarding change of control for any licensed insurer. The models, which are required in order for a state to comply with the NAIC Accreditation Program, are designed to regulate transactions among insurers and other affiliated entities, mergers and acquisitions, standards for transactions, and holding company information.

The *Holding Company Act* requires annual filings regarding the holding company system and detailing intercompany contract terms and relationships (known as Forms B and C). In addition, virtually all intercompany contracts must be filed with the state insurance department for review. The department must also be informed of major transactions, including material changes to reinsurance contracts, major transactions and investments, management agreements, cost sharing, tax allocation agreements, certain guarantees, intercompany investments and requests for extraordinary dividends. The NAIC Accreditation Program requires adequate and timely analysis of these findings by state insurance departments.

Control

The *Holding Company Act* defines "control" as more than just the presumed control involved with 10 percent or more ownership, in that it includes the ability to influence the insurer, and requires potential controlling owners to receive regulatory approval for changes in control (Form A, discussed in greater detail below). The *Act* specifies minimum financial and non-financial requirements for resources, and requires background information on applicants. Furthermore, the *Holding Company Act* sets out clear criteria under which regulators can deny a change in control:

- (a) After a change of control, the domestic insurer would not be able to satisfy the requirements for issuance of a license to write the line or lines of insurance for which it is currently licensed;
- (b) The effect of the merger or other acquisition of control would be substantially to lessen competition in insurance in the state or create a monopoly;
- (c) The financial condition of any acquiring party is such that it might jeopardize the financial stability of the insurer or prejudice the interests of its policyholders;
- (d) The acquiring entity's plans or proposals to liquidate the insurer, sell its assets, consolidate or merge it with any entity, or make any other material change in its business or corporate structure or management would be unfair and unreasonable to policyholders and not in the public interest;
- (e) The competence, experience and integrity of the persons who would control the operation of the insurer are such that it would not be in the interest of policyholders and the public to permit the merger or other acquisition of control; or
- (f) The acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

NAIC Framework for Insurance Holding Company Analysis

The *NAIC Framework for Insurance Holding Company Analysis* was incorporated into the NAIC's *Financial Analysis Handbook* to assist regulators in analyzing holding companies. The *Handbook* provides for the designation of a lead state to assist states in coordinating analysis and regulatory review of insurance groups; the Gramm-Leach-Bliley Act's timely action requirements underscore the importance of such coordination.

Elements of such analysis include:

Form A – Statement of Acquisition of Control of or Merger with a Domestic Insurer

The *Holding Company Act* outlines specific filing requirements for persons wishing to acquire control of or merge with a domestic insurer. The person wishing to acquire control must file a Statement of Acquisition of Control or Merger with a Domestic Insurer (Form A) with the domestic state of each insurer in the group. The domestic state or lead state then communicates

the filing with all impacted states. Individual state statutes and regulations may impose public hearing requirements and time limitations on the review period, and federal law sets out the time period for review of any transactions with depository institutions. The NAIC's Accreditation Program requires that the filing be reviewed in a timely manner and that the reviewing state insurance department have sufficiently qualified staff, as well as appropriate procedures, to perform the review.

Form B – Insurance Holding Company System Annual Registration Statement

The Insurance Holding Company System Annual Registration Statement (Form B) allows state regulators to identify and evaluate the relationships within holding companies that affect insurers. The *Holding Company Act* requires every insurer that is a member of an insurance holding company system to register by filing a Form B within 15 days after becoming subject to registration, and annually thereafter. Furthermore, a non-domiciliary state may require any insurer that is a member of a holding company system and authorized to do business in the state to furnish a copy of its Form B registration statement, even if the insurer is not subject to registration in its state of domicile.

Form D – Prior Notice of a Transaction

The *Holding Company Act* requires each insurer to give notice of certain material affiliated transactions through Form D, Prior Notice of a Transaction. These transactions are then reviewed by the company's domiciliary state to determine if they are fair and reasonable to the interests of the insurer. The transaction is considered material if, for non-life insurers, it is the lesser of three percent of the insurer's admitted assets or 25 percent of the policyholders' surplus, and for life insurers, three percent of the insurer's admitted assets. Each is considered as of the most recent year prior to December 31. Some states have stricter definitions of materiality in their holding company regulations.

Form E (or Other Required Information) – Pre-Acquisition Notification Form Regarding the Potential Competitive Impact of a Proposed Merger or Acquisition by a Non-Domiciliary Insurer Doing Business in the State or by a Domestic Insurer

The *Holding Company Act* requires that any domestic insurer, together with any person controlling a domestic insurer or proposing a merger or acquisition, file a Form E or other required pre-acquisition notification form. The insurer may also be required to file documents with the Federal Trade Commission under the Hart-Scott-Rodino Act. The period for review and action on proposed affiliations for transactions falling under the Gramm-Leach-Bliley Act (GLBA) is limited to 60 days prior to the effective date of the transaction. Under Section 104(c)(2) of GLBA, states have a 60 day period preceding the effective date of the acquisition, change, or continuation of control to collect information and take action.

Extraordinary Dividend/Distribution

The *Holding Company Act* requires that any domestic insurer planning to pay an extraordinary dividend or make any other such distribution to shareholders receive proper prior regulatory approval. Some states require a 30 day waiting period after the state insurance commissioner receives notice of the declaration, during which period the commissioner may approve or disapprove the payment. Hence, regulators use this tool to monitor capital flows within a holding company system.

The Berkshire Hathaway situation in my state of Nebraska is a good example, which I would be happy to expound upon in questioning.

Hitting It Head-On: What We've Done in Nebraska

Nebraska in 2008 enacted a new statute creating a voluntary system of supervision at the group level. The new law enables the Director of Insurance to promulgate rules and regulations for group-wide supervision of U.S. insurance groups having a Nebraska domestic insurer within the group. Under the new law, all group supervision requirements must yield to the concept of how group activities affect the operations of the insurer.

The statutory requirements set forth a voluntary review process whereby applicants must address capital adequacy policies, intra-group transactions, risk management and internal control policies. In promulgating regulations, the Director may consider rules and regulations adopted

by the European Union or any individual country. The law also contains enforcement ramifications for noncompliance.

State Regulators are Actively Strengthening Insurance Group Supervision

To date, state insurance regulation of groups has focused on ring fencing the insurers – requiring information about any material transaction with the insurers, including regulatory approval or at least review in most cases. In the case where there is an imminent threat to an insurer’s financial position, regulators may file an application for receivership in order to wall off the assets of the insurer from non-insurance entities within the group. Recent experience has shown that the activities of non-insurance entities within the group with no connection to the insurers can still have an impact on the insurers, due to contagion and reputational risk. In response to this and the recent global financial crisis, U.S. regulators and international standard setting organizations have taken steps to improve the financial services regulatory system and encourage more frequent communication and coordination among supervisors.

The Group Solvency Issues Working Group

Based on recent events and changes in the global marketplace, the NAIC established the Group Solvency Issues Working Group (GSIWG) and charged it with identifying necessary changes to the *Holding Company Act* . The working group will study the need to develop group-wide regulatory requirements and best practices, including the need for enhanced group-wide reporting and consideration of non-regulated entities. It will recommend courses of action to improve cross-border communication and coordination (both internationally and across U.S. state borders) among supervisors, including supervisors of other financial sectors where appropriate.

Group structures permitted to hold U.S.-based insurers come in many different forms. These groups may include unregulated entities as well as regulated entities – including financial services entities – within the same group holding company structure. Current state insurance holding company laws do not differentiate between a group that is local in nature and one that is internationally active. An internationally active group might simply operate across jurisdictional

borders while incorporating all entities under one jurisdiction, or it might choose to organize entities in other jurisdictions and operate from many global bases.

In the U.S., group supervision is conducted primarily through licensed entities during the quarterly financial analysis monitoring efforts arising from filings made under the *Holding Company Act*. The U.S. insurance regulatory system is often described as a “solo” or “legal” entity approach, with oversight concentrated on the legal entity, in contrast to the consolidated approach found in other jurisdictions. A better description might be “solo-plus,” given the licensing oversight, financial analysis and other monitoring conducted under the auspices of the *Holding Company Act* and the examination authority of the state insurance commissioner. It is important to emphasize the “lead state” concept woven into the U.S. supervisory regime for two or more insurers operating within a single group, but domiciled in different states, as well as in the aforementioned state regulator-only coordination and communication forum called the Financial Analysis Working Group (FAWG). FAWG provides an additional layer of surveillance for groups that supplements individual state insurance departments’ solvency monitoring.

Often overlooked is the existing authority of U.S. regulators to examine affiliates when information is not forthcoming from an insurer. Under state holding company laws, domestic regulators are required to review certain transactions between insurers and their affiliates to ensure that they are reasonable. As discussed, regulators must approve dividends and distribution payments in excess of a certain amount.

Enhancing Group-Wide Supervision

GSIWG has recommended that group supervision efforts be enhanced in a few key areas, building on the positive attributes of current insurance group regulation in the U.S. Specifically, GSIWG recommends that regulatory windows be added to the U.S. insurer solvency regime, regardless of the multidimensional nature of the group. The goal is to incorporate certain prudential benefits of group supervision into the solvency regime, providing a window into group operations, while building upon the existing walls that provide solvency protection. Ultimately, this “windows and walls” approach should provide much needed breadth and scope

enhancements to solvency regulation while maintaining the current high level of policyholder protection. It would also increase understanding of the potential implications of group financial and reputational risks on an insurer within the group.

Incorporation of these enhancements into the current U.S. group solvency supervision structure would advance a strong U.S. financial regulatory framework for insurers operating within groups.

The specific enhancements include the following.

1. Communication among Regulators. Communication among regulators is the first and most important component of group supervision of regulated entities. Communication with the primary regulator is the key, whether state, federal or international. At a minimum, this should occur on a bilateral “asked and answered” approach. While states have entered into memoranda of understanding (MOUs) with federal regulators, and a number of states have entered into confidentiality agreements with non-U.S. jurisdictions, state participation could be further coordinated on a national basis to better provide for sharing of confidential information with international regulators.

If the level of scrutiny given to a regulated entity is heightened to a “troubled financial status,” the level of communication should immediately be elevated from the “asked and answered” approach to a “proactive confidential communication.” This could conceivably be accomplished through existing MOUs or through an enhanced Master MOU mechanism for sharing with federal regulators as well as with international supervisors. While the legal authority for elevating such communication to a required status may need to be examined and clarified more fully, the idea would be to ensure that confidential notifications among state, federal and international regulators regarding troubled insurers occurs on a proactive basis when the insurer is operating in a group with entities subject to federal or international oversight. The other functional and international regulators should also immediately notify state insurance regulators of financially troubled entities within their jurisdiction to the extent such entities operate within a corporate group containing an insurer.

2. **Supervisory Colleges.** U.S. state insurance regulators participate regularly in supervisory colleges for insurance-related entities around the world. My state of Nebraska, along with Delaware and Maryland, is convening a supervisory college for Berkshire Hathaway Group, Inc. The Berkshire Hathaway Supervisory College serves as a permanent platform for facilitating the exchange of information, views, and assessments, enabling members to gain a common understanding of the risk profile of the group to enhance risk-based supervision and thereby strengthen solo supervision efforts.

Members of the Berkshire Hathaway Supervisory College have met via conference call several times over the past year to discuss procedural matters related to governance, process, timelines and information sharing agreements. They have set out goals and expectations for the supervisory college, and held substantive discussions on the regulated entities' inherent risks, financial positions and business plans to give supervisors a better understanding of the various entities regulated by supervisory college members. The supervisory college will have its first in-person annual meeting on April 14 here in Washington, D.C. It will include company presentations and discussions among regulators to facilitate the safe and efficient exchange of confidential information.

Supervisory colleges could be formally incorporated into the regular review processes of internationally active groups through *Holding Company Act* enhancement and regulator best practices. In addition to providing a “big picture” view of the group as a whole, supervisory colleges serve to provide clear channels of communication to navigate through a potential financial crisis.

3. **Access to and Collection of Information.** Access to meaningful information about unregulated entities that include non-operating holding companies represents a challenge for all regulators. The U.S. group solvency structure should enable broader access to information upstream and with regard to all holding company groups with regulated insurance entities. It may not be necessary to license holding companies if regulation can accomplish a centralized, regular and confidential reporting mechanism by the holding company with information on all entities under its control. Tools to aid in this regard could

include enhanced Form B registration requirements and establishment of a central collection of group consolidated financial information for certain holding companies.

This is an important item. One of the strengths of the national system of state-based regulation is the multiple sets of eyes on the same or similar issues. Ensuring that all functional regulators have access to relevant and meaningful data for more than the entities directly regulated will allow this strength to be capitalized upon for the entire U.S. financial system.

- 4. Enforcement Measures.** Clear regulatory tools should exist to protect the insurer and its policyholders when violations occur. This may not require registration of a holding company if sufficient jurisdiction exists to ensure access to information. Increased penalties and harsher consequences for not providing information should be put in place. Finally, standards for transactions with affiliates should be clarified and strengthened, as should standards used to establish whether an entity does or does not control an insurer.
- 5. Group Capital Assessment or Requirement.** Effective group supervision should provide a window with a panoramic view of the group as a whole, thereby alerting regulators to double gearing and excessive leveraging. U.S. group supervision should include a review and assessment of capital on a group basis, in addition to retaining separate capital requirements for the solo insurance entity. An understanding of group risk factors would help to assess the risk of financial contagion within a group and better determine the potential for systemic risk.
- 6. Accreditation.** Current language in the NAIC's Financial Regulation Standards and Accreditation Program requires Holding Company Filings to be reviewed. That requirement could be strengthened by requiring incorporation of a Holding Company Analysis Review Team Guideline.

Conclusion

The NAIC is a full partner with Congress and the Administration in seeking ways to improve the financial regulatory system and promote financial stability. That bears true for group supervision as well as for regulation of individual insurance companies, producers and products.

We are not seeking to *regulate* the non-insurance companies in a group, but rather seeking access to relevant information to assess and, where possible, minimize the impact of, contagion risk.

We have been pleased thus far with the cooperation we have received from other regulators where we have dealt with multi-faceted groups. We believe, however, that it would be in the national interest to formalize the information sharing that now exists, and are therefore working to secure changes to the *Holding Company Act* to accomplish that goal.

Thank you for the opportunity to testify, and I would be happy to answer your questions.