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Hearing entitled "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers, Part II"

House Financial Services Subcommittee on Housing and Insurance
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Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for inviting me to testify today on the impact of international regulatory standards on the competitiveness of U.S. insurers.

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

This past September, FIO published its second Annual Report on the Insurance Industry.[1] The 2014 Annual Report includes sections describing (1) a financial overview of the U.S. insurance industry, (2) developments and issues with respect to consumer protection and access to insurance, (3) regulatory developments, and (4) international developments.

Among the highlights, the 2014 Annual Report analyzes data demonstrating that insurers operating in the United States continue to show resilience in the aftermath of the financial crisis, including record levels of reported capital and surplus. On the subject of access to insurance, FIO is statutorily authorized to monitor the affordability of non-health insurance products for traditionally underserved communities, minorities, and low- and moderate-income consumers. Accordingly, the 2014 Annual Report describes FIO's request for public comment on an appropriate definition and metric for assessing the affordability of personal auto insurance.

With respect to U.S. regulatory developments, the 2014 Annual Report discusses matters at the state and federal levels, including activities of the Financial Stability Oversight Council and the pending National Association of Registered Agents and Brokers Reform Act of 2013 (NARAB II). Internationally, standard-setting activities have continued at the International Association of Insurance Supervisors (IAIS) and work to promote cooperation between insurance supervisors in the United States and the European Union (EU) has continued through the EU – U.S. Insurance Project. These international work streams form the basis for this hearing and are the focus of my testimony.

The insurance sector, both nationally and globally, is evolving dramatically, and we appreciate the opportunity to reflect with you upon where it is now and where it is going.

International insurance standard-setting activities are not new. In fact, the National Association of Insurance Commissioners (NAIC) was among the founding members of the IAIS in 1994. Since that time, the U.S. state regulators have worked to set and meet international standards.

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[1] FIO's 2014 Annual Report can be found at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2014_Annual_Report.pdf.

Each of the 56 members of the NAIC is also a member of the IAIS, and state regulators have more votes in the IAIS plenary session (15) than any other jurisdiction.

More recently, since it became a full member of the IAIS in 2012, and consistent with its statutory role, FIO has represented the United States on prudential aspects of international insurance matters, including representing the United States at the IAIS.

At the 2014 IAIS Annual Meeting in October, the U.S. Federal Reserve Board System (Federal Reserve) became a full member of the IAIS. With the participation of state regulators, the Federal Reserve, and FIO, all aspects of the unique U.S. insurance oversight system are engaged at the IAIS.

In addressing the standard-setting work of the IAIS, FIO, the Federal Reserve, and state insurance regulators work together extensively and coordinate frequently. With frequent calls, and meetings, the leadership and staff of all three groups are in close and meaningful engagement. We continue to build and improve upon the mechanisms for consultation and collaboration.

An essential predicate to any discussion of the U.S. insurance sector and its regulation is the recognition that the United States has the most diverse and competitive insurance market in the world. Thousands of insurance companies operate in the United States, ranging from small mutual companies operating in a few rural counties to massive global firms engaged in a variety of financial services. While serving as the Illinois Director of Insurance, I learned firsthand about the importance of small and mid-size companies to the marketplace and to local and regional economies. Despite significant consolidation pressures in the small insurer segment for many years, we work to preserve the important contributions of small- and mid-size insurers to the consumers and communities served by those firms.

The U.S. insurance sector, including the internationally active insurance groups which have generated global interest at the IAIS, has an important role in the national economy. Indeed, in the United States, insurance is both local and global. Insurers compete in markets throughout the country, underwrite risk on a local and personal basis, and consumers have the benefit of local support from state insurance regulators.

Supporting this local and global activity is the global reinsurance industry—a market with many important participants based outside the United States. In fact, based on gross premiums ceded, more than 90 percent of the unaffiliated reinsurance of U.S. property and casualty insurers is placed with a non-U.S. reinsurer or a U.S. reinsurer with a non-U.S. holding company parent.

In fulfilling the statutory role to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters, FIO engagement is guided by three priorities: (1) to promote and enhance a competitive U.S. insurance market through effective, efficient supervision; (2) to establish prudentially sound, equal footing for U.S.-based insurers to operate in new and developing global markets; and (3) to safeguard financial stability.

Competition in the United States means more affordable products tailored to meet the evolving needs of individuals, families, and businesses. At the same time, with an increasingly international insurance marketplace, FIO strongly supports the development of international prudential standards that promote consistent oversight.

In fact, U.S.-based insurers are extending operations in emerging markets around the world, and a growing number expect in the coming years to generate 40 percent or more of revenue from outside the United States. In addition, many well-known insurers in the United States are subsidiaries of non-U.S. holding companies.

Following the development of other financial services by several decades, the insurance marketplace is increasingly global. Private market premium volume increases in countries around the world illustrate that insurers are committed to international growth. Measuring global market share by aggregate premium volume, from 2008 to 2013, the United States' share of the world market declined from 29.06 percent to 27.13 percent despite an increase in real dollars of more than $32 billion. For the same period, China's share increased in real dollars by more than $137 billion and as a percentage of the global market from 3.30 percent to 6 percent. As reported in the 2014 Annual Report, similar proportional increases were seen for that same period in South Korea, South Africa, and Brazil.

These numbers reiterate the message that global demographics have delivered in other ways: developing markets present important growth opportunities for U.S.-based firms and that growth will continue at an increasing rate in the years to come.

As a result, many jurisdictions—including both developing and well-established markets—are modernizing insurance supervisory regimes. For example, in North America, both Mexico and Canada have undertaken sweeping insurance regulatory reforms, as have Australia, China, and South Africa.

With the concurrent forces of increased market globalization and regulatory modernization, international standard-setting activities aim to reduce the breadth of differences among the participating supervisors. By reducing the number of regulatory approaches, reporting requirements, and capital assessment practices, over time the compliance burden for insurers engaged in multinational operations should also decline.

As the insurance sector evolves globally, the United States will continue to contribute constructively in support of that change, and work in support of international standards that, when implemented, will benefit U.S. consumers and U.S. insurers. Working together, U.S. participants are already leading developments in international standard-setting activities. Absent the participation and leadership of U.S. participants, international standard-setting activities would continue without reflecting the unique features of the U.S. market and regulatory structure.

IAIS Capital Standard Development

The development of capital standards at the IAIS dates back to at least 2009, with the commencement of a common framework for the supervision of internationally active insurance groups, or ComFrame. More broadly, and in response to the global financial crisis, G-20 Leaders at recent Summits asked the Financial Stability Board (FSB) to develop a policy framework to address the systemic and moral hazard risks associated with systemically important financial institutions (SIFIs). In response, the FSB, which coordinates G-20 financial regulatory initiatives, developed a framework and called on the relevant international standard-setting bodies to, among other things, develop methodologies for identifying G-SIFIs in each financial services industry.

In July 2013, the FSB called upon the IAIS to develop by 2014 backstop capital requirements (now known as Basic Capital Requirements, or BCR) for global systemically important insurers (GSIIs) and to develop in 2015 an approach to higher loss absorbency (HLA) for GSIIs. These policy measures conform with the G-20 endorsed FSB SIFI framework, which calls for HLA for identified G-SIFIs. In addition, the FSB not only called upon the IAIS to continue development of ComFrame, but also to include in ComFrame a quantitative insurance capital standard applicable to all internationally active insurance groups (IAIGs). This comprehensive work plan and deliverables (including ComFrame, BCR, and HLA) were welcomed most recently by G-20 Leaders last year in St. Petersburg.

At its 2014 Annual Meeting in October, after more than 12 months of data analysis, testing and consultation, the IAIS adopted an approach to the BCR. The BCR is a basic, factor-based approach to measuring capital within an insurance group and across jurisdictions. While it represents a significant milestone as the first global group capital standard for the insurance sector, the BCR constitutes only a baseline, does not assess certain key aspects of risk, and fails to integrate essential features of any long-term capital regime. For example, by virtue of the compressed schedule for its development, the BCR does not measure a GSII's matching of assets and liabilities, an essential consideration when assessing the adequacy of an insurer's capital and risk management practices. However, the BCR serves as a starting point for the development of both the HLA and the Insurance Capital Standard (ICS), the latter of which will likely supersede the BCR as the future basis for HLA for GSIIs.

The HLA represents a significant technical challenge for the IAIS because of the heterogeneity of insurance firms and the variety and complexity of products sold by insurers across the world. The various structures and business models of firms potentially identified as GSIIs and subject to the HLA present a spectrum of considerations before the HLA standard can be designed. For this reason, IAIS members agreed to move the drafting and publication of an HLA consultation paper until the spring of 2015. With the benefit of additional study and outreach to technical experts, the spring release date of the HLA consultation paper will allow for more constructive and insightful feedback from stakeholders.

The IAIS plans to release an ICS consultation paper in December 2014 for a 60-day period. The ICS will be the capital standard applied to IAIGs and will presumably serve as the basis for HLA and GSIIs. The paper will include inquiries and questions relating to the many small and large technical aspects of an insurance capital standard. Notably from the U.S. perspective, the consultation paper will be a meaningful trigger for constructive feedback but is not a definitive statement of policy direction with respect to the ICS. Although technical experts from around the world, including representatives of all U.S. participants, have been involved in various aspects of the data analysis and testing leading to elements of the consultation paper, the IAIS membership has not considered or endorsed any specific approach to the ICS. Importantly, none of the IAIS-developed capital standards will be implemented until 2019, at the earliest.

For purposes of the ICS, U.S. representatives from FIO, the Federal Reserve, and state insurance regulators have been developing a U.S. approach to insurance group capital. This unprecedented undertaking represents a significant step in the ability of the U.S. participants to advocate for a national view on insurance group capital. The participating authorities have repeatedly expressed support for the effort and a continuing commitment to its success.

International standard-setting activities—with regard to capital in particular—remain in the early stages of development. Importantly, international standards are not self-executing and are entirely without legal effect in the United States until implemented through a federal or state process. While under development and prior to final adoption, the IAIS standards will be tested for accuracy, value, and impact both on the U.S. insurance market and on individual firms. In our view, consistent with past practice, implementation at either the state or federal level of an international standard should occur in a manner tailored to the unique features of the U.S. insurance sector, promote competition and consumer choice, and safeguard policyholder protection and financial stability.

IAIS Organizational Reform

The IAIS has recently undertaken organizational reform that improves the independence and transparency of its standard-setting activities. Formerly, the IAIS charged stakeholders as much as $20,400 annually in order to receive the designation of "observer" and thereby receive access to certain meetings and information. The IAIS received approximately 40 percent of its funding from industry and other stakeholders, thereby creating the appearance of a pay-to-play or *quid pro quo* arrangement that detracted from the credibility of IAIS members and stakeholders. Effective January 1, 2015, the IAIS will no longer collect or be dependent upon observer fees, a move which will promote the efficiency and independence of the organization.

Eliminating the observer status and concomitant annual fee has the additional, essential benefit of increasing IAIS transparency. First, open meetings on important topics, previously known as "observer sessions" and available only to those who paid the fee, will now be accessible for all interested stakeholders. Second, the revised consultation process formalizes and will require a written consultation processes that incorporates a publication and comment period so that all stakeholders can offer views. Third, technical experts will be included in and consulted throughout the standard-setting and drafting exercises. For example, as the IAIS recently developed an application paper on market conduct practices, a representative of a U.S. trade association was directly included in and throughout the drafting process. Fourth, access to materials on the IAIS web site will now be available to all stakeholders, not just those who can afford to pay the annual fee. Finally, as in the past, stakeholders will continue to be included in those work streams in which such direct intervention supports the progress and development of the standards.

The IAIS organizational reform is not finalized. A second draft of the consultation process with stakeholders was released yesterday (November 17, 2014) for public comment.

The current draft proposal for stakeholder engagement can be improved. Specifically, we support a requirement that stakeholders who submit comments to the IAIS through a consultation process should receive the benefit of a substantive reply similar to the U.S. administrative law that requires an agency to address comments submitted when adopting a regulation. In addition, stakeholders should have the opportunity to meet directly with the international supervisory community in a manner akin to that which has occurred during IAIS annual meetings. Finally, U.S. stakeholders should have the opportunity to meet and present to all U.S. participants at the IAIS in advance of or after an IAIS meeting. With experience, these opportunities have been increasing and will continue to grow in number and substance.

<u>EU and U.S. Insurance Project</u>

The U.S. and the EU are both significant insurance markets. In terms of premium volume, the EU ranks first and the U.S. second as consolidated markets. The U.S. and EU are home to many of the world's most prominent global insurers—large multinational insurance groups pushing more aggressively into new markets around the world. The EU is also modernizing its approach to insurance regulation through Solvency II.

With these facts in mind, FIO convened the insurance leadership of both jurisdictions at Treasury in January 2012. At this initial meeting, participants included FIO, state regulators, the European Commission, the European Insurance and Occupational Pension Authority, and the United Kingdom regulatory authority. We call this the EU – U.S. Insurance Project (Project). For the last three years, several state insurance commissioners, including Commissioners Voss, McCarty, Consedine, and Urias, among others, have contributed to this effort. With a goal of improved compatibility and consistency, the process recognizes that the U.S. and EU have different regulatory processes and systems, and different markets. Topics being addressed include group supervision, confidentiality or professional secrecy, and reinsurance, as well as reporting, on-site examinations, and actuarial standards.

The Project has been a demonstrably successful collaboration among all involved authorities and individuals. In September 2012, the Project released a report that identified similarities and differences between the regulatory approaches of the two jurisdictions, and in December 2012 the Project released an initial *Way Forward*, which outlined several common policy objectives and milestones for the next five years. Following adoption of Solvency II in the EU in late 2013, the December 2013 release of FIO's report entitled "*How To Modernize And Improve The System Of Insurance Regulation In The United States*," further developments at the IAIS, and continued modernization at the state level, the Project released a revised *Way Forward* in August

2014 which updated the common objectives and milestones.[2] Of course, as with all international developments, implementation will occur in the United States only through federal and state authorities.

A central issue being addressed by the Project is that of a covered agreement for reinsurance and reinsurance collateral requirements. Reinsurance is a risk-sharing tool which effectively provides global risk diversification. The authority to enter into a covered agreement, unlike a comprehensive free trade agreement, is a unique authority given to FIO and the office of the United States Trade Representative (USTR) to negotiate an agreement between the United States and one or more foreign jurisdictions. The terms of a covered agreement as authorized by statute involve prudential insurance measures and could preempt contrary state laws.

The 2014 *Way Forward* reiterates Treasury's support for USTR and Treasury to pursue a covered agreement with respect to state-based reinsurance collateral requirements. The reinsurance business model is global, and the regulation of reinsurance should reflect and integrate that business model. In our view, collateral requirements for reinsurers should be risk-based, not geography-based. The 2014 *Way Forward* also identifies both group supervision and confidentiality/professional secrecy as areas for which the possibility of a covered agreement should be explored. Importantly, a covered agreement must provide tangible benefits for U.S. stakeholders. While the mechanics of the covered agreement process remain under development, FIO welcomes robust engagement with Congress, state regulators, and other stakeholders on the opportunity presented by a covered agreement.

<u>Conclusion</u>

Through effective collaboration at home and abroad, U.S. insurance authorities are positioned to provide U.S. leadership that complements the shared interest in a well-regulated insurance market that fosters competition, promotes financial stability, and protects consumers.

Importantly, it bears repeating that, in all of our work, both internationally and domestically, Treasury priorities will remain the best interests of U.S. consumers, U.S. insurers, the U.S. economy, and jobs for the American people.

We welcome the chance to work with this Committee and its excellent staff, and look forward to more discussions on these important topics.

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

[2] FIO's report on *How To Modernize And Improve The System Of Insurance Regulation In The United States* is available at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf.