S. HRG. 114–98

THE STATE OF THE INSURANCE INDUSTRY AND INSURANCE REGULATIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE UNIQUE ASPECTS OF THE INSURANCE INDUSTRY, THE DEVELOPMENT AND IMPLICATIONS OF DOMESTIC AND INTERNATIONAL CAPITAL STANDARDS, AND EVALUATE THE CURRENT STATE OF INSURANCE REGULATION IN THE UNITED STATES AND ABROAD

APRIL 28, 2015

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PUBLISHING OFFICE

97–357 PDF WASHINGTON : 2015

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C O N T E N T S

TUESDAY, APRIL 28, 2015

WITNESSES

Additional Material Supplied for the Record

THE STATE OF THE INSURANCE INDUSTRY AND INSURANCE REGULATIONS

TUESDAY, APRIL 28, 2015

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Today the Committee will examine several issues of importance to the insurance industry both domestically and internationally.

Dodd-Frank drastically altered the regulatory landscape for insurers. It imposed a Federal regulatory framework on some insurers, despite a clear exemption that exists under the 1945 McCarran-Ferguson Act.

As a result, current law subjects certain insurance companies to regulatory requirements similar to those for banks. And while supporters of the existing regime claim that the law provides enough flexibility to account for differences between banks and insurers, many critics believe that it does not.

As a liability-driven business, insurance often has long-term cash-flow patterns compared to shorter-term activities at banks. Consequently, current law fails, I believe, to adequately account for the business model and risk profile of insurance companies, and that should concern us all.

Last Congress, we passed the so-called Collins fix to make clear that the Federal Reserve has the flexibility to structure capital standards for insurers based on their unique nature. Initially, the Federal Reserve proposed capital standards that, if applied to insurers, would have been all too similar to the capital standards for banks.

Recognizing this to be a mistake, the Federal Reserve then initiated a Quantitative Impact Study, or QIS, to better understand how to design a capital framework for the insurance holding companies that it supervises. I welcomed this development as I have always believed that a strong empirical analysis should inform our regulatory rulemaking process.

It would be unfortunate, I believe, if the Fed uses the QIS process solely to buy time for international insurance capital standards to be developed and subsequently adopted here in the U.S. An

international regulatory regime, I believe, should not dictate how U.S. regulators supervise American or U.S.-based companies.

For example, decisions made at the Financial Stability Board, or FSB, have been adopted in the U.S. by the FSOC with what appears to be little independent evaluation. I have publicly expressed my concerns with both the FSB and the FSOC processes.

The FSB, remember, is not a U.S. regulator, and it is not accountable to Congress or the American people. Therefore, the FSOC should not merely be a rubber stamp for the decisions made by an unaccountable international body like the FSB.

The Treasury Secretary, who also chairs the FSOC, has told this Committee that the FSB's decisions do not bind the FSOC. The FSOC's recent actions, however, leave us to wonder if some of the FSOC members agree with Secretary Lew on this point.

When it comes to insurance, our regulators should acknowledge that the U.S. insurance industry is structured and operates differently than its European counterparts. Our representatives to these international discussions must ensure that their positions, and especially any resulting agreements, recognize these differences and do not disadvantage U.S. companies. The insurance industry has traditionally weathered economic downturns relatively well, and the State-based regulatory framework generally works to protect policyholders.

Today's panel will help us better understand the unique nature of insurance, and hopefully shed light on how to appropriately take into account the differences between banking and insurance. The Committee can then consider whether any changes need to be made to current law.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Thank you to the four witnesses today for joining us. Insurance matters to my State. In addition to the millions of insurance consumers in Ohio, the city of Columbus is second in the Nation in concentration of insurance jobs behind only Hartford.

Insurance became an area of great concern to all of us in 2008 when the near failure and bailout of insurance giant AIG was a central event in the financial crisis, as we know. AIG realized 40 percent of the loss—45 percent of the losses of all insurance in 2008 and received 55 percent of the Government's support provided to insurers.

Dodd-Frank contains a number of provisions to prevent another AIG from happening again, including: creating FSOC, a single entity responsible for examining risks facing our entire financial system; identifying systemic financial firms and encouraging the regulation of risky activities; regulating derivatives, including credit default swaps, eliminating the Office of Thrift Supervision; moving thrift regulation to the Federal Reserve; creating nonbank systemically important financial institution designations; and requiring enhanced capital and leverage rules for nonbank SIFIs, including insurance companies.

Few laws, of course, are perfect. Last year, Congress passed and the President signed into law legislation that Senator Collins, Sen-

ator Johanns, and I introduced to address a specific unintended consequence of Section 171 of Dodd-Frank, known as the Collins amendment. The Insurance Capital Standards Clarification Act allowed the Fed to tailor capital rules to the insurance business model. I look forward to hearing about the Fed's ongoing implementation of that legislation, how it plans to design capital requirements for savings and loan holding companies and nonbank SIFIs.

I also look forward to hearing about international developments, as the Chairman mentioned. In order for our insurance companies small and large to succeed, all of our witnesses today need to be working together on international insurance issues.

Finally, I am interested in hearing about how State and Federal regulators are identifying and addressing emerging risks in the insurance markets, including captive reinsurance, private equity ownership, and reaching for yield.

You all have seats on FSOC where identifying emerging risks is part of preventing the next financial crisis. While I believe that traditional insurance is obviously a distinct business from banking and should be treated as such, it is important to remember, though, that institutions often condone regulated activities in so-called shadow banking. Special purpose vehicles, SPVs, that played a significant role in the financial crisis seem to be making their way back into the insurance market. And we know that insurers can engage in a wide range of activities from derivatives to securities lending.

As we move further and further away from 2008, we cannot forget what happened. We should not take our eyes off potential sources of risk to policyholders and more broadly to the financial system. Each of our witnesses today plays an important role in the regulatory framework for insurance companies. I look forward to each of your perspectives on domestic and international issues.

Thank you.

Chairman SHELBY. Thank you, Senator Brown.

First we will hear from the Honorable Roy Woodall, who currently serves as the Independent Member with Insurance Expertise on the Financial Stability Oversight Council.

Next we have Mr. Mark Van Der Weide from the Federal Reserve. He serves as the Deputy Director of the Division of Banking Supervision and Regulation, under which regulation of the insurance industry currently falls.

Third we will hear from Mr. Michael McRaith, the Director of the Federal Insurance Office.

And, finally, we will hear from Mr. Kevin McCarty, Commissioner of the Florida Office of Insurance Regulation, who will today testify on behalf of the National Association of Insurance Commissioners, of which he is a former president and has worked closely with on international insurance issues.

All of your written testimony will be made part of the hearing record. Mr. Woodall, we will start with you, if you will sum up your remarks. Welcome.

STATEMENT OF S. ROY WOODALL, JR., INDEPENDENT MEMBER WITH INSURANCE EXPERTISE, FINANCIAL STABILITY OVERSIGHT COUNCIL

Mr. WOODALL. Thank you, Chairman Shelby, Ranking Member Brown, and Members of the Committee, for inviting me to appear before you today. This is my second appearance before the Committee, and I truly appreciate the opportunity to share my thoughts with you on this important topic.

After a career in the insurance sector and its regulation that began in 1961, I was asked in 2002 to assist the Department of the Treasury for 1 year with the implementation of the Terrorism Risk Insurance Act, but I ended up staying for 8 years, during Republican and Democratic administrations, and serving under four different Treasury Secretaries.

While at Treasury, my insurance portfolio was broad, but a recurring theme was insurance regulatory modernization. Legislative proposals during that time included an Optional Federal Charter for insurers, Federal insurance regulatory standards to be administered by the States, and the creation of the Federal Insurance Office within Treasury. In addition, I was part of the team that led Treasury's involvement in the legislative debate that culminated in the passage of the Dodd-Frank Act, with a particular focus on those provisions of the law relating to insurance. Ironically, of all of those insurance-related provisions in Dodd-Frank, the one that occupied the least amount of my time was the three-line section that created the position I now fill.

It was not until the House–Senate conference committee convened that the provision for an insurance member with a voting seat on the Council was added to the bill, presumably to be a proxy in view of the absence of a Federal insurance regulator.

After retiring from Treasury, I was nominated by the President to be the newly created Independent Member of FSOC and was confirmed by the Senate in 2011. Today I am the second longest-serving voting member on the Council.

Having been involved in both the development and the implementation of Dodd-Frank, I think I bring a unique perspective on its treatment of insurance, as I have an understanding of how insurance regulatory reform was envisioned as working, where that reform has progressed as intended, where implementation has been effective, and areas in which it might be improved.

The Council has now designated four companies as systemically important nonbank financial institutions, or SIFIs, after deciding that their material financial distress or failure could pose a threat to the stability of the United States financial system: AIG, GE Capital, Prudential, and Metlife. I was in the dissenting minority with respect to the designation of Prudential and MetLife, but I joined the majority in designating AIG and GE Capital.

I am not here today to debate or rehash any of the SIFI designations. However, as noted in my dissents, I believe the Council's focus should be on the activities of financial firms, the interconnections that might arise from such activities, and any potential heightened risks posed by those activities. In my opinion, the preferred approach would be for the Council to examine whether particular activities present systemic risk and, if so, first consider the

Council's other options available under Dodd-Frank. If a company-specific designation does result, however, the Council, in my view, should specify the systemically risky or disfavored activities, or the combination of these activities, that caused the company to be considered a SIFI. This would provide some guidance as to what activities need to be addressed—not just so the SIFI can "exit" enhanced supervision but, more importantly, so that, over time, the company can reduce its "systemic footprint" and thus make the financial system safer and more resilient, which is, after all, the ultimate objective.

Another issue raised in my dissents is my concern that international regulatory organizations may be attempting to exert what I consider to be inappropriate influence on the development of U.S. regulatory policy. As you mentioned, in the aftermath of the financial crisis, the G20 created the Financial Stability Board, or FSB, with the aim of promoting global financial regulatory reform and harmonization.

To that end, the FSB directed the International Association of Insurance Supervisors, or the IAIS, to develop recommendations as to international insurance capital and other standards. These IAIS recommendations are ultimately submitted to the FSB for its consideration and international agreement. If consented to, they will be targeted at those U.S. insurers designated by the FSB as Global SIFIs, as well as those classified as Internationally Active Groups.

While the U.S. Government can enter into consensual international insurance agreements, it cannot commit to full implementation of those agreements or their underlying international standards, as insurance regulation is primarily the responsibility of the States. In the U.S., the decision as to whether and how to implement any FSB insurance-related international standards or policy measures resides with the States and their insurance regulators, and in some cases with the Fed.

Under Dodd-Frank, the insurance authorities granted to Treasury and the Fed are limited to prudential or regulatory matters involving insurance—with trade matters being reserved to the USTR. The USTR is not here today. It is not a member of the FSB or the IAIS, but it has an important role, as envisioned by Congress, especially since international agreements at the FSB may well affect market access, directly or indirectly.

It is this contorted international framework that I will not get into—my time is running out—that is why I think we should be cautious about ongoing initiatives.

As the negotiations are ongoing before your Committee, there is still time to ensure that any international agreement consented to by the FSB is reached through a more open process and that it is in the best interests of the United States and its insurance consumers.

Again, I appreciate the opportunity to appear before you today, and I am pleased to answer any questions you may have. I also stand ready to assist the Committee as you continue the important work of monitoring international developments and improving our regulatory framework.

Chairman SHELBY. Mr. Van Der Weide.

STATEMENT OF MARK E. VAN DER WEIDE, DEPUTY DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE

Mr. VAN DER WEIDE. Chairman Shelby, Ranking Member Brown, and other Members of the Committee, thank you for inviting me to testify today on behalf of the Federal Reserve.

The Federal Reserve welcomes the opportunity to participate in today's hearing, and I am pleased to be joined by my colleagues from the FIO and the NAIC and by the Independent Insurance Member of the FSOC. While we each have our own unique authority and mission to carry out, we remain committed to working collaboratively on a wide range of international and domestic insurance issues.

With the enactment of the Dodd-Frank Act, the Federal Reserve assumed responsibility as the consolidated supervisor of insurance holding companies that own banks or thrifts, as well as insurance holding companies that are designated by the FSOC.

Since the passage of the act, we have been hard at work creating a supervisory framework that is appropriate for the insurance groups that we oversee. Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firm and their subsidiary depository institutions, and also mitigating any risks to financial stability. We conduct our consolidated supervision of these firms in coordination with State insurance regulators who continue their established oversight of the insurance legal entities.

Congress recently amended the Dodd-Frank Act to enable the Federal Reserve to focus on constructing a domestic regulatory capital framework for our supervised insurance holding companies that is well tailored to the business of insurance. Since the passage of this amendment to the Dodd-Frank Act, the Fed has been engaged extensively with insurance supervisors and insurance firms to solicit views on the various approaches to developing an appropriate, consolidated capital regime for insurance holding companies. We are committed to continuing this engagement and to following formal notice and comment rulemaking processes as we move forward on our insurance capital work.

The Federal Reserve is also participating in the development of international insurance standards. Some of the insurance holding companies that we supervise are internationally active firms that compete with other global insurers to provide insurance products to businesses and consumers around the world. Accordingly, in November of 2013, the Fed joined our State insurance supervisory colleagues from the NAIC and the FIO as members of the International Association of Insurance Supervisors, or IAIS.

Through our membership in the IAIS, the Fed has been and will continue to be engaged in the development of global standards for regulating and supervising internationally active insurers.

As a general proposition, we believe in the utility of having effective global standards for global financial firms. When implemented consistently across jurisdictions, such standards can help provide a level playing field for global firms, can help limit regulatory arbitrage and jurisdiction shopping, and can promote financial stability.

Since joining the IAIS in late 2013, the Federal Reserve has been an active participant in several key committees, working groups, and work streams. Throughout our first year-and-a-half as a member of the organization and consistent with our statutory mandate, we have been particularly focused on the financial stability and consolidated supervision work of the IAIS.

One of the key strategic priorities of the IAIS is the development of a supervisory framework and consolidated capital standards for internationally active insurance groups. The Federal Reserve supports the construction of groupwide supervisory frameworks and consolidated capital standards for international insurance groups, so long as they are transparently developed, well tailored to U.S. insurance risks, properly calibrated, and complementary to insurance standards at the legal entity level.

A second key focus of the IAIS involves the identification of global systemically important insurers, or G–SIIs, and the design of an enhanced regulatory and supervisory framework for G–SIIs.

It is important to note that any standards adopted by the IAIS are not binding on the Fed, the FIO, State insurance regulators, or any U.S. insurance company. And during the buildout of standards for global insurance firms by the IAIS, the Fed will work to ensure that the standards do not conflict with U.S. law and are appropriate for U.S. insurance markets, U.S. insurance firms, and U.S. insurance consumers.

Moreover, the Fed will only adopt IAIS regulatory standards after following the well-established rulemaking protocols under U.S. law, which include a transparent process for proposal issuance, solicitation of public comment, and rule finalization.

The Federal Reserve has acted and will continue to act on the international insurance stage in an engaged partnership with our colleagues from the FIO, State insurance commissioners, and the NAIC. Our multiparty dialogue strives to develop a central "Team USA" position on the most critical matters of global insurance regulatory policy.

The Federal Reserve also will continue to actively engage with the U.S. insurance industry to help ensure that any global insurance regulatory standards work well for U.S.-based firms.

Mr. Chairman, thank you for inviting me here today. I look forward to an active dialogue on these issues with you and the other members of the Committee.

Chairman SHELBY. Mr. McRaith.

STATEMENT OF MICHAEL MCRAITH, DIRECTOR, FEDERAL INSURANCE OFFICE, DEPARTMENT OF THE TREASURY

Mr. MCRAITH. Chairman Shelby, Ranking Member Brown, Members of the Committee, thanks for inviting me to testify this morning. I am pleased to be here with my colleagues on this panel.

We released the Federal Insurance Office's second annual report on the insurance industry in September of 2014. The report cited 2013 data showing the U.S. industry reported record surplus levels of approximately $990 billion. Non-health insurers collected more than $1.1 trillion in premiums in 2013, or nearly 7 percent of GDP.

The report also cites data showing that private market volume is increasing dramatically in developing countries. For example,

China's private insurance market increased by more than $137 billion in the last 5 years, South Korea by nearly $50 billion, and Brazil by more than $41 billion in that same period. These facts illustrate the globalization of the insurance market and explain the increased focus on global standards.

For this reason, among others, FIO has a statutory role to coordinate and develop Federal policy on prudential aspects of international insurance matters, including representing the U.S. at the International Association of Insurance Supervisors.

In this work, we collaborate extensively with our colleagues at the Federal Reserve and the State regulators, including my two colleagues on this panel. Our U.S. multipart supervisory structure must be coordinated in order for the U.S. to assert leadership in international developments. That is exactly what happens today.

International insurance standards are not new. The IAIS was formed in 1994. In fact, State regulators were among the founding members. International standards reflect best practices based on collective analysis and the judgment of the participants.

Importantly, international standards are not self-executing in the U.S. Federal and State authorities will study, test, and analyze the potential value and impact of any international standard prior to implementation.

We have the most diverse and competitive insurance market in the world, with insurers that operate in one part of one State and insurers that are multinational and engaged in a variety of financial services. With this in mind, we work with our international counterparts to build a global consensus that works for the United States. Simply put, international standards must, when implemented, serve the interests of U.S. consumers and industry and our national economy.

The IAIS recently completed structural reform. These changes eliminated the pay-for-play dynamic and increased the IAIS' transparency and independence. No longer will the IAIS depend upon the $20,400 annual fee paid by industry observers. Now open meetings and information will be available to all stakeholders, not just those who can afford the annual fee. Consultation with stakeholders will be more rigorous and uniform. After 12 months of extensive public consideration, the IAIS implemented in 2015 a better approach to both governance and transparency.

At FIO, we continue to create opportunities for stakeholders to meet in one place with all U.S. IAIS participants and look forward to increasing those opportunities.

In 2015, we have continued with the EU–U.S. Insurance Project. The EU and the U.S. are two important jurisdictions both as markets and as homes for insurers. With the collaboration of State regulators, we have worked with our EU counterparts to improve understanding and compatibility where appropriate.

One objective identified in the project is a covered agreement. It is not a trade agreement. A covered agreement is an agreement between the United States and another country involving prudential insurance measures. We look forward to engaging with this Committee before and during the negotiations of a covered agreement.

The U.S. market and its oversight are unique. Through effective collaboration at home and abroad, U.S. authorities will continue to

provide leadership that complements our shared interest in a vibrant, well-regulated market that promotes competition and financial stability and protects consumers. In all of our work, internationally and domestically, Treasury priorities will remain the best interests of U.S. consumers and insurers, the U.S. economy, and jobs for the American people.

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

Chairman SHELBY. Mr. McCarty.

STATEMENT OF KEVIN M. MCCARTY, COMMISSIONER, FLORIDA OFFICE OF INSURANCE REGULATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. MCCARTY. Chairman Shelby, Ranking Member Brown, and Members of the Committee, thank you for inviting me to testify today.

The U.S. insurance market is the largest and most competitive in the world. Taken individually, U.S. States make up about half of the world's 50 largest insurance markets. My home State of Florida, for example, is the 12th largest insurance jurisdiction in the world. State regulators cooperate closely on a regular basis to provide leadership on global insurance issues and activities, with a focus on policyholder protections and maintaining stable and competitive markets.

As domestic and global capital rules for insurers are discussed and developed, State regulators continue to oppose a one-size-fits-all, bank-centric set of regulations and focus instead on the importance of company- and product-specific analysis and examination. Capital requirements are important, but if imposed incorrectly or without regard to differences in products and institutions, they can be onerous to companies, harmful to policyholders, and may even encourage new risk taking in the insurance industry. Any capital requirement must be adaptable to our markets and benefit our consumers.

It is also important to keep in mind that any new standards are in addition to, and not in lieu of, State risk-based capital requirements applicable to insurers within groups. Domestically, we encourage the Fed to work closely with us to ensure that standards complement our existing regulatory authority. We supported the passage of legislation last year to give flexibility to the Federal Reserve to tailor its capital requirements for companies subject to their regulation, and we are hopeful that they will now use this flexibility to craft rules consistent with the insurance business model and our legal entity regulation.

Internationally, the IAIS is developing capital proposals for internationally active groups, including many firms based in the United States. We have serious concerns about the process and the aggressive timeline given legal, regulatory, and accounting differences across the globe. All the same, we are fully engaged in the process to ensure that any standard appropriately reflects the risk characteristics of the underlying business and does not lead to unintended consequences such as limiting products or stagnating growth, jobs, and innovation.

While we are committed to collaborating with our Federal and foreign counterparts where we can, we have a responsibility to the U.S. insurance sector. We will not implement any international standard that is inconsistent with our time-tested solvency regime that puts policyholders first.

Critical to the credibility of the decision making at the IAIS is an inclusive and transparent process. We agree that the pay-to-play structure had to go, but we remain concerned with the new IAIS stakeholder and consultation process. We will continue to advocate for increased transparency and encourage our Federal colleagues to support this worthy goal.

We are also concerned with the lack of transparency at the FSB. While we appreciate the role of the Fed, the Treasury, and the SEC as members of the FSB, we have only limited access to the FSB discussions directly relevant to the sector that we regulate. What little participation we do have has only occurred as a representative of the IAIS, even after requesting inclusion from U.S. FSB representatives. Particularly given the role of the FSB in designating U.S. insurers as G–SIIs, we find the lack of support for our inclusion by our Federal colleagues troubling and not in the best interests of U.S. insurers and their policyholders.

For our part, the NAIC has longstanding procedures and ongoing responsibilities to seek input from consumers and other interested parties. We will continue working on these issues through an open, transparent NAIC process. To that end, last year, the NAIC formed the ComFrame Development and Analysis Working Group, known as CDAWG, which I chair, to provide ongoing review of ComFrame and international group capital development standards. CDAWG is also exploring group capital concepts that would be appropriate for U.S.-based internationally active group insurance companies and provide comprehensive feedback to the IAIS regarding their proposed ICS.

We also expect to finalize NAIC's updated position statements on ComFrame and international capital developments shortly, which we will be happy to share with your Committee.

In conclusion, State regulators have a strong track record of effective collaboration and supervision. We remain committed to coordinating with our Federal counterparts. We also take seriously our obligation to engage internationally in those areas that impact the U.S. economy, companies, and consumers. State-based regulation is always evolving to meet challenges posed by dynamic markets, and we continue to believe that well-regulated markets at home and abroad make for well-protected policyholders.

Thank you again for the opportunity to be here on behalf of the NAIC.

Chairman SHELBY. Thank you, Mr. McCarty.

I will start with you, Mr. Woodall. Each of the three insurers designated by FSOC were also designated by the Financial Stability Board, FSB. Two of the companies were designated by FSOC after they were designated by the FSB.

Sir, have you attended the FSB meetings that led to the designation of insurance companies?

Mr. WOODALL. No, Senator, I have not. I am not a member of any of the international bodies.

Chairman SHELBY. OK. Does FSOC take into account FSB designations when considering which nonbanks should be designated? And if so, how?

Mr. WOODALL. Well, essentially FSOC has its own methodology.

Chairman SHELBY. I know.

Mr. WOODALL. And the IAIS and FSB have their methodology. They are very similar. They are distinct in that one is for one organization and one is for the other. But my position has been they are not dissimilar, and the latest GAO report actually showed a chart and compared the methodology of the international to what the methodology of FSOC was and found them very similar.

Chairman SHELBY. Interesting. Mr. Van Der Weide, Section 171 of Dodd-Frank, which we call the "Collins amendment," Collins and others, requires the Federal Reserve to establish minimum leverage and risk-based capital standards for nonbanks that it supervises. Based in part on the Fed's indication that it lacked the ability to tailor these rules for insurers, Congress gave the Fed additional authority for insurers.

When will the Fed propose a capital rule for insurers under its supervision? And will the Fed issue an Advance Notice of Proposed Rulemaking before issuing proposed rules? In other words, where are you?

Mr. VAN DER WEIDE. Yes. So we very much appreciate the amendment to the Dodd-Frank Act a few months ago that has enabled us to tailor our forthcoming insurance capital standards to the actual risks of insurance firms. We think that is going to enable us to produce a better outcome. And we are very much committed to tailoring the forthcoming rule to the risks of the insurance firms that we supervise.

We are in the engagement with industry, data collection, and analysis phase of our work at this point. We are engaging quite extensively with regulated insurance firms, with trade associations, with members of the public, and with State and other regulators of insurance to explore the pros and cons of various approaches that are possible for the Fed's capital rule. We are in the early phases of that work. We will be issuing a proposed rule so that, in addition to the ad hoc engagement that we have been doing with insurance firms and insurance supervisors, we will also go through a formal rulemaking process where we issue a proposed rule for comment. But I cannot give you a timeline as to when that proposed rule is going to come out. At this point we are collecting information, and we want to make sure we get the proposal right.

Chairman SHELBY. Thank you.

Mr. McCarty, I understand that the insurance industry's focus in the U.S. has traditionally been on protecting the individual policyholders while European models traditionally focus more on preventing the failure of a company. Could you elaborate for the Committee on these differences and what importing a European standard would mean for the U.S. markets?

Mr. MCCARTY. Well, there are very fundamentally different ways of viewing the world. The U.S. system has always been predicated on policyholder protection, and when you pursue that particular line of philosophy, that engenders a different kind of policy response. For instance, we allow companies to fail as long as there

is capital sufficient to make sure that the policyholders are made good on their contracts. A very different model than the European system where you are looking really at creditors' protection, which gives a whole different flavor. I think when you try to harmonize those two, it would create the potential for great disruption in the delivery of different services in the marketplace and potentially raises prices for consumers in the United States and potentially jeopardizes the availability of products.

Chairman SHELBY. Mr. McRaith, I continue to hear reports of differing positions being held by U.S. representatives in the International Association of Insurance Supervisors discussions despite modest recent progress. It seems to me that if we are going to participate in these discussions, we should speak with one voice, and that voice should strongly advocate for standards that adhere to the U.S. insurance model.

Do you agree with this? And if so, what will the Federal Insurance Office do to ensure that this occurs?

Mr. MCRAITH. Mr. Chairman, I do agree with your statement and the objective. That is exactly why we spend so much time coordinating with the States and the Federal Reserve. We have a unique multipart structure in the United States in terms of insurance oversight. It is essential that we work together and coordinate. We do it in some cases on the technical subjects. Our teams are in contact every day. At the leadership level, we have regularly scheduled calls and meetings, frequent interaction. It is a relatively new apparatus, if you will. As you know, in the last few years our office was created; the Federal Reserve assumed its role. I think we have worked through the kinks. We are continuing to improve our process.

Chairman SHELBY. I want to go to a last question to Mr. Van Der Weide of the Fed. Will you publish the results of the QIS before the proposed rule? Where are you there?

Mr. VAN DER WEIDE. Yes, so last year we conducted a fairly extensive Quantitative Impact Study, or QIS, of the U.S. insurance industry. This QIS was conducted before the Dodd-Frank Act had been changed to provide the Federal Reserve with the flexibility to adopt a fully insurance-centric capital model.

Chairman SHELBY. How important is that?

Mr. VAN DER WEIDE. It is pretty important. A lot of the data that we collected was based on what was then our legal restriction, and we were at that point required, in our view, to adopt a more bank-centric regulatory capital framework for these firms. So we collected an extensive amount of information on that form of a capital requirement for insurance firms. But now that the Congress has amended the Dodd-Frank Act to give us the freedom to do an insurance-centric capital rule, a lot of that information is no longer going to be relevant to the path forward.

So the information was important, and it helped us to understand a lot of the insurance risk that the firms had. But now that the law has changed and we have freedom to develop an insurance-centric capital rule, the results of that QIS are no longer as relevant as they had been.

Chairman SHELBY. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Mr. Van Der Weide, let me start with you. I was encouraged that you said in your testimony that you are consulting with State supervisors and industry in developing capital standards. That is especially important. In the past, I have urged the Fed to lead, not follow, when negotiating international bank capital standards. I feel the same way about insurance capital.

When we implemented Basel III in the U.S., regulators made changes to some risk weighting and to the leverage ratio. The Fed departed from the Financial Stability Board, from the FSB's proposal for SIFI surcharges for the largest banks. I think that was the right decision also.

Do you agree that U.S. regulators have the discretion to implement international financial agreements, including insurance capital standards, as they see appropriate for U.S. companies? Do you have that discretion?

Mr. VAN DER WEIDE. Yes. It has long been true in the banking context—and it will be true in the insurance context as well—that as a general matter, a fair amount of national discretion is provided to each jurisdiction as to how to implement the international standard. And we would plan to use that national discretion to make sure that any of the international standards that come out are as well tailored as possible to the risks of the U.S. insurance market.

Senator BROWN. Good. Thank you.

Mr. McCarty, the Federal Insurance Office's Insurance Modernization Report in 2014, annual report, as well as FSOC's 2014 annual report, all identified concerns with captive reinsurance. New York's banking superintendent Ben Lawsky calls it "shadow insurance." He has submitted a statement for today's hearing in which he says, and I quote, "It is a troubling regulatory loophole that threatens the financial stability of the insurance market, puts everyday policyholders at substantial risks, and provides billions of dollars in unearned tax deductions to large multinational corporations."

Mr. Chairman, I would ask, if I could, unanimous consent to enter Mr. Lawsky's letter into the record.

Chairman SHELBY. Without objection.

Senator BROWN. Thank you.

The NAIC has released a revised proposal to address shadow insurance, as you know. Many believe that proposal is insufficient. When do you expect, Mr. McCarty, forceful action to address a practice that allows companies to overstate their capital that exposes policyholders and the financial system to risk?

Mr. MCCARTY. Well, first of all, we have been cognizant of this issue for a number of years. In 2011, we first formed a task force to look at the use of captives. The issue really arose out of the fact that products have been evolving and changing over the years. A number of formalistic approaches that were in place for traditional types of reinsurance were found to be lacking because of the changing and evolving marketplace. And one of the ways of addressing that was to use captives to provide relief, if you will, for those. I made it my goal as NAIC president in 2012 to implement a principal-based reserving which would right-size the reserving so we had a more appropriate reserving protocol addressing all across

AXXX and XXX products. We believe we have put in examination and transparency provisions. We are addressing the issue of shadow banking by—or shadow issues by having—both the ceded State and the ceding State have to agree with the transaction. We are putting more transparency in the process. We have organized the Financial Analysis Working Group to evaluate these going forward.

It is also our plan to look at other areas of potential captive abuse. We understand that it is a problem. We are dumping an enormous amount of resources into this situation, and we will continue to monitor this and report to you the progress that we make.

Senator BROWN. If the proposal was initially insufficient, as some have claimed, are you making up for that?

Mr. MCCARTY. No, I think that—the way the process works is you put proposals out there, and you look at ways of perhaps strengthening that proposal and addressing the shortcomings, and we are still engaged in that process and will continue to do so. It is our sincere desire as an organization to close those loopholes and to ensure that there are not any abuses in the captive systems going forward.

Senator BROWN. Thank you.

Mr. McRaith, do you have any comments on Mr. McCarty's comments?

Mr. MCRAITH. Briefly. The proliferation of captives is a concern. It is a concern in some ways less on the industry side. We think most of the industry participants are using these in a responsible fashion. But what it does is highlight differences between the States, and we have concerns about the proverbial race to the bottom. We know the States have confronted serious issues like this before and met the challenge. So that in the late 1980s, early 1990s, States developed an accreditation program, developed statutory accounting in the late 1990s. We think that States will meet the challenge. It is less on the substance of the oversight, more on the implementation and consistency State to State.

Senator BROWN. Thank you.

Mr. McCarty, one last question for you. A recent Goldman Sachs asset management survey of insurance executives found that U.S. insurers are looking to invest in less liquid assets like private equity and hedge funds, commercial mortgage loans, midsized business loans, and securitized credit. Insurers are also likely to outsource some of these investments to third-party asset managers because they lack the systems or the infrastructure to do it themselves.

How are State regulators monitoring these investments, including the third-party asset managers——

Mr. MCCARTY. Yes, we are very concerned about the role that equity hedge funds are playing with regard to—there have been some issues that have been raised, we have seen in articles recently in newspapers. We have formed a specific working group to address these issues, a way of addressing this in the long term.

Senator BROWN. Anyone else want to comment on that?

Mr. MCRAITH. Very briefly, Senator, the article points to the need for vigilance and real diligence at the State regulatory level and from all supervisors to monitor the inflow of unconventional capital into the insurance space.

Senator BROWN. Mr. Woodall.

Mr. WOODALL. In that report, in that survey—really it is a survey—when you get into as far as trying to farm out some of these activities, I think that the charts show that it is a pretty low percentage, maybe 12 percent, even considering that. That is what really it was. It was a survey by Goldman Sachs, and it was just reflecting what they were told by the companies.

Senator BROWN. Thanks.

Chairman SHELBY. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

Mr. McCarty, the National Association of Insurance Commissioners has a long history of successfully regulating and working through with the different States the business of insurance, and I might say successfully regulating over an extended period of time. When I was a State legislator, we worked using model legislation from the National Association of Insurance Commissioners, which we put in and changed the health insurance laws within our State, and we ended up with approximately 93 percent of all of our individuals having the opportunity to purchase insurance because of those model pieces of legislation, and it enhanced the market.

I have been very impressed over a period of years—and I was an actually an independent insurance agent in South Dakota, and I was very pleased with the way that the NAIC worked through a number of issues.

I am just curious. With regard to the NAIC, are there situations out here in which the changes that have been brought about from 2007 forward through the initiation of Dodd-Frank and all that goes with it, has this helped the National Association of Insurance Commissioners to do their job? Or have you found those changes and the further involvement at the Federal level, have you found that to be a detriment in terms of being able to assist in the regulatory process?

Mr. MCCARTY. Well, if you look at the aftermath of the financial crisis and the enactment of Dodd-Frank, Dodd-Frank for all intents and purposes left the State regulatory system intact, and I think that was congressional recognition that the States have been an effective force in protecting consumers and weathering through the financial crisis identifying, of course, the role of the Federal Insurance Office to help identify gaps, to be the voice of the U.S. Government as appropriate at the IAIS. So I think that, you know, there has arguably been some improvements.

We are, you know, finding our way in a new framework, and I think that the NAIC has really redoubled its efforts to try to identify through our Solvency Modernization Initiative to see what things we could do enhancing our Holding Company Act, for instance, looking at best practices around the world by using an own risk assessment like ORSA in our system and other ways to improve our regulatory system.

So we saw the challenges of the financial crisis as an opportunity to really bring out the best that the NAIC has to offer, which is to look at best practices around the country, around the world, and strengthening our solvency regime.

Senator ROUNDS. What has been your biggest challenge in finding your way?

Mr. MCCARTY. You know, I think that the struggles really have been—I think our biggest struggle to date really has to deal with our captives. I think we have done a lot to address the holding company—we have enhanced our Holding Company Act. I think our Holding Company Act would be comparable to what is being used as the standard around the world.

I think we have had good success in our reinsurance collateral reduction. You know, our goal this year is to be at 93 percent, which is a monumental achievement.

I think one of the things that challenges us is the fast changing world and the fast changing dynamics that requires us to change our business practices at home for us to have more rapid response teams, to have deliverables in a more timely fashion, and to coordinate our work with the Federal Reserve and FIO on the international arena so that, to the best of our ability, despite very different cultures and a very different view of the world, we have to do our best to come up with a "Team USA" response which I think strengthens our position globally and will have an impression on the development of the ICS as well as ComFrame.

Senator ROUNDS. Thank you.

Mr. Woodall, I noted in the testimony that you had provided to us earlier, you noted that the international insurance capital agreements contain, as you put it, "risks of unintended negative effects on the U.S. insurance consumers." Can you provide me with some examples of what these potential negative effects might be?

Mr. WOODALL. Well, when you are talking about potential, you do not know how negative they would be. But what I am saying is that when you do that, even though you are talking about prudential agreements, that is a very thin line between that and what a trade agreement might be, because it could affect access of companies abroad, like trade would do, either directly or indirectly. And that is what I was saying that we do not know when those things are being worked out at the international level, how they might affect it. And that is why it is so important that it be administered through the regulatory system that is set in place by Congress with the States and now with the Fed from Dodd-Frank.

Senator ROUNDS. Thank you.

Mr. Chairman, thank you.

Chairman SHELBY. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman. I want to thank you all for your testimony today, very, very good. And a special welcome to Senator Nelson. It is good to see you here back on the Hill.

I am going to start with you, Director McRaith. Senator Heller and I introduced the International Insurance Capital Standards Accountability Act yesterday, and this bill would require the Federal Reserve to create an Advisory Community on International Insurance Standards. I know that FIO already has an advisory committee. Could you briefly tell me how that is working out for you?

Mr. MCRAITH. Sure. So we were able to establish an advisory committee pursuant to the Federal Advisory Committee Act. We did not need a statutory requirement.

Senator TESTER. Right.

Mr. MCRAITH. We have excellent contributions on that committee from State regulators, former—Commissioner Lindeen is as former

member. We are learning how to make the best use of the time of those members. But we also receive advice and consult with stakeholders through many avenues, not just through our advisory committee.

Senator TESTER. Yes. But you consider that a positive avenue for getting information?

Mr. MCRAITH. We welcome advice and perspective in every opportunity.

Senator TESTER. Good. Now, you were directed by FSB to develop some international insurance standards, correct? And how often do you meet, the IAIS?

Mr. MCRAITH. The IAIS, at a technical level, meets frequently. In fact, a few weeks ago there were meetings in New York for a couple days, followed by a full-day public session. There is another public session, I think in New York, on May 6th.

Senator TESTER. All right. Are these advertised?

Mr. MCRAITH. Yes, these public sessions are well known.

Senator TESTER. And what is the difference between the technical level and the public level?

Mr. MCRAITH. So the technical level, the technical experts from around the world—the NAIC, the Federal Reserve, our office—will all meet with their counterparts around the world and discuss the important technical issues, for example, in the development of a capital standard.

Senator TESTER. All right. Are there observers in the technical-level meetings?

Mr. MCRAITH. The observers are—that is the value of the full-day public session. So there are a few days of meetings where ideas are developed. There is then a sharing of those ideas throughout the year. In fact, I think notably last year there were 12 hours for that subject; this year there are already 60 hours scheduled.

Senator TESTER. So when you have public meetings, you have consumer groups, advocates, and companies that can come?

Mr. MCRAITH. In fact, yes. This year——

Senator TESTER. OK. So——

Mr. MCRAITH. Last year, it was restricted to those who paid the fee. This year, anybody——

Senator TESTER. No, and we are not for the pay-to-play stuff. But they can come.

Mr. MCRAITH. That is right.

Senator TESTER. Are they invited, do they have to be invited? Or can they just show up?

Mr. MCRAITH. No, for the public sessions any person—your staff——

Senator TESTER. So that is good. So can you tell me why they are not allowed at the technical session? Or are they allowed?

Mr. MCRAITH. So the technical developments, again, brings people from around the world——

Senator TESTER. I got you.

Mr. MCRAITH. ——with different perspectives.

Senator TESTER. But why wouldn't you allow folks from industry and consumer groups, companies, advocates to listen?

Mr. MCRAITH. So those—any work product generated by those committees is shared directly with the stakeholders.

Senator TESTER. I got you.

Mr. MCRAITH. We also do that in the United States; we host sessions for stakeholders here with the States and——

Senator TESTER. I understand, but it appears to me that the real work—the formalized work will be done in a public session. The real work is done in the technical sessions. Am I wrong on that?

Mr. MCRAITH. Well, I disagree in this sense, Senator, respectfully: The real work is the engagement and the opportunities for engagement, so the development of the idea is then shared publicly, and the stakeholders are given opportunities not just through formal written mechanisms, but to provide direct feedback on the subject.

Senator TESTER. OK. So were these technical meetings that the folks were paying to play at? Were those technical meetings that they were asked not to come back?

Mr. MCRAITH. They were significantly less technical than the meetings now. In fact, this year, they are able to—they are authorized to provide much more technical input much earlier in the process.

Senator TESTER. Not unlike everybody that is on this—I mean, I have been on boards my whole life, and I know that there is—we make rules, and we develop policy, and we develop regulation. And it is my opinion in this democracy it ought to be open. And I do not think there is anything to be afraid of when you are sitting down with these technical meetings, to sit down and let them listen. There is nothing wrong with that. If there is something wrong with that, you have got to tell me. And let them in on it, because, quite frankly, once it gets to a public situation from my perspective—and I have never been to one of these meetings, technical or otherwise—it has already been greased, it is already going.

Mr. McCarty, would you like to respond to that at all?

Mr. MCCARTY. Yes, I would like to intervene. Ten years ago, Al Iuppa, who was the president of the NAIC and also the executive chair of the IAIS, pushed very hard to make the IAIS look more like the NAIC.

Senator TESTER. Right.

Mr. MCCARTY. The working groups and the working parties are where the decisions and discussions were ultimately made, and where the documents were first being formulated. It gave an opportunity for the insurance industry to say, wait a minute, that may work for a business practice in Europe, but our business structure in the United States is very different, and then they went off for help in developing that. So I think it actually improved the product.

Senator TESTER. I agree with you. And not only the industry but advocates, consumers, the works, right?

Mr. MCCARTY. Right. And we funded consumers last year to start attending these.

Senator TESTER. Yes. Look, I agree with the pay-to-play stuff. I do not think it should be—but I am telling you, transparency in Government is a good thing across the board. And the more people you can have—it makes it a pain in the neck, but the more people you can have giving their input, the better off we are. Thank you very much.

Thank you, Mr. Chair.

Chairman SHELBY. Senator Heller.

Senator HELLER. Mr. Chairman, thank you, and it is a pleasure to follow up after my friend from Montana. And a piece of legislation that we put together, I would like to just run down just a little bit, Mr. Chairman, what this legislation does, because in the vein of what he was saying—and I think I want to continue my questions down that path of the importance of accountability, transparency, and collaboration. I think that is incredibly important as we move forward.

And I certainly hope, Mr. Chairman, that you will take a good look at this because I think it is an important piece of legislation. I am not sure that I am comfortable with the Treasury's answers coming from the good Senator from Montana, but we will certainly try to get there. What we are trying to do in this effort is to make sure that the Federal Reserve and the Treasury provide Congress with an annual report and testimony on their activities with these forums, especially the International Insurance Forum.

There was a good article today in the *Wall Street Journal* that discussed what we introduced yesterday, and I certainly believe that Senator Tester and I are moving in the right direction. What we really want for our bill is to ensure that the Federal Reserve and the Treasury study and report to U.S. consumers and the market before—before—they enter into any international capital standards.

So let me try the Federal Reserve a little bit. Mr. Van Der Weide, shortly after the Federal Reserve joined the International Association of Insurance Supervisors, the IAIS voted to shut out the public observers, including consumer groups, from most of the meetings. Can you tell us how our representative voted on this issue?

Mr. VAN DER WEIDE. The Federal Reserve has been supportive of the IAIS structural reforms. Similar to the FIO, we felt like that those were good global regulatory policy moves. It is important, though, as the IAIS removes the paid observer status and attains funding that is not coming from the industry, that they keep as much of the transparency benefits of the old program as they can. They are doing what they can. They are holding multiple stakeholder meetings quite frequently on their developing capital rules and supervisory framework. They plan to continue to do that in formal, fully public meeting environments. This is more public transparency than there was before on those meetings.

So we are generally supportive of this IAIS move. I think it is incumbent on us as well, as U.S. members of IAIS, to enhance that global transparency and to provide as much U.S. stakeholder transparency as possible, and we have been doing that over the last 6 to 9 months. We plan to continue to do that going forward.

Senator HELLER. Let me make sure I understand you answer. So when the IAIS voted to shut out the public, our representative voted with the majority on that.

Mr. VAN DER WEIDE. The Federal Reserve does not have a member on the executive committee, the highest decision-making level body of the IAIS, so I cannot say that we——

Senator HELLER. How about the Treasury Department? Did you have a representative on that?

Mr. MCRAITH. That is correct, Senator.

Senator HELLER. How did they vote?

Mr. MCRAITH. We voted in support of the enhanced transparency that resulted from the structural changes. This year, for the first time we have required public sessions for all of the IAIS work streams. Last year, as I mentioned, there were just over 10 to 12 hours of those sessions. This year already we have about 50 to 60 hours and counting. So we are pleased with the level of engagement. It is much more substantive, technical, and the opportunities for engagement are much greater than ever before.

Senator HELLER. Mr. McCarty, do you have any comments?

Mr. MCCARTY. Well, you know, I agree with my colleagues that we needed to amend the process as it was, that we needed to amend the pay-to-play. But there were many other less intrusive ways of doing it than just closing it out completely to observers and consumers. I voted against that change; so did all of my colleagues from the NAIC. I sincerely believe that both the Federal Reserve and FIO are really looking for better ways to include stakeholders, but I was at the first stakeholders meeting, and I do not think it was going in the right direction in terms of the interaction that was necessary to provide the kind of feedback that the insurance industry needs in order for them to be a meaningful partner in the development of the standards. And hopefully going forward our colleagues can work together to find ways to improve that system.

Senator HELLER. Mr. Chairman, I am grateful that we have our witnesses with us today and their expertise. I just want to reemphasize the importance of this piece of legislation. We are talking accountability, transparency, and collaboration. I want to see that done. That is why Senator Tester and I are working together on this. So thank you.

Chairman SHELBY. Thank you.

Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman. And thank you to the panel for taking the time to be here with us today and talk about a very important issue from my perspective. I spent several years in my career in the insurance industry and am thankful that I had that opportunity and think that the uniqueness of the insurance industry is easily differentiated from the opportunities and uniqueness in the industries like banking. So the capital standards are very important how we get there. We should have a serious, long conversation about those capital standards as we move from in making sure that we have the delineation between the insurance industry and the banking industry as it relates to those capital standards.

My question, Mr. Woodall, is really about the FSOC and the SIFI designation process. FSOC is Dodd-Frank's super-regulator and consists of 15 financial regulators, each with vastly different jurisdictions and backgrounds. While there may be some value derived from getting this group together from time to time, I have real concerns with the designation voting process.

For example, the Director of the Federal Housing Finance Agency, which is the conservator for the GSEs, and the Chair of the Na-

tional Credit Union Administration each have as much say on whether an insurance company gets designated as a SIFI as you do, the Independent Member with Insurance Expertise.

Now, Director Watt and Chairman Matz are honorable and smart people, but I do think that you have a much better barometer of an insurance company's systemic risk than they do, and that matters. Let us take, for example, the case of Prudential. The FSOC voted to designate Prudential. You voted in your dissent, however, that "the FSOC's analysis of systemic risk makes it impossible for me to concur because the grounds for the final determination are simply not reasonable or defensible and provide no basis for me to concur in the vote for designation."

Can you please elaborate on your dissent and more generally on what systemic risk would look like in the insurance industry if it were to exist? Based on your experience with the Prudential and MetLife voting process, do you think the FSOC designation process should be reformed to give a greater say to members with a background in the company whose designation is at issue?

Mr. WOODALL. Well, Dodd-Frank actually gives two statutory determination standards in determining a SIFI, and one is that material financial distress could be a threat to the financial stability of the United States. That was the one that was used.

The second one is that the activities of the company or the mix of activities could amount to be a threat to the financial stability.

My position was that by taking just a scenario and projecting it to say that if they are in trouble it is going to be a threat, I would like to know what the activities are that people feel is a threat, and then that way the regulators know what the fix, the Fed knows what to fix when they get them, and then there is an exit ramp to get out if they do correct them, because what are trying to do is remove any systemic footprint that any of these companies leave. That was the basis of my dissent, and in both the dissents that I had, the State regulator nonvoting member also filed a comment, and then the FHFA, as you mentioned, also dissented in the Prudential matter.

Senator SCOTT. Thank you.

Chairman SHELBY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. I am glad we are here today to talk about insurance and insurance regulation, because I have been looking at a problem that is costing American families about $17 billion a year, and it starts with loopholes in the laws that make it perfectly legal for brokers and advisers, including folks who sell insurance products, to take kickbacks for pushing lousy retirement products on unsuspecting families.

Now, consider what happens with annuities. An annuity is an insurance product in which somebody invests today in order to get a steady payout when they hit retirement. The insurance industry is selling about $200 billion worth of annuities every year, and there may be some circumstances where buying an annuity makes sense. But as one observer noted, "It is not an accident that objective fee-only advisers hardly ever recommend annuities, while commissioned sales people seem to love them."

Now, I got interested in what kinds of kickbacks some of these insurance salesmen were getting when they pushed people to buy

annuities, and what I found is pretty amazing. I found free cruises, luxury vacations at five-star resorts, an African safari, private yacht tours of the Mediterranean, iPads, Mercedes Benz leases, and—get this one—a diamond-encrusted NFL Super Bowl style ring with a large ruby in the middle.

Mr. Chairman, I would like to enter a few of these examples in the record, if I may.

Chairman SHELBY. Without objection, it is so ordered.

Senator WARREN. Thank you, Mr. Chairman.

You know, that is a lot of money going to agent kickbacks instead of returns to customers who are just trying to provide for their retirement.

Now, Mr. McCarty, you have been Florida's insurance commissioner for over a decade, and in that role you have been a real leader in protecting vulnerable seniors from some of the insurance industry's most abusive practices around annuities. Since you are here today, could you describe some of the practices that you have found in this market?

Mr. MCCARTY. Yes. I share your deep concern for the vulnerability of our consumers, particularly as it relates to sales of annuities, where there is a lot of opportunities for misleading our elder seniors into buying products that are not suitable for them, and we use the term "churning and twisting," where you would move them from one product to another product so you could get the new commission and potential bonuses that you have already articulated.

We have taken a very aggressive role in Florida. We have specific laws not only in the insurance code but in the general code against any type of profiteering off of our seniors. We have passed extensive laws that require the salesmen to explain the different products that they are selling and how a difference in the product they have and why it would be superior.

We also have a rescission provision, a 14-day lookback period, but I have also been empowered by the Florida Legislature to rescind those contracts and return all the premium to the consumers if we find out that was something inappropriate to be done to that consumer.

We also looked at a lot of things in terms of we are one of the few States that look at sales materials to make sure they are not misrepresenting to our seniors.

So we have an aggressive policy of protecting consumers in Florida, and we are continuing to look at other States for best practices and would certainly welcome opportunities to do what we can. We want to make sure that there is a flow of benefits. We do not want to stop the opportunity of consumers, because there are legitimate products. But at the same time, we need to be vigilant in protecting our consumers, and I am proud that we do that in Florida.

Senator WARREN. Well, I want to thank you very much for your work. As you point out, you are one of the few States that is that aggressively involved.

You know, most Americans have no idea that the people they go to for retirement advice could get such outrageous giveaways for pushing these products. I believe that the solution here starts with transparency. That is why today I launched an investigation, sending letters to the 15 largest annuities companies, describing the

kickbacks that I found, and asking them to disclose complete information on the perks, the rewards, the incentives, or whatever else they call the inducements they offer to sell these annuities to families and small investors who are trying to plan for their retirements.

I believe that transparency is a powerful first step, but it is not enough. We all know that investing has risks and nobody is entitled to a guaranteed result. But there should be some basic rules of the road to make sure that investment advisers cannot get rich on kickbacks and that giveaways like these cause unsuspecting customers to lose out.

The Department of Labor is working right now to set up those rules. I believe they should act forcefully and quickly, and we should help them in any way we can.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator.

Senator Kirk.

Senator KIRK. Mr. Van Der Weide, I had a question about—as you know, the insurance industry is a pretty large employer in my State, and in your implementation of the Collins fix, I would like to know how the process is going to establish a different capital standard for the insurance industry.

Mr. VAN DER WEIDE. The process is going well, I think. We are in the information collection and analysis phase, so we are engaging heavily with a variety of insurance stakeholders in the United States, including individual insurance firms, their trade associations, and also interacting with insurance supervisors—State insurance supervisors, and foreign supervisors as well—to get their views on the best way for us to go.

This is going to be a very challenging task for us. The Collins amendment fix is very useful, and it will help us to get to an insurance-centric, insurance-tailored capital requirement. But the U.S. insurance industry is pretty intensely heterogeneous, and the 17 firms that we supervise are also intensely heterogeneous. We need to devise a regulatory capital framework that works for life insurers, for property and casualty insurers, for mutuals, for nonmutuals, for systemically important financial institutions, and the smaller firms.

We have a lot of work to do, but thanks to the amendment to the Dodd-Frank Act, I think we will be able to, at the end of the day, produce a capital requirement that works well for all the firms that we supervise.

Senator KIRK. Let me follow up and ask you what would slow down or speed up your work.

Mr. VAN DER WEIDE. I think the work is going pretty well as it is. We have had some pretty high quality and reasonably high quantity consultations with the insurance industry and various other groups. I think we are getting the information that we need.

To the extent that we decide we need additional information, formally or informally, I think we can get that. At this point I think the process is pretty well in train.

Senator KIRK. Mr. Chairman, I think we really need to get this right to make sure that we do not regulate the insurance companies like banks, which could put our insurance industry at a seri-

ous competitive disadvantage. I want to make sure that you have the expertise and ability and the time that you need to come up with a correct standard.

Mr. VAN DER WEIDE. I think we do, and we could not agree with you more that insurance companies have a very different business mix and risk profile than banks, and a bank-inspired capital framework is not the appropriate one for these firms. So we have built some expertise. We are building more expertise, and we are in a pretty deep engagement process with external parties to make sure that we understand how the U.S. State-level insurance capital rules work and the pros and cons of the different options.

Senator KIRK. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

I have one question, Mr. Van Der Weide. Many insurers, as you well know, hold assets to match long-term liabilities. They argue that measuring the day-to-day fluctuations in those assets through a capital regime would create harmful volatility and inaccurately measure solvency.

Do you agree with this assessment?

Mr. VAN DER WEIDE. Yes, insurers are quite different from banks in some material ways, and one of them is in the nature of the assets and liabilities mix that they have and the potential mismatch between their assets and liabilities. Most insurance firms, particularly life insurance firms, have longer-term liabilities and longer-term assets, and that needs to be reflected in any capital framework or supervisory framework that we develop or any insurance regulator develops. So that is a key issue that we need to keep in mind as we move forward.

Chairman SHELBY. Sir, how will the Federal Reserve ensure that the capital regime developed for insurers matches the held-to-maturity practice of insurers?

Mr. VAN DER WEIDE. I think we will do that.

Chairman SHELBY. OK.

Mr. VAN DER WEIDE. This is an issue where there is some international disagreement. Different insurance regulators and supervisors around the world treat these assets differently. So this is an issue that is going to be front and center in our international debates. It has been in the construction of the insurance capital standard, the ICS. We are going to be very focused on that. “Team USA” will be very focused on that as we move forward, and we want to make sure that we have a capital regime that does work for the economics of the U.S. insurance model.

Chairman SHELBY. Thank you. Gentlemen, we thank all of you for participating in the hearing. We have got some work to do, and we appreciate your information and your involvement. Thank you.

[Whereupon, at 11:17 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF S. ROY WOODALL, JR.

INDEPENDENT MEMBER WITH INSURANCE EXPERTISE, FINANCIAL STABILITY OVERSIGHT COUNCIL

APRIL 28, 2015

Thank you, Chairman Shelby, Ranking Member Brown, and Members of the Committee, for inviting me to appear before you today. This is my second appearance before the Committee and I truly appreciate the opportunity to share my thoughts with you on this important topic.

After a career in the insurance sector and its regulation that began in 1961, I was asked in 2002 to assist the U.S. Department of the Treasury (Treasury) for 1 year with the implementation of the Terrorism Risk Insurance Act (TRIA), but ended up staying at Treasury for 8 years, during Republican and Democratic administrations, and serving under four different Treasury Secretaries.

While at Treasury, my insurance portfolio was broad, but a recurring theme was insurance regulatory modernization. Proposals during that time included an Optional Federal Charter for insurers, as well as Federal insurance regulatory standards that would serve as a State regulatory floor. I also worked on legislative proposals that eventually led to the creation of the Federal Insurance Office (FIO) within Treasury, and was a principal contributor to the insurance sections in Treasury Secretary Paulson's *Blueprint for a Modernized Financial Regulatory Structure* (2008) and Secretary Geithner's *Financial Regulatory Reform, a New Framework* (2009).

In addition, I was part of the team that led Treasury's involvement in the legislative debate that culminated in passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), with a particular focus on the provisions of the law relating to insurance. Ironically, of all of those insurance-related provisions in Dodd-Frank, the one that occupied the least amount of my time was the three-line section that created the position I now fill. [1] It was not until the House–Senate conference committee convened that the provision for an insurance member with a voting seat on the Council was added to the bill. Because insurance is functionally regulated by the States, the position was essentially intended to be a "proxy" in the absence of a Federal insurance regulator to counterbalance the other nine voting Council members.

After my retirement from Treasury, I was nominated by the President to be the newly created Independent Member of the Council and was confirmed by the Senate in 2011. And today, I am the second longest-serving voting member on the FSOC.

Having been involved in both its development and now its implementation, I think I bring a unique perspective on Dodd-Frank's treatment of insurance, as I have an understanding of how insurance regulatory reform within Dodd-Frank was envisioned as working, where that reform has progressed as intended, where implementation has been effective, and areas in which it might be improved.

In exercising its Dodd-Frank authorities, the Council has designated four companies as systemically important nonbank financial institutions, or "SIFIs," after deciding that their material financial distress or failure could pose a threat to the stability of the U.S. financial system: American International Group (AIG), GE Capital Corporation (GE Capital), Prudential Financial Inc. (Prudential) and MetLife Inc. (MetLife). I was in the dissenting minority with respect to the designation of two of those companies—Prudential and MetLife, but joined the majority in designating the other two—AIG and GE Capital, as well as the Council's decisions not to advance for further review five other nonbank financial companies.

I am not here to debate any of the four SIFI designations. However, as noted in my dissents, I believe the Council's focus should be on the activities of financial firms, the interconnections that may arise from such activities, and any potential heightened risks posed by those activities. In my opinion, the better approach would be for the Council to examine whether particular activities present systemic risk, and if so, consider the Council's other options available under Dodd-Frank: (1) make recommendations to regulators or to Congress aimed at those activities; (2) designate the activities themselves as presenting systemic risk; and/or (3) designate companies that, in a concentrated manner, engage in such activities or mix of activities in a manner that could pose a threat to U.S. financial stability. If a company-

[1] First, Section 111(b)(1) of Dodd-Frank lists the voting members of the Council and includes "(J) an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise." Second, Section 111(c)(1) of Dodd-Frank sets the Independent Member's term: "The independent member of the Council shall serve for a term of 6 years . . . ." And third, Section 111(i)(2) sets the level of the Independent Member's compensation.

specific SIFI designation does result, the Council, in my view, should specify the systemically risky or disfavored activities, or the combination of those activities, that caused the company to be considered a SIFI. This would provide some guidance as to what activities need to be addressed—not just so the SIFI can "exit" enhanced supervision, but, more importantly, so that, over time, the company can reduce its "systemic footprint" and thus make the financial system safer and more resilient, which is, after all, our ultimate objective.

Another issue raised in my dissents is my concern that international regulatory organizations may be attempting to exert what I consider to be inappropriate influence on the development of U.S. regulatory policy. I would like to elaborate on this concern today, as I remain wary of such influence on our U.S. domestic insurance regulation.

Even though the three lines in Dodd-Frank creating the Independent Member position do not specifically charge it with a specific international role, all members of the Council have a duty under Dodd-Frank, "to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress and make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets."

It is through exercising this general charge that I have become concerned over international developments and pressures. In the aftermath of the financial crisis, the Group of Twenty (G20) created the Financial Stability Board (FSB) with the aim of promoting global financial regulatory reform and harmonization. The FSB's mandate is to: "promote international financial stability; . . . by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies . . . [and] foster a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions."

To that end, the FSB directed the Basel, Switzerland-based International Association of Insurance Supervisors (IAIS)—an international standard-setting organization composed of global insurance supervisors and supported by the Bank for International Settlements (BIS)—to develop recommendations to the FSB regarding international insurance capital and other standards. These IAIS recommendations are ultimately to be submitted to the FSB for its consideration and international agreement. If consented to, these international standards will be targeted at those U.S. insurers designated by the FSB as Global SIFIs, as well as those classified as Internationally Active Insurance Groups.

Decisions made at the FSB, such as those that may soon include international insurance standards and policy measures, are made in private and by "consensus," including the consent of the three U.S. Government agencies that are members of the FSB and act as "national authorities" for the U.S.—Treasury, the Board of Governors of the Federal Reserve System (Board of Governors), and the United States Securities and Exchange Commission (SEC). U.S. State insurance regulators are not represented at the FSB, nor are they party to any consensus agreements at the FSB. In my opinion, U.S. interests may be underrepresented at the FSB, not only regarding the insurance industry, but also as a function of the absence of other U.S. financial regulatory agencies.

Additional international pressures are exerted through the International Monetary Fund and World Bank Financial Sector Assessment Program (FSAP), which issues public "report cards" on U.S. insurance regulators' compliance with the IAIS International Core Standards (ICPs). The most recent FSAP report acknowledges that the U.S. is the largest insurance market in the world and has strong consumer protections. However, it found the U.S. lacking in rigid compliance with some of the ICPs, and endorsed more Federal government involvement in U.S. insurance regulation.

While the Federal Government can enter into consensual international insurance agreements, it cannot commit to full implementation of these agreements or their underlying international standards, as insurance regulation is primarily the responsibility of the States. In the U.S., the decision as to whether, and how, to implement any FSB insurance-related international standards and policy measures resides with the States and their insurance regulators (as provided by Congress under the McCarran-Ferguson Act and reaffirmed in the Gramm-Leach-Bliley Act and Dodd-Frank). The Board of Governors was granted certain authorities by Dodd-Frank in addition to those held by the States with respect to a subset of insurance companies that are either part of a savings and loan holding company, or part of parent holding company that has been designated as a SIFI by the Council. Accordingly, it is critically important to look to the views of the State regulators and the Board of

Governors regarding implementation of any forthcoming international insurance agreements.

It is also important to remember that international agreements and commitments made by the U.S. members of the FSB, including the adoption of IAIS measures, are commitments made under the auspices of the G20. As such, they carry considerable weight. Although it is true that they are not legally binding, such commitments are expected to be implemented as part of the G20's global regulatory reform agenda. Indeed, the current Chairman of the FSB, Bank of England Governor Mark Carney, recently informed the G20 Finance Ministers and Central Bank Governors that "full, consistent, and prompt implementation" of agreed reforms is essential to maintaining an open and resilient global financial system.

If an internationally agreed-upon insurance agreement is not fully or uniformly implemented by the States, or not comparably implemented for both dually regulated (State and Federal) and State-regulated insurance companies, it could, at a minimum, reflect negatively on U.S. leadership internationally. Moreover, less than full implementation of such agreements in the U.S. could prompt foreign jurisdictions to subject U.S. insurers operating abroad to more stringent regulation, which, in turn, could affect U.S. competitiveness. We should be guided by what this situation could mean for U.S. insurance consumers and whether it would be in their best interest.

The competitiveness of U.S. insurance companies abroad also raises international trade considerations. It is important that we also look to the views of another U.S. partner not represented here today—the Office of the United States Trade Representative (USTR) which resides within the Executive Office of the President. While some people may try to separate "prudential" (or regulatory) matters from "trade" matters, in reality, they are closely joined and considered by many to overlap.

Under Dodd-Frank, Treasury and the Board of Governors each has certain authorities that are limited to prudential matters involving insurance—with trade matters being expressly reserved to the USTR as provided under trade statutes. Although USTR is not a member of the FSB or the IAIS, it has an important role, as envisioned by Congress, especially since international agreements at the FSB may well affect market access, directly or indirectly. In this connection, I will note that the USTR and U.S. State insurance regulators have worked well together over many decades to open markets to U.S. insurers, and have done so in a very transparent manner as compared to many international processes.

These international developments that I have briefly noted, help explain why many are raising what I consider to be legitimate concerns now, ahead of any international commitments being finalized, and why we should be cautious about ongoing initiatives by international bodies that could be used to influence policy decisions that Congress has either expressly delegated to the States, or that are the prerogative of the Congress itself. If U.S. Federal Government officials at the FSB are to commit, on behalf of the U.S. to implement international insurance standards in the U.S., then, given the regulatory structure endorsed by Congress, I believe that the outcome of any such commitment should be consistent with proven effective State-based regulation and that any resulting agreement should contain express reservations preserving the discretion as to whether, or how, those standards will be implemented in the United States.

While the negotiation of international insurance agreements may not grab headlines that capture the attention of everyday Americans, these agreements are nonetheless important to the lives of all Americans, given the potentially positive impacts and the risks of unintended negative effects on U.S. insurance consumers, as well as the consequential benefits and costs to the insurance industry and our financial system.

As negotiations are ongoing, there is still time to ensure that any international agreements consented to by the FSB are reached through a more open process and are in the best interests of the United States. And, as is evident in the holding of this oversight hearing, Congress has an important role to play.

Again, I appreciate the opportunity to appear before you today and am pleased to answer any questions you may have. I also stand ready to assist the Committee in any way I can as you continue the important work of monitoring international developments and improving our regulatory framework.

PREPARED STATEMENT OF MARK E. VAN DER WEIDE

DEPUTY DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE

APRIL 28, 2015

Chairman Shelby, Ranking Member Brown, and other Members of the Committee, thank you for inviting me to testify on behalf of the Federal Reserve.

The Federal Reserve welcomes the opportunity to participate in today's hearing, and I am pleased to be joined by my colleagues from the Federal Insurance Office (FIO) of the U.S. Treasury, the National Association of Insurance Commissioners (NAIC), and the independent insurance member of the Financial Stability Oversight Council (FSOC). While we each have our own unique authority and mission to carry out, we remain committed to working collaboratively on a wide range of international and domestic insurance supervisory and regulatory issues.

The Federal Reserve's Role in the Supervision of Certain Insurance Holding Companies

With the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the Federal Reserve assumed expanded responsibility as the consolidated supervisor of a significant number of insurance holding companies. As a result of the Dodd-Frank Act, the Federal Reserve is responsible for the consolidated supervision of insurance holding companies that own an insured bank or thrift, as well as insurance holding companies designated for Federal Reserve supervision by the FSOC. The insurance holding companies for which the Federal Reserve is the consolidated supervisor hold approximately one-third of U.S. insurance industry assets and vary greatly in size and in the types of products they offer.

After the passage of the Dodd-Frank Act, the Federal Reserve moved quickly to develop a supervisory framework that is appropriate for insurance holding companies that own depository institutions and promptly assigned supervisory teams to handle day-to-day supervision of those insurance holding companies. We also acted promptly to commence supervision of the three insurance holding companies designated by the FSOC for Federal Reserve supervision. While building our supervisory regime for these firms, we have reached out to our colleagues in the State insurance departments. Our supervisory teams for insurance holding companies are a combination of experienced Federal Reserve staff as well as newly hired staff with insurance expertise. The Federal Reserve is investing significant time and effort into enhancing our understanding of the insurance industry and firms we supervise, and we are committed to tailoring our supervisory framework to the specific business lines, risk profiles, and systemic footprints of the insurance holding companies we oversee. Our supervisory efforts to date have focused on strengthening firms' risk identification, measurement, and management; internal controls; and corporate governance. Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions while mitigating any risks to financial stability.[1] We conduct our consolidated supervision efforts in a manner that is complementary to, and coordinated with, State insurance regulators, who continue their established oversight of insurance legal entities. We do not regulate the manner in which insurance is provided by these companies or the types of insurance that they provide. Those important aspects of the actual business of providing insurance are the province of the relevant State insurance supervisors.

The Federal Reserve's Development of Domestic Capital Standards for Insurance Holding Companies

Congress recently enacted the Insurance Capital Standards Clarification Act of 2014 (S. 2270), which amended the provision of the Dodd-Frank Act that had required the minimum capital standards for banks be applied to any insurance holding company that controls an insured depository institution or is designated for Federal Reserve supervision by the FSOC. With this amendment to the Dodd-Frank Act, the Federal Reserve may now focus on constructing a domestic regulatory capital framework for our supervised insurance holding companies that is well tailored to the business of insurance. To that end, the Federal Reserve has been engaging extensively with insurance supervisors and regulated entities to increase our under-

[1] Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation (2014), "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program", Supervision and Regulation Letter SR 14-9 (November 7), *www.federalreserve.gov/bankinforeg/srletters/sr1409.htm*.

standing of the regulatory capital regime that already applies to insurance companies under State laws and to solicit feedback on various approaches to the development of an appropriate consolidated groupwide capital regime for insurance holding companies that would be consistent with Federal requirements. We are exercising great care as we approach this challenging mandate. We are committed to following formal rule-making processes to develop our insurance capital framework, which will allow for an open public comment period on a concrete proposal. We will continue to engage with interested parties as we move forward.

The Federal Reserve's Participation in the International Association of Insurance Supervisors (IAIS)

Some of the insurance holding companies subject to Federal Reserve supervision are internationally active firms that compete with other global insurers to provide insurance products to businesses and consumers around the world. Our supervisory activities for these firms include collaborating with our regulatory counterparts internationally as well as domestically. As part of this role, in November 2013, the Federal Reserve joined our State insurance supervisory colleagues from the NAIC and the FIO as members of the International Association of Insurance Supervisors (IAIS). Accordingly, the Federal Reserve has been and will continue to be engaged in the development of global standards for regulating and supervising internationally active insurers. Global standard setting is not new to the Federal Reserve, as we have for decades participated in standard setting for global banks through our membership in the Basel Committee on Banking Supervision. As a general proposition, we believe in the utility of having effective global standards for regulation and supervision of internationally active financial firms. When implemented consistently across jurisdictions, such standards help provide a level playing field for global financial institutions. Further, consistent global financial regulatory standards can help limit regulatory arbitrage and jurisdiction shopping and can promote financial stability. We recognize, of course, that international regulatory standards cannot be imposed on U.S. firms by an international body; rather, these standards apply in the United States only if adopted by the appropriate U.S. regulators in accordance with applicable rulemaking procedures conducted here.

Since joining the IAIS in late 2013, the Federal Reserve has been an active participant in several key committees, working groups, and work streams. We currently hold a seat on the Financial Stability Committee and the Technical Committee of the IAIS. Throughout our first year-and-a-half as a member of the organization, and consistent with our statutory mandate, the Federal Reserve has been particularly focused on the financial stability and consolidated supervision work of the IAIS. In these tasks, we have worked closely with our U.S. partners, including in particular the NAIC and its member supervisors.

IAIS Strategic Priorities

At the heart of the strategic priorities of the IAIS is the development of its Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). Among other things, ComFrame includes the development of a global consolidated capital standard for large, complex international insurance companies. A group capital requirement for insurers with significant international operations is a new concept for U.S. insurance companies. State law includes capital requirements for insurance legal entities but does not include a groupwide or consolidated capital requirement for insurance groups. For the largest and most active global insurers, the Federal Reserve supports groupwide consolidated capital standards that are well tailored to insurance risks. We also strongly believe such standards must be deliberately developed through transparent processes and must be properly calibrated.

A second key focus of the IAIS involves the identification of global systemically important insurers (G–SIIs) and the design of an enhanced regulatory and supervisory framework for G–SIIs. In 2013, the Financial Stability Board, in consultation with the IAIS and using a methodology developed by the IAIS, designated a set of nine global insurance firms (including three U.S.-based insurers) as G–SIIs. In addition to developing enhanced supervision standards and resolution planning requirements for G–SIIs, the IAIS continues to refine its G–SII designation methodology and to work diligently to design loss absorbency requirements for G–SIIs.

Last year, the IAIS released the Basic Capital Requirement (BCR) for G–SIIs. It is the first international consolidated capital standard developed for the insurance industry. The IAIS developed the BCR to help provide a level playing field for the capital adequacy of global insurance firms with the largest systemic footprints. The IAIS intends to supplement the BCR with a Higher Loss Absorbency (HLA) capital

standard for G–SIIs. The IAIS expects to release a consultation draft on HLA in June with an accompanying request for public comment.

In time, the IAIS expects that the BCR will be replaced by the more detailed and comprehensive Insurance Capital Standard (ICS), which is currently under development. Although the ICS likely will apply to a broader range of internationally active insurance groups, the IAIS expects that the ICS ultimately will also serve as the basis upon which HLA capital requirements for G–Slls are applied by the relevant national jurisdictions. IAIS began work on the ICS in 2013, issued an initial consultative proposal on the ICS late last year, and will continue work on the ICS for at least the next few years. This work includes the active participation of many volunteer insurance companies, including U.S. insurance companies, through field testing of various approaches and options, as well as the participation of State insurance supervisors and others.

It is important to note that any standards adopted by the IAIS are not binding on the Federal Reserve, the FIO, State insurance regulators, or any U.S. insurance company. During the development of global standards for insurance firms by the IAIS, the Federal Reserve will work to ensure that the standards do not conflict with U.S. law and are appropriate for U.S. insurance markets and U.S. insurers. Moreover, the Federal Reserve would only adopt IAIS regulatory standards after following the well-established rulemaking protocols under U.S. law, which include a transparent process for proposal issuance, solicitation of public comments, and rule finalization.

Cooperation and Coordination Among U.S. Supervisors, Regulators, and the Industry

The Federal Reserve, along with the FIO and the NAIC, continues to actively engage with U.S. insurance companies on the development of global regulatory standards for insurance firms. For instance, the Federal Reserve, the FIO, and the NAIC have hosted four separate meetings with U.S. participants on the BCR and ICS since August of last year. These meetings were distinct and independent of two international sessions hosted by the IAIS. Moreover, in the coming months, the Federal Reserve, the FIO, and the NAIC are planning additional sessions with U.S. insurance firms, consumer groups, trade associations, and other interested parties. The Federal Reserve is committed to continuing this active level of dialogue and engagement and to continuing our work with the FIO and State and international insurance regulators to develop a set of standards for global insurance firms that is consistent across countries and appropriate for internationally active U.S. insurers.

Nothing in the IAIS work plan, including the group capital requirement, seeks to lessen the critical role of individual insurance legal entity supervision conducted by the U.S. States and foreign countries. Rather, groupwide consolidated supervision and consolidated capital requirements supplement this legal-entity approach with a perspective that considers the risks across the entire firm, including risks that emanate from non-insurance subsidiaries and entities within the group. The Federal Reserve is a consolidated holding company supervisor that focuses on identifying and evaluating risks, capital and liquidity adequacy, governance, and controls across its supervised organizations. U.S. insurers with a global footprint or global aspirations stand to benefit considerably from a level global regulatory framework that is strong but pragmatic. Reasonably consistent global insurance standards for internationally active insurers and international cooperation among global regulators provide the means to that end.

The Federal Reserve has acted on the international insurance stage in an engaged partnership with our colleagues from the FIO, the State insurance commissioners, and the NAIC. Our multiparty dialogue, while respectful of each of our individual authorities, strives to develop a central "Team USA" position on the most critical matters of global insurance regulatory policy.

Mr. Chairman, thank you for inviting me here today. I look forward to an active dialogue on these issues with you and other Members of the Committee.

PREPARED STATEMENT OF MICHAEL MCRAITH

DIRECTOR, FEDERAL INSURANCE OFFICE, DEPARTMENT OF THE TREASURY

APRIL 28, 2015

Chairman Shelby, Ranking Member Brown, Members of the Committee, thank you for inviting me to testify today on the state of the insurance industry and insurance regulation.

The Federal Insurance Office (FIO) publishes an annual report to address the state of the insurance industry and related regulatory or macroeconomic develop-

ments. FIO's 2014 Annual Report included 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. [1]

Among the highlights, the 2014 Annual Report analyzed data demonstrating that, in the aggregate, insurers operating in the United States continue to show resilience in the aftermath of the financial crisis, including record levels of capital and surplus. At year-end 2013, the life and health sector (L/H) reported $335 billion in capital and surplus, and the property and casualty sector (P/C) reported approximately $665 billion in capital and surplus.

Aggregate net written premiums in the L/H sector declined slightly from the record level set in 2012, largely as a result of lower annuity sales, whereas P/C sector net written premiums grew modestly in 2013.

2013 bottom line numbers were encouraging. Record net income levels were achieved in 2013 for both the L/H and P/C sectors. The protracted low interest rate environment, however, has been a drag on net income, particularly for life insurers. To partially mitigate declining investment yields, insurers, as a sector, have marginally increased asset allocations toward lower rated and less liquid assets with longer durations, indicating increased portfolio risks. The L/H sector benefited from the performance of separate accounts, and recorded net income of $44 billion for 2013, as compared to the previous record high of $37 billion set in 2006. Lower catastrophe losses and favorable loss development contributed to higher net income for the P/C sector, which reached a record $72 billion; the previous high net income was $66 billion, also set in 2006.

Per capita premium expenditures are a measure of private insurance density, or prevalence, throughout a national economy. On a per capita basis, from 2009–2014 insurance premiums for the combined L/H and P/C sectors have increased in the United States at an average rate of 1.6 percent, better than developed economies in Western Europe but less than growth rates in fast-developing Asian economies. For example, while France's per capita premium expenditure declined by 3.7 percent from 2009–2014, China's increased by 13.6 percent.

Aggregate premiums as a percentage of Gross Domestic Product (GDP) are a measure of private insurance penetration in a national economy. In 2005, aggregate L/H and P/C premiums amounted to 8.91 percent of U.S. GDP, and in 2013 total premiums amounted to 7.51 percent of gross domestic product, a decline of 15.7 percent. This indicates that the aggregate growth of U.S. premium volume did not maintain the pace of growth in GDP. In that same period, developing economies saw an increase in private insurance premium volume as a percentage of GDP, an indication that developing economies are pursing private capital to support retirement security and the protection of personal and commercial assets.

To be sure, the U.S. insurance sector, including those firms that are internationally active, 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 regulators.

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

Recent Federal developments are one aspect of change within the U.S. insurance sector. In January, Congress passed and President Obama signed the Terrorism Risk Insurance Program Reauthorization Act of 2015 (Reauthorization Act). The Reauthorization Act both renewed and reformed the Terrorism Risk Insurance Program (TRIP), and, in Title II, reestablished the National Association of Registered Agents and Brokers (NARAB). With respect to TRIP, the program includes sensible reforms that further reduce taxpayer exposure, increase private sector contributions, and support national security and continued economic growth. When fully operational, NARAB will serve as a solution to the long-standing multistate licensing and administrative burden confronted by many insurance agents and brokers.

Much attention has been devoted to developments in international standard-setting in the insurance sector. International insurance standard-setting activities are not new. In fact, the National Association of Insurance Commissioners (NAIC) was among the founding members of the International Association of Insurance Supervisors (IAIS) in 1994. Since that time, U.S. State insurance regulators have worked to set and meet international standards. Each of the 56 independent members of the NAIC (50 States, the District of Columbia, and five territories) is also a member

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

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 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.

In October 2014, the Board of Governors of the Federal Reserve System (Federal Reserve) became a full member of the IAIS. With the combined participation of State insurance regulators, the Federal Reserve and FIO, all aspects of the unique U.S. insurance oversight system are actively engaged at the IAIS.

When dealing with the IAIS standard-setting work, FIO, the Federal Reserve and State insurance regulators work together extensively and regularly coordinate. As the U.S. participants of IAIS, the leadership and staff of all three groups are in close and meaningful engagement through frequent calls and meetings. Our collaboration is a testament to the shared objectives of the agencies involved.

Any discussion of the U.S. insurance sector and its regulation must begin with the recognition that the United States has the most diverse and competitive insurance market in the world. Thousands of insurers 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 activities. As the Illinois Director of Insurance, I learned firsthand about the importance of small and midsize insurers to the marketplace and to local and regional economies. Consolidation pressures in the small insurer market segment have existed for years, but we recognize and want to preserve the important contributions of local and regional insurers to consumers and communities.

Supporting much of 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 recognition of both the U.S. market and the U.S. system of insurance supervision, FIO's international work 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 successfully around the world; and (3) to safeguard financial stability.

At the same time that we support diverse and competitive U.S. insurance markets, FIO strongly supports continued growth of the increasingly international insurance market and the prudential standards that promote consistent and rigorous oversight across jurisdictions.

In the last 10 years, the pace of globalization in insurance markets has increased exponentially and is expected to continue to grow in the coming years. Insurers based in the United States are pursuing opportunities for organic growth in new markets. Aon Benfield's 2014 Country Opportunity Index, which identifies the world's most promising P/C markets, listed five Asian markets among its top ten, in addition to three from Africa and two from South America. Even a cursory review of the demographics in Brazil, China, India, Indonesia, and South Korea demonstrates this point.

In fact, U.S.-based insurers are extending operations 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, in 2014, well-known U.S. insurers that are subsidiaries of non-U.S. holding companies accounted for more than 13 percent of aggregate L/H and P/C premium volume.

Private market premium volume growth shows 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 percent to 27 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 percent to 6 percent. As reported in FIO's 2014 Annual Report, South Korea, Brazil, and South Africa experienced similar proportional increases.

These numbers reiterate the message that 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. Growing economies around the world seek private sector solutions through life insurance products for retirement security and through property and casualty insurers for private asset accumulation and protection.

Due to global economic growth, many jurisdictions—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, just as have Australia, China, and South Africa.

Global supervisors welcome the influx of private capital from insurers domiciled in the United States, and elsewhere, and are increasingly desirous of a common language and common standards by which to understand how a globally active insurer manages risk. These supervisors want to know how consumers subject to that supervisor's protection fit into the insurer's broader risk management approach. This is fundamentally a question of consumer protection: how are consumers around the world protected when insurers operate globally?

As the insurance sector evolves globally, the United States will continue to contribute constructively in support of international standards that, when implemented, will benefit U.S. consumers, U.S. insurers and global financial stability. Working together, U.S. participants of the IAIS 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

International coordination can be difficult even under the best of circumstances. However, through the IAIS, our engagement, communication and coordination with other countries has been collaborative and productive. This is not to say that we agree with every IAIS member on all substantive, technical or procedural issues. Insurance supervisors from around the world come together through the IAIS to learn, to analyze, to develop and to understand best practices for insurance supervision. Each country or region brings its unique perspective and predisposition to the conversation, and all have the opportunity to learn. The challenge is to find a path to consensus, around practical and achievable objectives.

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, G20 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. In response, the FSB, which coordinates G20 financial regulatory initiatives, developed a framework and called on the relevant international standard-setting bodies to, among other things, develop methodologies for identifying globally systemically important financial institutions (G–SIFIs) in each financial services industry.

In July 2013, the FSB called upon the IAIS to develop a backstop capital requirement (now known as Basic Capital Requirement, or BCR) by 2014 for globally systemically important insurers (G–SIIs) and to develop in 2015 an approach to higher loss absorbency (HLA) for G–SIIs in 2015. These policy measures conform with the G20 endorsed FSB framework for systemically important financial institutions, which calls for higher loss absorbency for all G–SIFIs. The FSB called upon the IAIS to continue development of ComFrame, and to include in ComFrame a quantitative insurance capital standard. This comprehensive work plan and the related deliverables (including ComFrame, BCR and HLA) have been welcomed by G20 Leaders.

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 the first global group capital standard for the insurance sector and provides a simplistic method to measure capital within an insurance group across jurisdictions. The BCR will serve as the starting point for 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 G–SIIs.

Development of HLA for the insurance sector presents a significant technical challenge. Insurers, the products sold by insurers, and existing jurisdictional capital requirements, vary greatly around the world. Following months of intense analysis and drafting, the IAIS consultation paper on HLA will be released in June for a period of 60 days.

With respect to the ICS, the IAIS released a consultation paper in December and written comments were received from stakeholders for more than 60 days. The consultation paper was highly technical, and generated 1,500 pages of comments from stakeholders.

As publicly described in March 2015, IAIS members agreed on the "ultimate goal" of the ICS which provides a focal point, a guiding light, for the technical work that is underway. IAIS members agreed:

> The ultimate goal of a single ICS will include a common methodology by which on ICS achieves comparable, i.e., substantially the same, outcomes

> across jurisdictions. Ongoing work is intended to lead to improved convergence over time on the key elements of the ICS toward the ultimate goal. Not prejudging the substance, the key elements include valuation, capital resources, and capital requirements.[2]

As technical experts from the United States and around the world sort through the many complexities of the key elements, the "ultimate goal" provides the boundaries to shape and influence those conversations and the day-to-day developments.

Given the enormous amount of technical work and the magnitude of the global differences, achieving this "ultimate goal" will not happen quickly. In the near term, building upon data, analysis and testing, progress will be made and convergence will improve. Importantly, work will proceed incrementally toward milestones that are realistic, achievable, and that are fact-driven and consensus-driven.

IAIS Organizational Reform

IAIS organizational reform has improved its financial independence, efficiency and transparency. 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, social events, and information. Through 2014, the IAIS received approximately 40 percent of funding from observers—primarily industry—thereby creating the appearance of a quid pro quo arrangement that detracted from the credibility of IAIS members and stakeholders. Due to the IAIS organizational reform, the financial dependence upon industry no longer exists.

At the same time, the IAIS has dramatically improved its engagement with and transparency to stakeholders. Perhaps most importantly, the IAIS no longer discriminates between stakeholders that pay the fee and those that do not. In addition, the following examples illustrate the improvements to the IAIS processes for stakeholder consultation:

- In 2014, stakeholder sessions for all IAIS workstreams amounted to less than 12 hours, but in 2015 IAIS stakeholder sessions for all IAIS already amount to more than 60 hours, with more sessions to be scheduled.
- The IAIS Web site will contain information available to the public, not just to stakeholders who pay the annual fee.
- With the launch of a consultation paper, the IAIS will host explanatory meetings and calls so that stakeholders can learn about substance and structure of the document in advance of providing comments.
- After receiving comments on a consultation paper, the IAIS will publish the comments received, release a summary of comments, and offer a reply to the comments.
- For the various work streams (e.g., capital, governance, or market conduct), stakeholder contact lists are being developed so that those stakeholders can provide input to a consultation paper prior to the paper's release for comment.
- Release of a monthly newsletter to describe developments in the preceding month and events scheduled for the coming month.

While only a few IAIS workstreams were directly open to stakeholders before 2015, the new governance and transparency practices provide a uniform approach to openness and stakeholder engagement for all IAIS activities.

Finally, U.S. stakeholders have opportunities to meet and work with the U.S. participants. Working with State regulators and the Federal Reserve, FIO has coordinated opportunities for stakeholders, including industry and consumer advocates, to meet and present to all U.S. members of the IAIS at one time, thereby enabling the U.S. members to receive the views of a wide range of U.S. stakeholders in a U.S.-based forum.

EU and U.S. Insurance Project

The EU and the United States are both significant insurance markets. In terms of premium volume, despite the growing prominence of developing markets, the EU ranks first and the United States ranks second as consolidated markets. The EU and the United States are home to many of the world's most prominent global insurers—large multinational insurance groups that are pushing more aggressively into new markets around the world. The EU is also modernizing its approach to insur-

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[2] The ultimate goal of the ICS can be found in the IAIS's March 2015 Newsletter and can be found at *http://iaisweb.org/index.cfm?event=getPage&persistId=T347DFD3A5155D896B001B1CB99C644F78.*

ance regulation through Solvency II, a new EU-wide harmonized insurance regulatory regime.

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's Prudential Regulatory Authority. We call this the EU–U.S. Insurance Project (Project). State insurance regulators, including Commissioners Voss, McCarty and Consedine, among others, have made invaluable contributions to the effort. Going forward, we welcome the participation of the Federal Reserve in the Project.

Thanks to the participants, the Project has been a demonstrably successful transatlantic collaboration. In September 2012, the Project released a report that identified similarities and differences between the regulatory approaches in the EU and United States, and, in December 2012, the Project released an initial *Way Forward*, which outlined common policy objectives and milestones through 2017. Following the EU's adoption of Solvency II in late 2013, and the December 2013 release of FIO's report entitled "How To Modernize and Improve the System of Insurance Regulation in the United States", continued modernization by State regulators, and developments at the IAIS, the Project released a revised *Way Forward* in August 2014 which updated the common objectives and milestones.[3] Of course, as with all such international developments, implementation will occur in the United States only through Federal and State authorities.

A central feature of the Project is work toward a potential covered agreement between the EU and the United States. A covered agreement is a unique statutory authority given to Treasury and the Office of the United States Trade Representative (USTR) to negotiate an agreement between the United States and one or more foreign jurisdictions that relates only to prudential insurance and reinsurance measures.

The 2014 *Way Forward* reiterates Treasury's support for USTR and FIO to pursue a covered agreement with respect to State-based reinsurance collateral requirements. 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.

Recently, the EU nations gave the European Commission the negotiating mandate to pursue an agreement with the United States that will "greatly facilitate trade in reinsurance and related activities" and "will enable us . . . to recognize each other's prudential rules and help supervisors exchange information."

Importantly, a covered agreement must provide tangible benefits for U.S. stakeholders. While the mechanics of a covered agreement process remain under development, and negotiations with the EU are not scheduled, FIO welcomes robust engagement with Congress, State regulators, and other stakeholders on the opportunity presented by a covered agreement.

Conclusion

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, our priorities will remain in 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.

[3] FIO's report on *How To Modernize and Improve the System of Insurance Regulation in the United States* can be found at *http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/*. The Project's revised *Way Forward* can be found at *http://www.treasury.gov/initiatives/fio/EU-US%20Insurance%20Project/Documents/The%20Way%20Forward%20(July%20 2014%20Revision).pdf.*

PREPARED STATEMENT OF KEVIN M. MCCARTY

COMMISSIONER, FLORIDA OFFICE OF INSURANCE REGULATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

APRIL 28, 2015

Introductory Remarks

Chairman Shelby, Ranking Member Brown, and Members of the Committee, thank you for the opportunity to testify today. My name is Kevin McCarty, and I am the Insurance Commissioner for the State of Florida. I am also a past President of the National Association of Insurance Commissioners (NAIC) and serve as the Chair of the NAIC's International Insurance Relations (G) Committee. I present this testimony on behalf of the NAIC.

The NAIC is the United States standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 States, the District of Columbia, and five U.S. territories. Through the NAIC, we establish standards and best practices, conduct peer review, and coordinate our regulatory oversight. NAIC members, together with the central resources of the NAIC, form the national system of State-based insurance regulation in the U.S.

Insurance is critical to the U.S. economy and plays an equally important role in global markets. The U.S. insurance market is the largest and most competitive in the world, with $1.8 trillion in premium volume and thousands of insurers writing policies. State insurance regulators supervise nearly a third of all global premium, and taken individually, U.S. States make up more than 24 of the world's 50 largest insurance markets. My home State of Florida, for example, is the 12th largest insurance jurisdiction worldwide by premium volume. To help put that in perspective, the Florida market for insurance is about the same size as Canada's market, about 50 percent larger than Australia's market, and nearly twice as large as Switzerland's market for insurance. As U.S. State insurance regulators who cooperate closely on a regular basis, we have long been committed to providing leadership on a wide range of global insurance issues and activities, with a focus on ensuring policyholder protections and maintaining stable and competitive insurance markets.

As discussions move forward regarding the development of domestic and global capital rules, State insurance regulators continue to oppose imposing a one-size-fits-all bank-centric set of regulations on insurers and instead focus on the importance of company and product specific analysis and examination. While insurer capital requirements are important, such requirements are not a substitute for the other tools in the regulatory tool box and, if imposed incorrectly, can be unnecessarily onerous to the company and ultimately harmful to the policyholder. We are concerned that taking a uniform regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry. The NAIC and its members remain extensively engaged with our Federal and international counterparts to ensure that our national State-based system has a prominent voice in the development and implementation of domestic and global capital standards and that they are adaptable to our markets and benefit our consumers.

Distinguishing Characteristics of Insurance Products and U.S. Insurance Regulation

The fundamental tenet of our U.S. system is to protect policyholders by ensuring the solvency of the insurer and its ability to pay insurance claims. Insurance companies are different from other financial institutions and from each other. There is a large amount of variability in insurance products. The insurance regulatory system is purposely flexible to address the depth and breadth of these differences. While insurance policies involve up-front payment in exchange for a legal promise to pay benefits upon a specified loss-triggering event in the future, banking products involve money deposited by customers and are commonly subject to withdrawal on demand. The very nature of insurance significantly reduces the potential of a run-on-the-bank scenario for property/casualty, health and most life insurance products. For those limited products sold by insurers that could be subject to some level of run risk, mitigating factors exist such as policy loan limitations, surrender/withdrawal penalties, and additional taxes. Additionally, insurers typically maintain a diverse product mix so only a portion of the company's products would be subject to the already reduced level of run risk.

Insurance products, unlike banking products, do not transform short term liabilities into longer term assets. Insurance has shorter duration liabilities in many of the property/casualty and health product lines, and the assets held are similarly short term. Insurance has longer duration liabilities in life and annuity product lines, and these liabilities are matched against similarly longer term assets. This

is a critical distinction from banking and other financial products. A key reason many other financial firms suffered during the financial crisis was that the duration of their assets and liabilities were not matched in a way that enabled them to fund their liabilities when they came due.

It is important to design regulation that best recognizes and addresses the differences in products and the financial institutions that offer them while providing the appropriate level of protection for policyholders. State insurance regulators want to make certain that insurance policyholders' assets are protected when an insurer operates within a large, diverse financial group. That is why State insurance regulators strongly support The Policyholder Protection Act (S. 798) to clarify our existing authority to wall off the insurance legal entity from contagion elsewhere in the group. It is critical that the regulatory walls around legal entity insurers that have protected policyholders for decades remain intact regardless of an insurer's organizational structure or financial circumstance.

Federal Reserve Capital Rules Should Be Appropriate for the Insurance Business Model

Given the different business models and regulatory objectives between banking and insurance, State insurance regulators want to ensure that any new capital standards at home or abroad appreciate these distinctions. We are keenly aware of the many complicated considerations involved in setting capital standards appropriate for insurers, and are committed to assisting the Federal Reserve in its efforts to implement capital rules for savings and loan holding companies (SLHCs) and insurers that are designated systemically important financial institutions (SIFIs) by the Financial Stability Oversight Council. It is important to keep in mind that these standards are in addition to, and not in lieu of, State risk-based capital standards applicable to the insurers within those groups, so we would encourage the Federal Reserve to work closely with us to ensure their standards complement our existing regulatory authority. We supported the passage of the Insurance Capital Standards Clarification Act last year to give flexibility to the Federal Reserve to tailor its capital rules for these companies. We are hopeful that the Federal Reserve will utilize this flexibility to apply capital rules to these entities that are consistent with the insurance business model and our legal entity regulation and we are committed to assisting them in this important endeavor. We have had some constructive initial conversations with them and look forward to continued discussions in the future.

Global Capital Standards for Insurers Should Be Compatible With the U.S. System

In addition to the regulatory changes occurring domestically, it is important to note that changes are occurring internationally at the same time. The International Association of Insurance Supervisors (IAIS) is simultaneously developing capital proposals primarily to address systemically important firms, but also new requirements on internationally active groups that are not deemed too big to fail, including many firms based in the U.S. As part of the policy measures recommended for application to globally systemically important insurers (G–SIIs), the IAIS has moved rapidly, under specific direction and pressure from the Financial Stability Board (FSB), to develop international standards for a basic group capital requirement (BCR) and additional higher loss absorbency (HLA) capital measures (capital buffers) that would be imposed on firms that are deemed too big to fail.

In addition, the IAIS is developing a global insurance capital standard (ICS) as part of a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). State insurance regulators are concerned about the development of international capital standards for the insurance industry as well as the process and speed with which the IAIS has been developing them. We have serious concerns about the aggressive timeline of developing a global capital standard given legal, regulatory, and accounting differences around the globe, but are fully engaged in the process to ensure that any development appropriately reflects the risk characteristics of the underlying business and does not undermine legal entity capital requirements in the U.S.

The NAIC's objective is to ensure that the capital proposals developed at the IAIS are reasonable and compatible with our system. We must also ensure they don't inadvertently lead to unintended consequences such as limiting insurance products or stagnating growth in the insurance sector, including jobs and innovation. If tailored for our regulatory system, there is value in understanding the capital adequacy of insurance groups, particularly when part of a larger conglomerate or affiliated with other entities. But that value only exists if it supplements and wraps around our existing legal entity standards. We also remain concerned with the more volatile market valuation accounting approach favored by Europe as an international stand-

ard because it represents a short-term focus rather than a longer-term view and could have a negative impact on the U.S. market to the detriment of American insurance consumers.

In our view, taking a more homogenous regulatory approach that treats insurers more like banks may actually encourage new risk-taking in the insurance industry. Also, if the new standards are excessive or too inflexible, then they could increase costs on U.S. insurers and consumers and undermine the U.S. State-based insurance regulatory system, which is based on protecting policyholders and has a strong track record of effective solvency supervision and stable, competitive insurance markets. The IAIS must recognize that a system that has existing safeguards and controls to supervise the movement of capital within a group may take a different approach to capital adequacy at the group level than jurisdictions that do not have similar requirements. The IAIS objectives on capital standards are not easily achievable and will require a significant commitment of resources over many years to ensure that they are compatible with the U.S. system of insurance regulation as well as with other jurisdictions around the world.

Of crucial importance to the international discussions will be the Federal Reserve's implementation of capital rules. But let me be clear, while the Federal Reserve has its responsibilities, we have our own. Most of the Internationally Active Insurance Groups (IAIGs) that will potentially be subject to the ICS are not SLHCs or SIFIs that are also regulated by the Federal Reserve. To that end, while we are committed to collaborating with our Federal and foreign counterparts where we can, we still have a responsibility to the U.S. insurance sector. We will not implement any international standard that is inconsistent with our time-tested solvency regime that has provided long-standing protection to policyholders and ensured a competitive and stable U.S. insurance marketplace.

Inclusive and Transparent Decision-Making Process Is Critical to Effective Regulation

Critical to the credibility of decision making at the IAIS is an inclusive and transparent decision-making process. It is difficult to achieve optimum regulatory outcomes or reach broad consensus about international standards without the input of those most affected, in particular the consumer we protect and the industry we regulate. That is why State insurance regulators adamantly opposed efforts at the IAIS to limit stakeholder engagement. We continue to believe the IAIS's decision represents a step back for the openness and transparency necessary to give IAIS work credibility and legitimacy, particularly if and when legislative bodies are expected to consider IAIS proposals. The IAIS has new stakeholder and consultation procedures in place and State regulators participating at the IAIS will assess the effectiveness of these new procedures and continue to advocate for increased transparency, and will urge other U.S. IAIS members to support this worthy goal.

We remain equally concerned with the lack of transparency at the Financial Stability Board. While we appreciate the role of the Federal Reserve, Treasury, and the Securities and Exchange Commission as members of the FSB, State insurance regulators supervise 100 percent of the private insurance market in the United States and to date have had only limited access into FSB discussions directly relevant to our sector. This direct participation has only occurred as a representative of our international standard setting body, the IAIS, and not after requesting inclusion from our own U.S. FSB representatives. Particularly given the role of the FSB in designating three U.S. insurers as globally systemically important insurers, we find the lack of support for our inclusion at the FSB by our Federal colleagues troubling and not reflective of the best interests of U.S. insurers and policyholders. In light of the significant influence the FSB has on the IAIS, it is important that the entire "Team USA" be involved in insurance related discussions at the FSB.

For our part, the NAIC has long-standing procedures and ongoing responsibilities to seek input from policyholders and other interested parties, and we will continue working on these issues in a transparent manner through our NAIC process. To that end, last year, the NAIC formed the ComFrame Development and Analysis (G) Working Group (CDAWG), which I chair, to provide ongoing review, and technical as well as expedited strategic input on ComFrame and the international group capital developments. In addition, the CDAWG has been exploring group capital concepts that would be appropriate for U.S. based internationally active insurance groups.

Most recently, the CDAWG helped review the first IAIS Consultation Draft on the ICS, which was issued in December 2014. State insurance regulators provided comprehensive feedback to the IAIS regarding the elements of the proposed ICS such as valuation and potential methods for determining capital requirements. The NAIC is currently working through its open and public process to update its position state-

ments on ComFrame and international capital developments with input from consumer and industry stakeholders. These documents serve to articulate the views of U.S. State insurance regulators toward the uses of capital within prudential regulation and help guide our ongoing work regarding IAIS capital proposals. As we work to affirm and update our positions, we welcome these additional perspectives to further enhance the focus of our regulatory priorities. We expect to finalize these positions shortly and will share them with the Committee.

Conclusion

U.S. insurance regulators have a strong track record of effective collaboration and supervision, and the NAIC is committed to coordinating with our Federal and international counterparts to help ensure open, competitive, and stable markets around the world. It is critical that we promote a level playing field across the globe through strong regulatory systems while recognizing that there will continue to be different cultural, legal, and operational differences in regulatory regimes around the world. Consistency in regulation globally is important, but preserving regulatory independence and diversity of thought can also serve as a buffer against contagion or one-size-fits-all behaviors by financial firms that can result from one-size-fits-all regulatory approaches. Congress has delegated insurance regulatory authority to the States so we have a continuing obligation to engage internationally in those areas that impact the U.S. State-based system, companies, and consumers. U.S. State insurance regulation has a strong track record of evolving to meet the challenges posed by dynamic markets, and we continue to believe that well-regulated markets, both here and abroad, make for well-protected policyholders. Thank you again for the opportunity to be here on behalf of the NAIC, and I look forward to your questions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM S. ROY WOODALL, JR.

Q.1. Mr. Woodall, in regards to the international capital standards being developed and the historical differences between the U.S. and European approaches, stated, "When you try to harmonize those two, you're creating the potential for great disruption in the delivery of different services in the marketplace, a potential raise in prices for consumers in the United States and potentially jeopardizes the availability of products."

Does this mean you see the potential imposition of international capital standards on State-regulated insurers as disrupting our Nation's insurance markets and having a negative impact for U.S. customers?

A.1. Yes, potentially.

The upcoming introduction of capital directives from foreign organizations without any legal basis to promulgate regulations directed toward U.S. insurers, coupled with any implicit Federal commitments to impose such standards if not agreed to or otherwise endorsed by our State regulators, is inconsistent with our Congressionally chosen domestic system of prudential regulation of insurance companies. Beginning with the McCarran-Ferguson Act, and reaffirmed in the Gramm-Leach-Bliley Act and the Dodd-Frank Act, Congress has affirmatively entrusted the States and the State insurance regulators with the safety and soundness of insurance companies and the protection of consumers of insurance. Congress should consider whether the scope of Federal efforts to develop and coordinate Federal policy on international insurance prudential matters has gone too far in displacing authorities that Congress has reserved to the States and State regulators.

The current pursuit of these types of international agreements has been occurring in an atmosphere of secrecy that is an anathema to our U.S. principles of openness, transparency, and oversight. Given that I, just like many members of Congress, am not fully informed as to what capital standards may lay ahead—yes, I am concerned about the potential negative impacts that may follow from imprudent, hurried and untested capital directives coming not from our own State insurance regulators, but rather from foreign organizations and foreign regulators who have a weak understanding of the fundamentally different basis on which the U.S. insurance regulatory system operates.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM S. ROY WOODALL, JR.

Q.1. The historic role for international financial regulatory organizations was limited to fostering a dialogue between regulators and serving as a platform for cooperation between Governments. To me, it appears that mission has been greatly expanded. Today, these organizations issue rules that effectively bind their participants' national Governments to new, internationally negotiated rules.

As a legislative body principally charged with fair and efficient regulation of industry, isn't Congress right to be concerned that recent mission creep at these international organizations is resulting

in regulatory decisions that do not have the input of their elected representatives?

Should we consider refocusing the mission of international organizations on facilitating cooperation amongst regulators?

A.1. Yes.

Congress is right to be concerned about ongoing efforts by foreign organizations that could be used to mandate changes in decisions that Congress has left to our regulators, or that have been reserved for Congress itself to decide. Such concerns should not be limited to insurance regulation. U.S. financial market regulation is apparently also in the sights of such foreign entities. Several Commissioners at the Securities and Exchange Commission, for example, have been outspoken about this threat.

Putting aside any debate as to how much influence the various foreign organizations do, or should, have over our domestic regulatory policies, I think we would all agree that international fora can play an important role in regulatory coordination given the global interconnections of the financial system. However, when such bodies by themselves decide to assume a position of primacy with the domestic regulatory policies of sovereign countries, including the U.S., even if such efforts are well intentioned, a concern will exist that the effort has gone awry. In my opinion, it is very important that Congress consider a clear statutory framework for: (1) fuller U.S. participation at these various foreign organizations; (2) the appropriate parameters of such participation so as to align with the domestic regulatory authorities established by Congress; and (3) the requisite level of reporting to Congress and transparency with the public.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MICHAEL MCRAITH

Q.1. Director McRaith, currently there is a lot of discussion, given GE's recent divestment, around the SIFI de-designation process. If we assume there is a robust de-designation process that is set up by the Financial Stability Oversight Council (FSOC), the three current insurance companies designated as nonbank SIFIs make the appropriate changes to their businesses to become de-designated, and any insurance companies that own or are affiliated with a bank or thrift sell that bank or thrift.

Under this scenario, can you tell me what insurance companies the Federal Reserve would have regulatory authority (or standard-setting authority) for?

A.1. The Federal Reserve is responsible for the supervision of an insurer that is a bank holding company, savings and loan company, or is a part of either a bank holding company or savings and loan holding company, subject to certain conditions, and for an insurer that is designated by the Financial Stability Oversight Council (Council) to be subject to supervision by the Federal Reserve and enhanced prudential standards. The Council's process for annual review allows any designated company to present information for the Council to consider when determining whether that company's designation should be removed. Importantly, the Federal Reserve Board will determine the extent to which it will be involved in

standard-setting activities which may, in fact, be independent of its regulatory role.

Q.2. How many staff members do you have that participate in or work with either the Financial Stability Board (FSB) or the International Association of Insurance Supervisors (IAIS)? What are their names? What is the exact role that each of them play with either one of or both organizations? (Please provide a detailed list.) Are these full time positions? Who pays the salaries of these employees? How much money does your organization contribute or provide to the FSB? How much money does your organization contribute or provide to the IAIS?

A.2. FIO has 15 full-time employees, each of whom contributes to the work of the Office, including international matters. FIO staff are Treasury employees and are paid by the Treasury. FIO, through Treasury, pays an annual fee to the IAIS which, for 2015, was approximately $17,225.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM MICHAEL MCRAITH

Q.1. Will you work with the State insurance regulators to gain consensus between the Federal Insurance Office, the Federal Reserve and the National Association of Insurance Commissioners (NAIC) before agreeing to an international capital standard? Would you support an international capital standard that is opposed by the NAIC?

A.1. As required by law, FIO coordinates efforts to develop Federal policy on prudential aspects of international insurance matters, including on matters related to a global capital standard. This collaborative work with State insurance regulators and the Federal Reserve occurs many times each week at both the leadership and staff levels. Given FIO's own collaborative practices, and that State insurance regulators are active participants in the IAIS's consensus-driven deliberations, the potential for an outcome related to an international capital standard that is not supported by the State insurance regulators is very unlikely. Further, international standards are not self-executing. Each country implements international standards in a manner tailored to that country and its regulatory regime. In the United States, once developed, international capital standards are expected to be tested and then—only after testing—implemented at the Federal and State level.

Q.2. The historic role for international financial regulatory organizations was limited to fostering a dialogue between regulators and serving as a platform for cooperation between Governments. To me, it appears that mission has been greatly expanded. Today, these organizations issue rules that effectively bind their participants' national Governments to new, internationally negotiated rules.

As a legislative body principally charged with fair and efficient regulation of industry, isn't Congress right to be concerned that recent mission creep at these international organizations is resulting in regulatory decisions that do not have the input of their elected representatives?

Should we consider refocusing the mission of international organizations on facilitating cooperation amongst regulators?

A.2. The financial crisis demonstrated many things including that (1) the insurance sector is an integral part of capital markets and the financial sector, and (2) the economies of different countries are increasingly connected. Further, in recent years, insurers based in the United States and elsewhere are finding opportunities for organic growth in new markets and developing economies. For these reasons, international insurance standard-setting activities involve technical subjects and are not limited to relationship building. International standard-setting activities promote global financial stability and equal footing for U.S. insurers operating around the world.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM KEVIN M. MCCARTY

Q.1. Commissioner McCarty, in regards to the international capital standards being developed and the historical differences between the U.S. and European approaches, stated, "When you try to harmonize those two, you're creating the potential for great disruption in the delivery of different services in the marketplace, a potential raise in prices for consumers in the United States and potentially jeopardizes the availability of products."

Does this mean you see the potential imposition of international capital standards on State-regulated insurers as disrupting our Nation's insurance markets and having a negative impact for U.S. customers?

A.1. Yes, that is a real potential and that is why State insurance regulators are working to ensure that the capital proposals developed at the International Association of Insurance Supervisors are reasonable and compatible with our system. We want to ensure that bank-centric standards based on mark-to-market accounting don't inadvertently lead to unintended consequences such as limiting insurance products or stagnating growth in the insurance sector, including jobs and innovation. If these standards are excessive or too inflexible, then they could increase costs on U.S. insurers and consumers and undermine the U.S. State-based insurance regulatory system, which is based on protecting policyholders and has a strong track record of effective solvency supervision and stable, competitive insurance markets. If tailored for our regulatory system, there is value in understanding the capital adequacy of insurance groups, particularly when part of a larger conglomerate or affiliated with other entities. But that value only exists if it supplements and wraps around our existing legal entity standards.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM KEVIN M. MCCARTY

Q.1. The historic role for international financial regulatory organizations was limited to fostering a dialogue between regulators and serving as a platform for cooperation between Governments. To me, it appears that mission has been greatly expanded. Today, these or-

ganizations issue rules that effectively bind their participants' national Governments to new, internationally negotiated rules.

As a legislative body principally charged with fair and efficient regulation of industry, isn't Congress right to be concerned that recent mission creep at these international organizations is resulting in regulatory decisions that do not have the input of their elected representatives?

A.1. Yes. We agree the role of international standard-setting organizations has evolved significantly since the financial crisis from facilitating cooperation and sharing best practices to advancing "mandates" and sometimes insisting on prescriptive "requirements" that do not always have the full consensus of participating jurisdictions. Efforts of the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB) are ostensibly under the auspices of the G20, and there are clear expectations and pressures to implement key standards regardless of whether they fit with a particular jurisdiction's system and irrespective of legislative authority to do so. While it's true these standards are not self-executing, the IAIS is leveraging the support of the FSB to expand its impact on domestic regulatory rulemaking and put pressure on jurisdictions to comply. Congress has an important role to play in overseeing the international insurance roles and policy objectives of the Treasury and the Federal Reserve, since both are deeply engaged in the decisions of the Financial Stability Board and the IAIS.

Q.2. Should we consider refocusing the mission of international organizations on facilitating cooperation amongst regulators?

A.2. Multijurisdictional cooperation and sharing of best practices can help elevate the quality of insurance regulation around the globe, and this will help promote more stable and competitive markets for our U.S. insurance companies operating internationally. At the same time, it is imperative that international organizations recognize that there will continue to be different cultural, legal, and operational differences in regulatory regimes around the world, and that uniform standards are not necessary to achieve compatibility and equivalent results. International standards should be flexible enough to deal with these structural and legal differences to avoid putting insurers, and by extension consumers, at a disadvantage in one market relative to another. As a practical example, a current reform underway in the State system is to reduce collateral required of foreign reinsurers. Reduction of this collateral is contingent on the foreign reinsurer's domestic regulator being deemed a "qualified jurisdiction" by the NAIC. The NAIC has quickly made these assessments to establish full faith and confidence that our U.S. ceding insurers are doing business with a well-regulated reinsurer, and at no time have we asked any of the foreign jurisdictions to overhaul their regulatory systems to look more like ours or to follow some prescribed standard. That type of flexibility to foster trust and collaboration while respecting our differences is exactly what we should expect from international regulatory standard setters.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HELLER FROM KEVIN M. MCCARTY

Q.1. I understand that the Federal Insurance Office (FIO), the Federal Reserve, and the National Association of Insurance Commissioners (NAIC) have frequent communication and participate in number discussions and calls on international insurance standards.

As a result of these ongoing discussions, does the NAIC have a clear sense of what the Federal Reserve's and FIO's specific views and objectives are for the development of international capital standards?

A.1. We have received very little in writing or on public record, and there is significant room for improvement. Communication and coordination among Federal agencies and State insurance regulators is essential to fostering a collaborative U.S. approach to international standard-setting activities at the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB). While we appreciate the current levels of communication with FIO and the Federal Reserve, and we certainly exchange views on some matters, we do not have a clear picture of their policy objectives or level of commitment to ensure that U.S. Federal policy is consistent and compatible with our State-based system. The U.S. insurance sector, including company and consumer stakeholders, is handicapped because U.S. State insurance regulators are not engaged directly with the FSB on insurance matters, and because of the FSB's lack of transparency and the recent retreat from open sessions at the IAIS. We would encourage more transparency across the board from the international standard-setting organizations and the U.S. Federal Government agencies in activities relating to international insurance standards.

Q.2. Do State insurance regulators through the NAIC articulate their views on international capital standards to FIO and the Federal Reserve?

A.2. Yes, we do. U.S. State insurance regulators are committed to providing an open and inclusive forum through the NAIC that provides transparency into the development of our policy positions and has proven effective for many years. We believe it is important to articulate our views on international capital standards not only to our Federal colleagues, but also to the larger stakeholder community. That is why we have been engaged in an open and public process with our Federal colleagues, industry, and consumer stakeholder through our ComFrame Development and Analysis Working Group (CDAWG) to update our position statements on ComFrame and international capital development. These public documents are posted on our NAIC Web site and serve to articulate State insurance regulators' views toward the uses of capital within prudential regulation and help guide our ongoing work regarding IAIS capital proposals.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER FROM BENJAMIN M. LAWSKY, SUPERINTENDANT OF FINANCIAL SERVICES, NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES, SUBMITTED BY SENATOR BROWN

NEW YORK STATE
DEPARTMENT of
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Benjamin M. Lawsky
Superintendent

April 27, 2015

The Honorable Sherrod Brown
Ranking Member
U.S. Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Brown:

We write today to highlight a troubling regulatory loophole that threatens the financial stability of the insurance markets, puts everyday policyholders at substantial risk, and provides billions of dollars in unearned tax deductions to large, multi-national corporations. That loophole is life insurance companies' use of "shadow insurance" vehicles to divert policyholder reserves to other purposes, such as executive compensation, dividends, and acquisitions.

Insurance is often presented as a sleepy corner of the financial world that draws little attention. However, under that cover, insurers have quietly sought to exploit differing rules and laws across state lines to lower their reserve requirements through shadow insurance vehicles. It is absolutely essential that regulators now take forceful action to address this textbook example of regulatory arbitrage in order to protect the efficacy of our state-based system of regulation.

In June 2013, the New York Department of Financial Services ("DFS") concluded a nearly year-long investigation into life insurer-owned captive "shadow insurance" vehicles. As detailed in our Department's report, insurance companies use shadow insurance to shift blocks of insurance policy claims to special entities – often in states or other jurisdictions outside where the companies are based – in order to take advantage of looser reserve and regulatory requirements, and make their balance sheets appear artificially rosy. (Reserves are the funds set aside to pay policyholder claims when they come due.)

In a typical shadow insurance transaction, an insurance company creates a "captive" insurance subsidiary, which is essentially a shell company owned by the insurer's parent. The company then "reinsures" a block of existing policy claims through the shell company – and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve and collateral requirements for the captive shell company are typically lower.

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This financial alchemy, however, does not actually transfer the risk for those insurance policies off the parent company's books because, in many instances, the parent company is ultimately still on the hook for paying claims if the shell company's weaker reserves are exhausted through a "parental guarantee." This shell game means that when the time finally comes for a policyholder to collect their promised benefits after years of paying premiums — such as when there is a death in their family – there is a smaller reserve buffer available at the insurance company to ensure that the policyholders receive the benefits to which they are legally entitled.

Upon finding that New York-based insurers and their affiliates engaged in at least $48 billion in shadow insurance transactions that enabled them to reduce their reserves and artificially inflate their balance sheets and Risk Based Capital ("RBC"), a measure often used to gauge solvency, DFS urged fellow state insurance commissioners to adopt a national moratorium with regard to future captive transactions until a fuller and more complete picture could emerge.

No sooner had DFS characterized the transactions of the New York-based insurers it examined as the "tip of the iceberg," Moody's Investor Services issued a report in August 2013 called, "The Captive Triangle: Where Life Insurers' Reserve and Capital Requirements Disappear." That report provided additional support for New York's findings. Moody's concluded that through the use of captives, the life insurance industry has realized more than $324 billion of so-called accounting "relief." A subsequent study by the Federal Reserve Bank of Minneapolis and the London School of Business in April 2014 put the figure at more than $360 billion.

Life insurers that utilize captives to lower their reserves and diminish statutory protections for policyholders believe that the reserve standards established by formulae prescribed in state law require them to hold in excess of what they need to cover the risk in question. The use of captives enables life insurers to retain only the so-called "economic reserve" for policyholders, and otherwise deploy the capital standing behind what they term "excess" reserves for other corporate purposes. Those other purposes may include anything from an acquisition of another company to executive compensation to paying dividends to investors. Quality assets standing behind the excess reserve are then replaced with letters of credit guaranteed in full by a corporate parent, or some other means of financial alchemy, that insurance regulators do not typically accept as genuine assets.

Recognizing full well that the life insurance industry's use of captives creates opportunities for regulatory arbitrage and encourages a lack of uniformity that raises serious questions about the efficacy of the state-based system of insurance regulation to safeguard solvency and protect consumers, the National Association of Insurance Commissioners ("NAIC") opted not to heed the call for a moratorium, but instead engaged a consultant to assist in tackling the problem. While the results of that process place some minor guardrails on new captive transactions, it will not eliminate captives and actually perpetuates the use of questionable assets to support reserves.

Many state insurance commissioners believe that the use of captives will subside with the NAIC's move towards principle-based reserving ("PBR"), a deregulatory initiative that scraps statutory reserve formulae in favor of a regime that enables life insurers to set their own (i.e., lower) reserves based primarily on company-specific models that regulators are ill-equipped to understand or challenge. The life insurance industry, however, has maintained that it will need to continue to resort to captive insurance structures irrespective of whether PBR ultimately is adopted on a national basis.

While much of the national focus on life insurer captives has involved just term life insurance ("XXX reserves") and universal life insurance with secondary guarantees ("AXXX reserves"), life insurers are also using captives to reinsure their risks associated with long term care insurance and the guarantees under variable annuities with guaranteed living benefits ("VAGLBs"). DFS now annually collects data that captures information for all of these captives affiliated with New York licensed life insurers to get a more complete picture of the situation. However, it is unclear at this time whether captives will expand to support even a greater number of products in the future whenever life insurers feel the reserves or RBC requirements are too high.

It is noteworthy that the XXX and AXXX captive transactions also allow insurers to exploit a gaping tax loophole that provides billions of dollars of unearned and unwarranted tax deductions. Because reserves are a cost of doing business, they are typically tax deductible. Although reserve requirements are lower in jurisdictions where captives are located, under current federal tax rules, insurers can still take a full tax deduction for the original amount of reserves they held before they engaged in the captive transaction. In other words, the insurers can have their cake and eat it, too. DFS has recommended that the IRS examine the gamesmanship associated with life-insurer owned captives including ways to close that loophole.

DFS continues to monitor the evolving nature of life insurer captives and hopes to shed light on and further stimulate a national debate on this important issue to our financial system. We thank you for opportunity to highlight this important issue.

Sincerely,

Benjamin M. Lawsky
Superintendent of Financial Services

EXAMPLES OF INCENTIVES FOR ANNUITY BROKERS, SUBMITTED BY SENATOR WARREN

ELIZABETH WARREN
U.S. SENATOR FOR MASSACHUSETTS

EXAMPLES OF INCENTIVES FOR ANNUITY BROKERS

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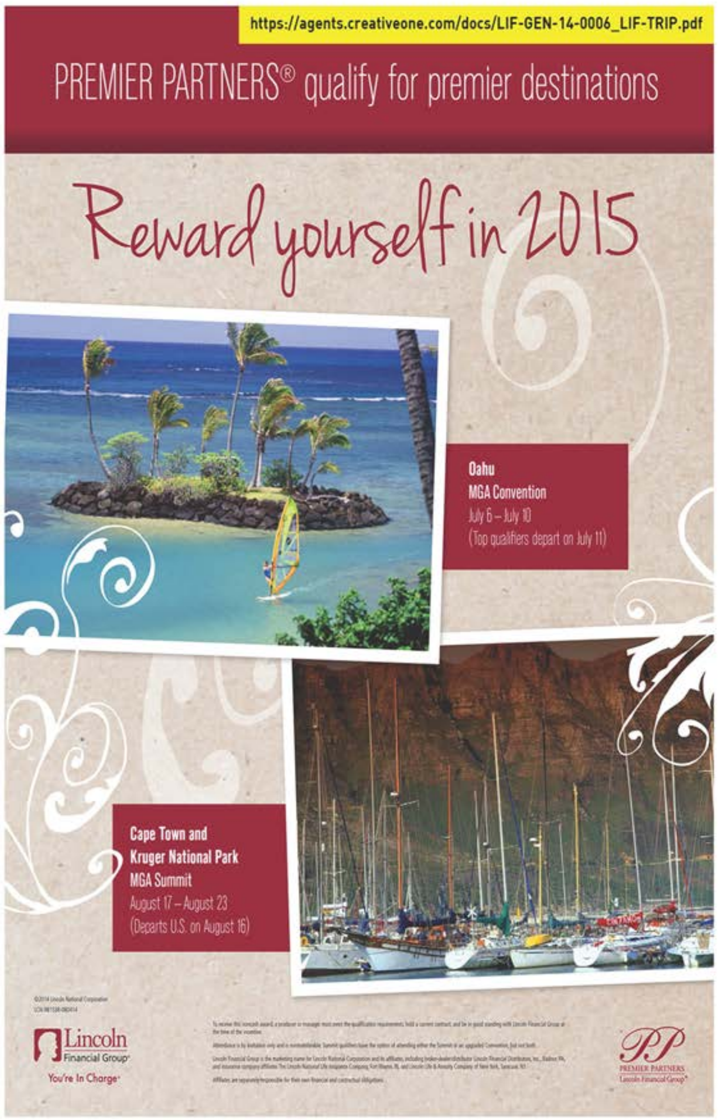
ELIZABETH WARREN
U.S. SENATOR FOR MASSACHUSETTS



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