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Submitted for the Record

U.S. House Financial Services Subcommittee on Housing and Insurance Hearing
Titled "The Impact of Domestic Regulatory Standards on the U.S. Insurance Market"
September 29, 2015

Chairman Luetkemeyer, Ranking Member Cleaver, and distinguished Members of the Subcommittee:

As the chairperson of the American Academy of Actuaries'[1] Solvency Committee, I appreciate the opportunity to provide this written testimony for the Subcommittee's Sept. 29 hearing: "The Impact of Domestic Regulatory Standards on the U.S. Insurance Market." U.S. insurance markets are strong, due in large part to effective regulation and oversight based on sound solvency and actuarial principles. My testimony will focus on recent proposals to regulate U.S. insurers' capital and solvency in order to promote financial stability.

Insurance Capital Standards Clarification Act of 2014

First, I commend the action of Congress in passing the Insurance Capital Standards Clarification Act of 2014 during the 113th congressional session. The statute provides the Board of Governors of the Federal Reserve System with the much needed authority to differentiate regulatory capital requirements between banks and insurers.

Insurance companies operate in different markets under different accounting constructs and face different risks than other financial institutions. The business models for insurance companies and other financial institutions have important differences relative to, among other things, the needs of consumers, the nature of risks transferred, and the timing and certainty of cash flows. Regulation focused on risks that are not necessarily significant to insurers could drive changes to their product offerings, impact policyholders by impeding competition and creating affordability

[1] The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

and accessibility problems, and lead to actions that increase the economic risks to insurers and their policyholders. Furthermore, some risks could be more significant for insurers than other financial institutions, particularly with respect to liabilities that are sensitive to changes to interest rates. As such, applying the same regulations or capital requirements to insurers and other financial institutions, including banks, is not appropriate.

Basic Solvency Principles for Capital Standards

Although U.S. insurers are generally regulated at the state level, both the National Association of Insurance Commissioners (NAIC) and the Board of Governors of the Federal Reserve System are developing insurance regulations for large U.S. insurers to meet certain group capital requirements. To help guide regulators in connection with their development processes, the Academy's Solvency Committee has created a comprehensive set of basic principles that it believes are essential to the development of effective group solvency and capital standards for insurers. Adhering to these principles will help policymakers create insurance capital standards that are appropriate for insurance business models and do not negatively impact U.S. insurance markets or consumers. The committee also believes that the basic principles highlighted below should be taken into account during the development process for international insurance regulations and capital standards.[2] These principles include:

1. A group solvency regime should be **clear regarding its regulatory purpose and goals**. For example, the purpose could be to protect policyholders, enhance financial stability, ensure a competitive marketplace, provide a level playing field, identify weakly capitalized companies, rank well-capitalized insurers, improve risk management practices and procedures, or some combination of the above. The regulatory purpose and goals will aid in the development of a standard itself, the associated regulatory actions, and priorities.

2. Any **metrics, information, or other output** of a group solvency standard should be useful to all relevant parties, including regulators, management, shareholders, and rating agencies.

3. A group solvency regime should **promote responsible risk management** in the regulated group and **encourage risk-based regulation**. For example, a solvency regime should recognize risk-mitigation activities, such as asset/liability matching, hedging, and reinsurance. Actuarial functions are critical in the risk management process and their role should be well defined, as it is in the state-based reserving and solvency framework. Actuaries can and should identify where factor-based systems could miss emerging risks, set reasonable boundaries around estimates and modeling, and, as appropriate, render actuarial opinions.

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[2] For more information on application of these principles to international standards, please refer to previous Academy testimony to this Subcommittee for the April 29, 2015, hearing on "The Impact of International Regulatory Standards on the Competitiveness of U.S. Insurers." This testimony offered the Solvency Committee's perspectives on the International Association of Insurance Supervisors' (IAIS) capital standards setting activities.

4. Methods should recognize and take into consideration the **local jurisdictional environments** under which members of an insurer group operate, including the local regulatory regime, product market, and economic, legal, political, and tax conditions.

5. A group solvency standard should be **compatible across accounting regimes**, given the technical and political uncertainties in achieving uniform standards.

6. A group solvency standard should **minimize pro-cyclical volatility** so as to avoid unintended consequences on insurance groups, insurance markets, and the broader financial markets.

7. A group solvency standard should present a **realistic view of an insurance group's financial position and exposures to risk** over an agreed-upon time frame.

8. All **assumptions** used in any capital or solvency model should be **internally consistent**.

9. It is more important to **focus on the total asset requirement** than the level of required reserves or capital on a separate basis. The focus should be on holding adequate total assets to meet obligations as they come due. Whether a jurisdictional standard requires the allocation of these assets to liabilities versus capital/surplus should be irrelevant to the overall solvency regime.

10. It must be **demonstrated that the capital held is accessible**, including in times of financial or economic stress, to the entity facing the risk for which the capital is required.

In addition, the American Academy of Actuaries provided written testimony[3] on the challenges associated with developing entity-level capital requirements for insurers to the Senate Banking Subcommittee on Financial Institutions and Consumer Protection for the March 11, 2014 hearing on "Finding the Right Capital Regulation for Insurers." This testimony contained an overview of the NAIC's risk-based capital (RBC) requirements, which are currently in effect in the United States.

Board of Governors of the Federal Reserve System Capital Standards Proposals

Currently, the Board of Governors of the Federal Reserve System is in the process of developing capital standards for non-bank systemically important financial institutions (SIFI). The Academy's Risk Management and Financial Reporting Council is closely following the development of these standards and other regulatory proposals, although there are no formal proposals from the Board at this time.

[3] http://actuary.org/files/RMFRC_HouseTestimonyHines_031114.pdf

NAIC Group Capital Standards Proposals

The NAIC has been actively developing proposals related to group capital calculations, in addition to the regulatory proposals under development by the Board of Governors of the Federal Reserve System.

The July 23, 2015, discussion draft[4] from the NAIC's ComFrame Development and Analysis (G) Working Group (CDAWG) offered an overview of potential advantages and disadvantages of three possible factor-based approaches to a U.S. group capital calculation for insurers:

> (1) Aggregation of existing RBC calculations within a group;
> (2) A consolidated group RBC calculation based on U.S. statutory accounting principles; and
> (3) A consolidated group RBC calculation based on Generally Accepted Accounting Principles (GAAP).

In the Solvency Committee's view, each of these factor-based approaches offers potential as a component of a new group capital measure that leverages the existing U.S. system of RBC. However, the committee has urged the NAIC, in addition to exploring potential capital measures based on RBC, to include a cash flow stress testing methodology in its final recommendations. The committee believes that a hybrid approach, incorporating both factor-based and cash flow methodologies, as originally proposed by the NAIC in late 2014,[5] has significant merit.

Factor-based approaches like the NAIC's RBC requirements are useful regulatory tools, but also have significant limitations. For example, it is not practical to expect that factors can be designed to take into account every nuance of risk across insurers. In contrast, a cash flow approach based on internal models can be calibrated to an insurer's actual risks. The cash flow approach, of course, has its own disadvantages. Comparable results may be elusive because risks can differ dramatically from insurer to insurer, and internal models require significant resources to implement and monitor from both regulators and insurers.

A hybrid approach offers a potential path that draws the best features from RBC and cash flow methodologies. For example, state regulators could use an RBC methodology to establish a minimum required level of capital that applies to all U.S. insurers. A cash flow methodology then could be used to establish a prudent capital level above this minimum. Such an approach could maximize the advantages of each methodology while minimizing the disadvantages. In addition, a well-designed RBC-based minimum could give regulators the flexibility to design a cash flow or similar prudent capital methodology that accounts for the significant economic differences between life insurers, property and casualty insurers, and health insurers.

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Thank you for this opportunity to discuss the impact of domestic regulatory standards on U.S. insurers. Actuaries have worked for many years with insurance and other financial sector

[4] http://www.naic.org/documents/committees_g_cfwg_related_us_group_capital_calc_draft.pdf
[5] http://www.naic.org/documents/committees_g_cfwg_exposure_disc_paper_us_grp_cap_method_concepts.pdf

policymakers to help develop prudent laws and regulations that address insurer solvency, including capital requirements. Actuarial expertise remains crucial to the creation of both domestic and international insurance regulatory standards.

If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202-223-8196 or sarper@actuary.org.