STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS
AND THE
AMERICAN INSURANCE ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON SECURITIES, INSURANCE & INVESTMENT
OF THE
SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

ON

EXAMINING INSURANCE CAPITAL RULES AND FSOC PROCESS

April 30, 2015

Statement Made by
Robert M. Falzon
Executive Vice President & Chief Financial Officer
Prudential Financial

Chairman Crapo and Ranking Member Warner, my name is Robert Falzon, and I am Executive Vice President and Chief Financial Officer of Prudential Financial. I am testifying today on behalf of the American Council of Life Insurers ("ACLI") and the American Insurance Association ("AIA"). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. ACLI member companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums. The American Insurance Association (AIA) is the leading U.S. property-casualty insurer trade organization, representing approximately 325 insurers that write more than $127 billion in U.S. premiums each year. AIA member companies offer all types of property - casualty insurance, including personal and commercial auto insurance, commercial property and liability coverage for small businesses, workers' compensation, homeowners' insurance, medical malpractice coverage, and product liability insurance.

ACLI and AIA appreciate the opportunity to address the ongoing development of capital rules by the Federal Reserve Board (the "Board") applicable to those insurers that have been designated as systemically important by the Financial Stability Oversight Council ("FSOC") or that own savings and loan associations, the related group insurance capital standard being developed by the International Association of Insurance Supervisors ("IAIS"), and the transparency and fairness of the FSOC designation process.

Prudential Financial is one of the three insurers that has been designated as systemically important by FSOC, and as a consequence my company was intimately involved with the legislation enacted late last year enabling the Board to craft capital standards suitable for an insurance

enterprise. In addition, I am personally involved in the overall industry effort to work with the Board to come up with the actual capital rules that will be applied to those insurance groups now subject to the Board's jurisdiction.

The Collins Amendment & The Insurance Capital Standards Clarification Act

Please allow me to thank Chairman Crapo, Ranking Member Warner and the members of this Subcommittee for your leadership in support of the Insurance Capital Standards Clarification Act of 2014. As you know, this legislation, authored by Senator Susan Collins, Senator Sherrod Brown, Senator Mike Johanns, Representative Gary Miller, and Representative Carolyn McCarthy, was unanimously approved by the Senate and House last year. This essential legislation clarified Federal Reserve Board authority to develop capital standards for insurance companies subject to Board supervision that reflect insurance businesses and risks, rather than defaulting to inappropriate bank standards. The unanimous support for this legislation in both the Senate and House constituted a definitive statement of Congressional intent that insurance capital standards must be appropriately designed and tailored. The legislation was also an important recognition that the business of insurance is substantially and fundamentally different from the business of banking, and that supervision of these different industries, particularly where capital adequacy is being assessed, should account for their different risk profiles, balance sheets, and business models.

Without question, capital standards are stronger when they are appropriately designed for the type of company to which they are applied. Appropriately designed and tailored capital standards further the goals of prudential supervision and provide the highest level of safety and protection for consumers. In the case of insurance, the application of bank standards would have

disrupted the operations of well capitalized insurance companies. In fact, capital standards governing banks and bank holding companies should never be applied to insurance entities.

In the near future, we expect that the Board will begin drafting a proposed regulation establishing a consolidated group capital standard for insurers that are savings and loan holding companies, or that have been designated by the FSOC as systemically important. Earlier this year, we met with senior representatives of the Board to stress the importance of moving forward with a proposal that reflects the well established methodologies for measuring the financial strength and resiliency of an insurance group. We have continued our communications with the Board's staff on the issue since then, and will continue to do so as this process unfolds. Since the passage of the Act, we are encouraged by the Board's approach to the issue and are hopeful that any proposed regulation will reflect the clear Congressional intent behind its passage.

International Insurance Capital Standards

The International Association of Insurance Supervisors (IAIS) is working to develop an international group Insurance Capital Standard (ICS) as part of IAIS work on a proposed Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). ComFrame is a set of international supervisory standards focusing on group-wide supervision of Internationally Active Insurance Groups (IAIGs). Under the current proposed ComFrame definition of an IAIG, there are likely to be approximately 50 IAIGs around the world. IAIGs are defined as companies that operate in three or more countries, generate more than ten percent of their revenue from outside their home country, and meet significant size requirements.

The U.S. insurance industry is concerned about the haste with which the ICS is being developed, particularly in the context of Congress' passage into law of the Insurance Capital

Standards Clarification Act in December 2014. The IAIS timeline must accommodate full implementation of that law and a formal rulemaking process for development of domestic insurance capital standards by the Board.

The IAIS recently announced that it will take a staged or incremental approach to developing the ICS over several years with the ultimate goal of global convergence around one standard in the longer term. This signals a longer, rational and thoughtful process to developing the ICS than originally identified. With that said, we will not grow complacent, we have not claimed victory - we will continue to actively engage our U.S. representatives to the IAIS as well as international supervisors to make sure that they remain true to a more deliberative approach to ICS development - one that reflects a capital/solvency framework that is appropriate for the U.S. insurance market and consumers.

The U.S. representative members of the IAIS will be informed by a deliberative rulemaking process by the Board that draws on the risk-based capital framework currently utilized by the states, and they will bring that experience to bear in the international process. The IAIS timeline should not be elevated above the importance of developing an international standard that is complementary to local capital standards and results in a level competitive playing field that promotes private market expansion around the world. The ICS would clearly benefit from the work of the Board, and the insurance industry supports appropriate adjustments to the IAIS timeline for the ICS to accomplish these objectives. Importantly, the IAIS has slowed its overly aggressive timeline for development of the ICS, which can only be implemented through a state or federal rulemaking process.

Any ICS must be rooted in principles that are common to insurance in all jurisdictions, but must also be flexible enough to recognize and appropriately reflect existing accounting practices and the need for jurisdictional differences based on market, societal and consumer needs. Such

flexibility is an essential precondition to the U.S. and other jurisdictions' willingness and political ability to adopt it into law and put it into practice.

In fact, Team USA, consisting of the Board, State Insurance Supervisors, and the Treasury Department's Federal Insurance Office (FIO), has been forcefully advocating that any ICS cannot be finalized that does not allow for the foundational elements of the U.S. regulatory system. We understand that the IAIS will begin field testing two different approaches to the ICS this year. One of these approaches was largely developed, advanced and endorsed by all members of Team USA and is more representative of the U.S. regulatory framework. These two approaches will be field tested by more than 25 global firms, including several U.S. based companies, over the next several years. This is another positive step. We commend the Board, State Insurance Supervisors, and FIO for working together to achieve this outcome.

Another factor slowing the pace of ICS development is a realization by policymakers in markets around the world that life insurers not only meet a tremendous social need for protecting individuals and their families, but also are fundamentally important as one of the few industries that invest for the long term in infrastructure. Those investments are key drivers of global job creation and economic growth. We believe that it is critical for the U.S. to elevate this issue to the political level of the G20. The balance of regulatory intensity and investment and growth needs to be made at the macro political and economic level and not only by regulators who are not responsible for job creation and economic recovery. In a similar way, property-casualty companies provide the insurance that makes infrastructure development possible, as well as investments that support continued growth. It is critical that capital standards promote those roles to the benefit of consumers and a healthy economy with robust private insurance markets. We are optimistic that with high level

political appreciation for the role that insurers play in the global economy, policies can be developed that begin a virtuous cycle of growth and stability.

Solvency II and the US-EU Regulatory Dialogue Project

The core intent of Solvency II was and is to improve the prudential regulation of the European Common Market in insurance. As we recognize that Solvency II is an internal European undertaking, we have been engaged on "third country" provisions, which are intended to extend the benefits of unilateral recognition to insurers and reinsurers that conduct business into and out of the EU but are headquartered elsewhere.

We have strongly advocated that the U.S. regulatory regime is equivalent in outcome to Solvency II and that this should be recognized by the European Commission. We are pleased that there has been a productive process established between the U.S. Federal and State Governments and the European Commission and the European Member state regulators through their statutory consultative body the European Insurance and Occupational Pension Authority (EIOPA).

This process, called the US-EU Regulatory Dialogue Project, is in its fourth year of a detailed information exchange intended to build greater transatlantic understanding between regulators of the different U.S. and EU approaches to achieving the same regulatory outcomes of stability, consumer protection and fair competition. In our opinion, this regulatory confidence building has been a tremendous success in removing misunderstanding and paving the way for the U.S. to be deemed either transitionally or permanently equivalent by the European Union.

This positive progress however is not a foregone conclusion and the Dialogue Project process requires continued work by all sides. We believe that the maintenance of a positive relationship between the world's two largest markets is simply too important to be disrupted by

perceived differences in regulatory approach. We also commend the state supervisors and FIO for the time and effort they have made to patiently explain the U.S. system and to address potential misperceptions.

The US-EU Dialogue Project has had the ancillary benefit of bringing together U.S. and EU regulators within the IAIS decision making process. We urge this continued expansion of coordination between U.S. and EU regulators within the IAIS to support markets where all competitors are held to the same high standards of solvency, market conduct and consumer protection.

The FSOC Designation Process

While FSOC has made improvements to its designation process, we believe additional reforms are necessary to enhance transparency and ensure a fairer overall designation and de-designation process. Our suggestions for improvement focus on the following: providing better and more transparent procedural safeguards; affording greater weight to the views of an insurer's primary financial regulator; implementing an "activities-based approach" for evaluating the systemic importance of insurers; putting in place a viable process for de-designation; and promulgating the regulations required by Section 170 of the Dodd-Frank Act.

Improve Procedural Safeguards

One of the most important improvements to the FSOC designation process would be to require that a company under consideration be provided with access to the entire FSOC record. A company that advances to the third and final stage of review has no way of knowing what materials FSOC believes are relevant, whether and in what form the materials it submits are provided to voting members of FSOC, or what materials, in addition to those submitted by the

company, FSOC staff and voting members reviewed and relied upon. In other words, a company is not provided with the evidentiary record upon which the voting members will make a proposed or final determination.

In addition, FSOC should have separate staff assigned to its enforcement and adjudicative functions. Council staff who identify and analyze a company's suitability for designation and author the notice of proposed determination and final determination should not also advise Council members in deciding whether to adopt the notice of proposed determination and final determination. Dividing Council staff between enforcement and adjudicative functions would protect the independence of both functions. Communications between Council members and enforcement staff should also be memorialized as part of the agency record and provided to companies under consideration for designation.

For an insurer, we believe an essential part of the designation process must be to afford special weight to the views of the FSOC member with insurance expertise. FSOC must vote, by two-thirds of the voting members then serving including the affirmative vote of the Chairperson, to issue a final determination. The requirement for a supermajority vote is intended to ensure that designation is reserved for companies that pose the most obvious risk to the financial stability of the United States. Yet, the members of FSOC vote as individuals rather than as representatives of their agencies. Thus, the vote is based upon their own assessment of risks in the financial system rather than the assessment of their respective agencies. Moreover, the voting process gives equal weight to views of all members, regardless of a member's experience in regulating the type of company being considered for designation. In the case of a company primarily engaged in the business of insurance, special weight should be given to the views of the Council member with insurance experience.

Upon receipt of a final designation, a company may seek judicial review before a federal court. Even this safeguard, however, is subject to limitations. A company has only 30 days in which to file a complaint, and loses the right to do so beyond that date. We believe that timeframe should be extended. Moreover, filing the complaint should carry an automatic stay of supervision by the Federal Reserve Board. While a company is challenging the legitimacy of a designation, it should not be forced to simultaneously establish a comprehensive infrastructure (e.g., systems, procedures, and controls) to comply with Board supervision.

Finally, from a procedural standpoint, we believe FSOC should be prevented from misapplying the "material financial distress" standard for designation. With respect to insurers, it seems clear that FSOC *assumed* the existence of material financial distress at a company and then concluded that such distress could be transmitted to the broader financial system. Under a material financial distress standard that actually meets the statutory requirements of the Dodd-Frank Act, FSOC would need to employ the 11 statutory factors to first determine whether the company is vulnerable to material financial distress based upon its company-specific risk profile and, if it is, then determine whether the company's failure could threaten the financial stability of the United States. FSOC should not be able to designate a company on an *assumption* it is failing, but instead should designate a company only when a company's specific risk profile – including its leverage, liquidity, risk and maturity alignment, and existing regulatory scrutiny – reasonably support the expectations that the company is vulnerable to financial distress, and then that its distress could threaten the financial stability of the United States. The purpose of designations should be to regulate nonbanking firms that are engaged in risky activities that realistically "could" cause the failure of the firm, not to regulate firms that are not likely to fail.

Afford Greater Weight to the Views of an Insurer's Primary Financial Regulator

In drafting the Dodd-Frank Act, Congress recognized that many nonbank financial companies are subject to supervision and regulation by other financial regulators. Insurance companies, for example, are subject to comprehensive regulation and supervision by state insurance authorities. Thus, Congress directed FSOC to consult with other primary regulators when making a designation determination, and required FSOC to consider "the degree" to which a company is already regulated by another financial regulator. Congress also gave the Federal Reserve Board authority to exempt certain classes or categories of nonbank financial companies from supervision by the Board, and directed the Board to take actions that avoid imposing "duplicative" regulatory requirements on designated nonbank companies.

FSOC's designation of insurance companies shows little deference to these requirements. In the case of MetLife, for example, FSOC discounted state insurance regulation even after the Superintendent of the New York State Department of Financial Services (NYDFS), Benjamin Lawsky, told FSOC that: (1) MetLife does not engage in non-traditional, non-insurance activities that create any appreciable systemic risk; (2) MetLife is already closely and carefully regulated by NYDFS and other regulators; and (3) in the event that MetLife or one or more of its insurance subsidiaries were to fail, NYDFS and other regulators would be able to ensure an orderly resolution. Similarly, in his dissent in the Prudential case, the Council member with insurance experience noted that the scenarios used in the analysis of Prudential were "antithetical" to the insurance regulatory environment and the state insurance company resolution and guaranty fund systems, and all three of Prudential's primary state insurance regulators submitted statements rebutting any argument that Prudential could cause systemic risk.

This lack of deference to an insurer's primary financial regulator is particularly troubling given the fact that insurance, unlike every other segment of the financial service industry, does not have any of its primary regulators as voting members of FSOC. Moreover, none of the primary regulators of the three insurers that have been designated were "at the table" when FSOC designation decisions were made.

Implement an "Activities-Based" Approach for Insurance.

The Dodd-Frank Act gives FSOC two principal powers to address systemic risk. One power is the authority to designate nonbank financial companies for supervision by the Federal Reserve Board. The other power is an "activities-based" authority to recommend more stringent regulation of specific financial activities and practices that could pose systemic risks. FSOC has not been consistent in its exercise of these powers. In the case of the insurance industry, FSOC has actively used its power to designate. In the case of the asset management industry, FSOC has undertaken an analysis of the industry so it can consider the application of more stringent regulation for certain activities or practices of asset managers, and it has not designated any asset management firm to date.

FSOC held a public conference on the asset management industry in order to hear directly from the asset management industry and other stakeholders, including academics and public interest groups, on the industry and its activities. Furthermore, following its meeting on July 31, 2014, FSOC issued a "readout" stating that FSOC had directed its staff "to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."

In contrast, FSOC has not held any public forum at which stakeholders could discuss the insurance industry and its activities. Instead, FSOC has used its power to designate three insurance companies for supervision by the Federal Reserve Board.

ACLI and AIA support the more reasoned approach that FSOC has taken in connection with the asset management industry and believes that FSOC should be required to use its power to recommend regulation of the specific activities of a potential designee *before* making a designation decision with respect to that company.

FSOC's power to recommend more stringent regulation of specific activities and practices has distinctive public policy advantages over its power to designate individual companies for supervision by the Federal Reserve Board. FSOC's power to recommend primary regulator action brings real focus to the specific activities that may involve potential systemic risk and avoids the competitive harm that an individual company may face following designation. As noted above, in certain markets, such as insurance, designated companies can be placed at a competitive disadvantage to non-designated companies because of different regulatory requirements. Finally, the power to recommend avoids the "too-big-to-fail" stigma that some have associated with designations.

FSOC's recommendations for more stringent regulation of certain activities and practices must be made to "primary financial regulatory agencies." These agencies are defined in the Dodd-Frank Act to include the SEC for securities firms, the CFTC for commodity firms, and state insurance commissioners for insurance companies. A recommendation made by FSOC is not binding on such agencies, but the Dodd-Frank Act includes a "name and shame" provision that encourages the adoption of a recommendation. That provision requires an agency to notify FSOC

within 90 days if it does not intend to follow the recommendation, and FSOC is required to report to Congress on the status of each recommendation.

Permit Companies to Petition for a Designation Review Based on a Change in Operations or Regulation

FSOC is required to review the designation of a company on an annual basis. A company also should have the opportunity to petition for a review based upon a change in its operations, such as the divestiture of certain business lines, or a change in regulation. Moreover, during a review, FSOC should be required to provide a company with an analysis of the factors that would lead FSOC to de-designate a company. This would lead a company to know precisely what changes in its operations or activities are needed to eliminate any potential for the company to pose a threat to the financial stability of the United States.

Promulgate the regulations required by Section 170 of the Dodd-Frank Act.

Section 170 of the Dodd-Frank Act directs the Federal Reserve Board, in consultation with FSOC, to issue regulations exempting certain classes or categories of companies from supervision by the Federal Reserve Board. However, to date no such regulations have been issued. This requirement represents yet another tool Congress created to delineate between those entities that pose systemic risk and those that do not. How such regulations might affect insurance companies, if at all, is unknown. But presumably the regulations will shed additional light on what metrics, standards or criteria operate to categorize a company as non-systemic. The primary goal here should be to clearly inform companies of how to conduct their business and structure their operations in such a way as to be non-systemic. Only if that primary goal cannot be met should the focus turn to regulating systemic enterprises.

Conclusion

The insurance industry strongly supports full implementation of the Insurance Capital Standards Clarification Act. In addition, the insurance industry supports a formal rulemaking process with notice and public comment for the development of insurance capital standards to ensure that the Federal Reserve Board has the best information and input from public stakeholders. The goal of this process should be the development of capital standards that are specifically designed and tailored for the insurance business model. Furthermore, this domestic process should not be condensed, abridged, or confused by IAIS standard setting. Because the IAIS would benefit from the work of the Federal Reserve Board, and because the U.S. position is certain to be informed by that work, the IAIS timeline for the development of the ICS must accommodate the U.S. process. This sequencing is essential to good market and regulatory outcomes for U.S. companies and consumers, and also for a healthy outcome to the international discussion.

The insurance industry also supports reform of the FSOC process, including improved procedures for de-designation and increased consideration of the views of primary insurance regulators. These reforms would strengthen the FSOC and its regulatory goals of identifying and diminishing systemic risk.

Chairman Crapo, Ranking Member Warner, thank you for the opportunity to testify before the Subcommittee today.