Testimony for the Hearing, "Emerging Issues in Insurance Regulation," Prepared for the Senate Subcommittee on Securities, Insurance, and Investment

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September 10, 2011

My comments for this hearing are mostly directed to emerging issues in insurance regulation, including international issues. The following issues, I believe, are important issues for the insurance industry and insurance regulators:

1. (International) Group Supervision. Most insurance carried out in the U.S. is done by families of insurance companies called groups. Companies within the group are related to each other by common ownership. Recent history has shown that groups can be complex and opaque in nature. In some cases this can hamper insurance regulation, as discussed below.

   Many groups are involved in noninsurance activities.[1] These noninsurance activities may be regulated or they may not. Importantly these activities, especially if they are unregulated and involve capital markets, could make a group systemically risky (as was the case for AIG). That is, a convincing case can be made that the insurance activities carried out by insurers do not create systemic risk. However, when insurers drift towards noninsurance activities that involve capital markets, the latter activities can be a source of systemic risk. U.S. insurance regulators at present do not have the authority to supervise these noninsurance activities, and there appears to be no mechanism in place that allows

[1] Group and the group holding company are used interchangeably here.

regulators of the insurance and noninsurance activities to work together in maintaining the viability of the total enterprise or even to assess the riskiness of the enterprise as a whole. Even worse, no regulatory authority is present to cooperate with if the noninsurance activities are conducted by a nonregulated entity.

The factors discussed above have an important bearing in determining capital requirements for insurers that are part of a group. For example, it raises the question of whether insurance regulators should put in place capital requirements for noninsurance activities (especially unregulated ones). There are many other questions concerning determination of group capital requirements. For example, there is a question about whether insurers that are part of a group should be allowed to recognize diversification benefits because they operate across different geographic areas and/or in very different lines of business. The latter issue, of course, is one raised by insurers.

Also, some of the products offered by insurers are similar to products offered by other financial institutions. For example, some life insurance products compete with banking products. Therefore care must be taken that regulation of these products are consistent. Regulatory arbitrage can occur if a product of one type of financial institution is considered to be regulated less rigorously than products offered by the other type of institution. Thus, direct coordination between financial institution regulators is required to prevent regulatory arbitrage of this type from occurring.

Many groups operate internationally. Yet, insurers are actually regulated by national domestic bodies. The wind-up of a perhaps complex insurance group raises questions as to how assets of the group will be distributed among the different countries that the group operates in. This points to the need for direct coordination and cooperation among regulators from different countries. At present, there is some degree of coordination among international insurance regulators when a group experiences financial distress. In this case a "supervisory college" consisting of regulators of companies in the group is convened to deal with the problem. However, these supervisory colleges are in place only so long as the group is in financial distress – they are disbanded when the problem is resolved. Thus supervisory colleges are ad hoc and intermittent. To prevent problems in the first place, coordination among regulators of companies in a group should be ongoing, with regulators in the supervisory college in regular communication with each other.

2. Optional Federal Chartering. A perennial issue that arises is whether insurers should be able to choose to be regulated at the Federal level, leaving the remaining insurers to continue to be regulated at the state level. Arguments exist in favor of this Federal chartering option – many of which are related to efficiency (e.g., streamlined producer and company licensing, speed to market for products,

removal of rate regulation). For example, currently an insurer that wants to write insurance in all states must meet the statutory requirements of all of these states. This is cumbersome and time consuming, for U.S. insurers and foreign insurers alike.

Although there are arguments in favor of Federal chartering, I believe there are better reasons not to follow such a route. In my opinion, large insurers would likely opt for federal chartering, and these insurers could present a powerful lobbying force to the Federal regulator. In fact, the regulator might be prone to regulatory capture, a phenomenon in which the regulator ends up serving the interests of the regulated entities rather than pursuing traditional goals of regulation. One has only to contrast the lobbying power of insurers now – lobbying 50 state regulators – with the lobbying power of insurers if one Federal regulator/agency is in place to see how there could be a problem.

Optional Federal chartering is sometimes compared to the dual system of banking regulation that exists in the U.S. But the cost to multistate, Federally-chartered insurers to switch back to state regulation in multiple states might be larger than it is for banks to switch from Federal to state chartering. Further, it is not clear that federal regulators would not succumb to the same political pressures of state regulators to provide cross-subsidies to policyholders across and within states (e.g., making insurance affordable by mandating lower insurance prices or limiting risk classification for underwriting purposes). The latter would defeat some of the arguments in favor of optional Federal chartering. Finally there are substantial risks and cost involved with setting up a Federal insurance regulatory agency. For example, Federal policies might be put in place that have unintended consequences and such mistaken policies then would have national effects. Finally, Federal regulation was unable to fend off the most recent financial crisis and may in fact have contributed to it through some deregulation policies preceding the crisis.

Alternatives to optional federal chartering exist. These might entail minimum Federal standards that states must meet (e.g., about licensing or product approval). Streamlining of insurance regulation might also be achieved by allowing an insurer to choose a primary state for the purpose of rate, policy form and perhaps other types of regulation. Then the insurer would be allowed to operate in all other states they are licensed in without having to meet regulations such as rate and policy form regulations that are governed by the primary state. Note that the primary state regulations would govern only select aspects of regulation so that solvency regulation or market conduct regulation could still be regulated by each individual state the insurer operates in.[2]

3. Solvency II, the Swiss Solvency Test and U.S. Insurance Regulation. The Swiss Solvency Test (SST) is now in force in Switzerland. Solvency II is slated to go into effect sometime in 2012. Both systems represent a major overhaul of the

[2] For further explanation, see Scott Harrington, 2006, “Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation,” Policy Brief, Networks Financial Institute at Indiana State University.

way insurance will be regulated in Europe. A major aspect of Solvency II concerns capital requirements. An insurer's required capital will be determined by a risk-weighted formula (similar to an RBC approach as used in the U.S.) or on the basis of an internal model created by the insurer which purports to accurately capture the riskiness of the insurer's activities. The basic idea is that large insurers will use the model approach while smaller insurers (for whom developing a model is likely to be expensive) would use the risk based formula approach. Obviously, the modeling approach is radically different from the regulatory approach used in the U.S., and I believe it is unlikely that relying on a company's own model to determine its capital requirements will be adopted here.[3]

Nevertheless there are some important aspects of Europe's new regulation framework that could prove to be quite useful in the U.S. For example, under the Swiss Solvency Test, insurers are required to undergo stress tests to see how solvency would be affected by adverse economic or loss development. Stress tests consist of scenarios that would severely affect the insurer. For example, a life insurer might undergo a stress test in which a pandemic is assumed to occur that results in major reinsurer insolvencies and panic in the capital markets.

Also under Solvency II, insurers will be required to provide the regulator with a document entitled the Own Risk Solvency Assessment (ORSA) which details the major risks the insurer faces, among other things. This document is treated

[3] This is not to say that modeling or principles-based regulation does not occur in the U.S. In fact it does exist for certain life insurance products.

confidentially and the use of such a document in U.S. regulation could be quite useful.

The new European insurance regulatory regime also embraces the importance of corporate governance and internal control systems. Under the Swiss Solvency Test, insurers are required to complete two questionnaires that detail the corporate governance and risk management controls within the insurer. These types of questionnaires could be useful in the U.S.

I believe that stress tests, ORSA, and the Swiss Quality Assessment questionnaires are being considered under the Solvency Modernization Initiative (SMI).

4. Leverage, Assets and Life Insurance. Although insurer assets are generally liquid and of high quality, there are some danger signals with respect to the life insurance industry. Life insurers hold 18.4% of their assets in mortgage-backed and other asset-backed securities (MBS and ABS), including pass through securities such as CMOs. Even more startling, the amounts invested in MBS and ABS represent 169.8% of life insurer equity (policyholders' surplus). These numbers are relevant because ABS and MBS were especially problematical during the financial crisis. Thus, even minor problems with asset defaults and liquidity demands could significantly threaten the solvency of many life insurers. Somewhat offsetting their asset liquidity risk, life insurers receive a significant

amount of net cash from operations, defined as premiums plus investment income net of benefit payments, expenses and taxes. Life insurers' net cash from operations represents 39% of equity.

The capital to asset ratios of life insurers was approximately 6.3% in 2010, while that for banks was 10.9%. Therefore at the present time, banks have about 75% more capital relative to assets than life insurers. Excessive leverage is risky because it exposes a firm's equity to slight declines in the value of assets. Therefore, the statutory statements of life insurers make them appear excessively leveraged, especially considering their exposure to mortgage-backed securities.

It is possible that the true leverage ratios of life insurers are much lower than indicated above. This is because statutory accounting is very conservative – overstating liabilities and understating assets. Nevertheless, I believe that leverage might well be a problem for many life insurers.

5. New global accounting standards are being used around the world, and the new insurance solvency systems for Europe rely on market value accounting. These accounting standards are very different from statutory accounting standards used in the U.S. Pressure is likely to develop on regulators to abandon statutory accounting and use accounting standards that are more universally in use. If statutory accounting is continued, this will require firms to continue to maintain two systems of accounting which is cumbersome and expensive.

Much regulation of insurers is underpinned by statutory statements. For example, RBC requirements consist of factors that are applied to statutory accounting values. Other solvency tests, such as ratio analysis (under the FAST system) rely on statutory accounting as well. Thus changing insurance accounting standards would have serious repercussions on how insurers are assessed for regulatory purposes.

6. Passage of the NAIC Reinsurance Modernization Proposal. This proposal entails creation of two new classes of reinsurers in the U.S., national reinsurers and "port of entry" (foreign) reinsurers. Each type of reinsurer would be regulated by only one state (the domiciliary state or the port of entry state). That is, a single state would be the sole regulator of a reinsurer writing assumed business in the U.S. Federal legislation could make this improvement in the regulatory system possible.

   Otherwise, reinsurers (both foreign and domestic) must meet the requirements under the NAIC Model Credit for Reinsurance Law. Under the latter, U.S. insurers can take balance sheet credit for reinsurance as long as the reinsurer is "authorized," i.e., licensed in the ceding insurer's state of domicile, accredited in the ceding insurer's state of domicile, or licensed in a state with substantially similar credit for reinsurance laws. Insurers can take credit for unauthorized reinsurance only if the reinsurer posts collateral, in the form of funds held in the

U.S. or letters of credit from U.S. banks. The NAIC and several individual U.S. states have begun to liberalize collateralization rules, and the process is ongoing.