

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

SUBCOMITTEE ON HOUSING AND INSURANCE

OF THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

ON

LEGISLATIVE PROPOSALS TO REFORM DOMESTIC INSURANCE POLICY

May 20, 2014

Statement Made by
Gary E. Hughes
Executive Vice President & General Counsel
American Council of Life Insurers

Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee, my name is Gary Hughes, and I am Executive Vice President and General Counsel of the American Council of Life Insurers ("ACLI"). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. These companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums.

ACLI appreciates the opportunity to provide you with its views on several legislative initiatives addressing the way in which insurance is regulated in the U. S. The focus of our testimony today, however, is on H.R. 4510, the Capital Standards Clarification Act of 2014 introduced by Representatives Miller and McCarthy. Passage of H.R. 4510 is one of the very highest priorities for ACLI and is essential in order to ensure that evolving capital standards both here and abroad protect and preserve the ability of life insurance companies to offer retirement and financial security products benefiting millions of U.S. consumers.

H.R. 4510 - The Capital Standards Clarification Act of 2014

Background

Through authorities provided in the Dodd-Frank Act, the Federal Reserve Board now regulates at the holding company level a number of companies that are primarily life insurers. The Dodd-Frank Act granted the Federal Reserve new supervisory authority over savings and loan holding companies (SLHC's), including those which are, or own, life insurers. The Dodd-Frank Act also authorized the Federal Reserve to supervise nonbank financial companies designated as Systemically Important Financial Institutions ("SIFIs") by the Financial Stability Oversight Council (FSOC). As we noted in testimony before this Subcommittee in February, two of ACLI's member companies have been designated by FSOC as systemically important and one additional company is under review for possible designation. Twelve of our member life insurers own thrifts. All of these life insurance companies will be subject to whatever capital standards the Federal Reserve ultimately determines to impose under powers conferred on it by Section 171 of the Dodd-Frank Act (the Collins Amendment).

In July of 2013, the Federal Reserve issued a final rule implementing Basel III for Bank Holding Companies and Savings & Loan Holding Companies. This rule included a temporary exemption for insurers that are, or are owned by, SLHCs to allow for further evaluation of appropriate consolidated standards for those companies. Similarly, the Federal Reserve's February 2014 rule implementing enhanced prudential standards for SIFI's (Section 165 of the Dodd-Frank Act), explicitly does not apply to insurers so that the Federal Reserve can study and develop appropriate standards for those companies. However, as a result of section 171 of the Dodd-Frank Act, it remains unclear how or if the Federal Reserve will apply Basel III to those insurers. ACLI adamantly and strongly opposes any application of bank-centric capital standards such as Basel III to life insurance companies.

Life Insurers Strongly Support Appropriate Capital Standards

ACLI strongly supports appropriate rules intended to ensure the capital adequacy of insurance companies. ACLI believes that any consolidated capital standards developed by the Federal Reserve for insurance companies must be insurance-based capital standards modeled on the current insurer risk-based capital system (RBC). RBC was specifically designed by insurance regulators for insurance company entities and is a holistic, comprehensive and accurate measure of their unique risks.

RBC recognizes the unique characteristics of insurance companies' business models and balance sheets, which are very different from those of banks. Specifically, it recognizes that premiums are collected in advance and invested ahead of anticipated claims, that insurers have relative predictability of those claims, and that products have safety mechanisms such as surrender charges to protect against illiquidity. Unlike banks, which are typically exposed to large amounts of highly liquid demand deposits, insurers have longer-term liabilities and therefore find that longer-term assets, even those with higher short-term volatility, pose less risk and are a key component to the long-term viability and financial strength of an insurer.

In addition to capturing credit risk of fixed income investments and the risk of fair value losses from equity (and similar) investments, RBC also captures many other risks, such as asset risk, insurance/underwriting risk, interest rate risk, and business risk, as well as differentiating

between insurance industry structures (life, property & casualty, and health). Over more than twenty years, RBC has been and continues to be repeatedly reviewed and refined, reflecting changing conditions and increasing sophistication of modeling techniques.

The foundation of RBC is statutory accounting where both assets and liabilities are valued conservatively. This results in an appropriately prudent measure of surplus as the starting point for the RBC calculation. Statutory accounting also takes a long-term oriented asset/liability matching posture that appropriately incents insurers to invest for the long term. It intentionally avoids application of fair value accounting rules to most life insurance company assets, thereby avoiding unwarranted volatility in regulatory capital. Such short-term volatility is usually inappropriate, particularly for life insurers that typically have long-term and inherently stable liability structures.

All U.S. insurance companies currently prepare statutory accounting statements, as is required by law in all jurisdictions, whereas many life insurance companies do not prepare GAAP-based financial statements. Requiring GAAP-based financial statements coupled with a bank-centric capital adequacy regime would unnecessarily result in an additional and competing set of financials and capital measures for many companies.

The ACLI believes the insurance-based principles and methodologies of RBC must be the model for any Federal Reserve rulemaking on consolidated capital standards for the insurance companies under its supervision. Insurance-based capital standards would provide the Federal Reserve with the best measure of the capital adequacy and risks unique to insurance operations.

Bank Standards Are Not Appropriate for Insurers and Insurer Supervision

The Basel capital framework is designed specifically for banks by bank regulators. It was never intended to be applied to insurance companies and it would be inappropriate to do so. A bank-centric Basel framework is disconnected from the risks specific to insurance and would provide a distorted view of the financial strength or weakness of an insurance company. In short, life insurance companies have significantly different business models, risk profiles, and capital structures than banks.

Life insurers provide coverage to customers for their long-term risks, and their regulation requires them to match those long-term, illiquid liabilities with appropriate assets to ensure that those liabilities can be met. Current life insurer capital requirements directly reflect the level to which an insurer has matched the duration of its assets to the duration of its liabilities. This business model is fundamentally different than that of banks, where assets and liabilities are not matched and where the institutions are more dependent on short-term, on-demand funding, and are thus potentially subject to a "run" in periods of stress. Banking capital requirements implicitly assume this inherent mismatch. The business models, risk profiles and capital structures of life insurers and banks are so divergent that it would be incongruous to attempt the application of a single, one-size-fits-all capital standard to both.

The application of a bank-centric Basel framework to insurers would very likely have the opposite effect of that intended, disrupting sound insurance companies and incentivizing the wrong activity. The application of bank-centric capital standards to insurance companies would harm the risk management frameworks that insurers have in place to manage the risks that arise from their traditional business. Bank-centric standards would harm the ability of life insurers to perform their fundamental business of delivering long-term, guaranteed financial security products to millions of families and retirees. Disrupting the operations of well-run life insurance companies is completely at odds with the purposes of the Dodd-Frank Act and should not be permitted to occur.

The Dodd-Frank Act Authorizes the Federal Reserve to Apply Equally Robust Insurance Capital Standards

ACLI believes that Section 171 of the Dodd-Frank Act enables the Federal Reserve to apply insurance-based capital standards to meet the requirements under that section. Section 171 provides that the risk-based and leverage capital requirements "shall not be less than" nor "quantitatively lower than" the generally applicable minimum requirements under Basel III. This language clearly empowers the Federal Reserve to apply insurance-based standards similar to insurance RBC so long as they are not "less than" nor "quantitatively lower than" the minimum bank risk-based and leverage capital requirements. While ACLI continues to urge the Federal Reserve to exercise this authority by developing an appropriate RBC-based capital regime for

insurance entities, to date the Federal Reserve has declined to do so. The agency asserts that without congressional clarification, Section 171 compels it to apply Basel III standards to insurers.

The Importance of H.R. 4510

Given the Federal Reserve position that it does not have the statutory latitude to develop insurance-based capital standards for insurance companies, ACLI believes it is imperative for Congress to provide a legislative solution to this dilemma. For this reason, ACLI strongly supports H.R. 4510, legislation authored by Congressman Gary Miller and Congresswoman Carolyn McCarthy that would clarify the Federal Reserve's authority to develop insurance-based capital standards for the insurance companies under its supervision.

This common sense legislation would facilitate strong prudential supervision of insurance companies and at the same time prevent unnecessary disruptions in the insurance marketplace. ACLI looks forward to working with this Subcommittee and the full Financial Service Committee to advance this legislation. ACLI supports similar efforts in the Senate led by Senators Collins, Brown and Johanns, and we look forward to working with both houses of Congress to see that this critical legislation is enacted.

ACLI Views on Other Legislative Proposals

H.R. 4557, the Policyholder Protection Act of 2014

ACLI supports H.R. 4557, a bill that would afford insurance policyholders in the context of a savings and loan holding company the same protections as those currently provided under the Bank Holding Company Act. ACLI strongly supported language in the Gramm-Leach-Bliley Act constraining the ability of the Federal Reserve to compel movement of funds out of an insurance company that was part of a bank holding company in order to provide a "source of strength" to an affiliated insured depository institution if such action would jeopardize the interests of insurance policyholders. Extending this same protection to an insurer that is affiliated with a savings and loan association reflects sound regulatory policy.

H.R. 605, the Insurance Consumer Protection and Solvency Act of 2013

H.R. 605 would exclude insurance companies from the Federal Depository Insurance Corporation's "orderly liquidation authority." ACLI has no objection to this provision. During the pendency of the Dodd-Frank Act, ACLI supported language that would make clear that the FDIC's authority in the event of the insolvency of an insurance enterprise extended only to the insurance holding company and not to the regulated insurance affiliates or subsidiaries of that holding company. These regulated insurance entities would always be handled through the state-based insurance rehabilitation and liquidation process. H.R. 605 would also excuse insurance companies from any FDIC assessments to recover costs associated with the resolution of a "covered financial company." ACLI has no objection to this provision.

H.R. __, the Insurance Data Protection Act

This bill would modify the authority of the Federal Insurance Office and the Office of Financial Research to subpoena data from insurance companies. ACLI has not taken any position on this measure. As ACLI considered the data collection and subpoena powers of both the Federal Insurance Office and the Office of Financial Research during the pendency of the Dodd-Frank Act, our concerns were, and remain, assuring an efficient and non-duplicative process for collecting data on the insurance industry (e.g., not initiating separate federal data calls on insurance companies to secure information already in the possession of state insurance regulators) and assuring that data that is confidential in the hands of state insurance regulators retains that confidentiality should it be passed on to either of these two federal offices. We believe the provisions set forth in Sections 313 and 153 of the Dodd-Frank Act satisfy our concerns in this regard.

H.R. __, the Risk Retention Modernization Act of 2014

This bill would expand the authority of risk retention groups to offer other commercial lines of insurance. Since this pertains exclusively to property/casualty insurers, ACLI has no position on the measure.

Conclusion

ACLI's legislative priority in the House with respect to domestic regulatory policy remains the passage of H.R. 4510. The Federal Reserve must be afforded the flexibility to utilize insurance risk-based capital standards with respect to those insurance groups under its jurisdiction. These insurance standards are a proven, reliable, and comprehensive measure of an insurance company's financial strength. They have been developed over many decades by state insurance supervisors, provide the best measure of the capital needs of an insurer and are the best tool for the Federal Reserve to assess an institution's capital adequacy. Substituting bank-centric standards for insurance RBC standards undermines rather than enhances the supervision of insurance companies and would be at odds with efforts to enhance the stability of the U.S. financial markets. We look forward to working with this Subcommittee and with both houses of Congress to pass this important piece of legislation.