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Submitted for the Record

U.S. Senate Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment Hearing Entitled
“Examining Insurance Capital Rules and FSOC Process”
April 30, 2015

Chairman Crapo, Ranking Member Warner, and distinguished Members of the Subcommittee:

On behalf of the American Academy of Actuaries’¹ Solvency Committee, I appreciate the opportunity to provide this written testimony for your Subcommittee’s April 30 hearing: “Examining Insurance Capital Rules and FSOC Process.” The state of the U.S. insurance sector is strong, in no small part due to the effective regulation and oversight based on sound solvency and actuarial principles. Our testimony will focus on the Academy’s Solvency Committee’s perspectives on recent domestic and international efforts to regulate insurers’ capital and solvency in order to promote financial stability.

Domestic Efforts

Insurance Capital Standards Clarification Act of 2014

First, we would like to thank the Senate for passing the *Insurance Capital Standards Clarification Act of 2014* during the 113th Congress. 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 entities should be regulated distinct from other financial institutions, such as banks. Insurance companies operate under different regulatory systems and accounting constructs than

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.

other financial institutions. The business models for insurance companies and other financial institutions have important differences in terms of the needs of consumers, the nature of risks transferred, and the timing and certainty of generating profits. Assigning risks to insurers that are not necessarily significant to them could drive changes to their product offerings, impact policyholders in the long-term by impeding competition and creating affordability 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 for liabilities that rely on changes to interest rates. As such, applying the same regulations or capital requirements to insurers and other financial institutions, including banks, is not appropriate.

We hope the Subcommittee will work in an expeditious manner to ensure that the Board of Governors of the Federal Reserve System can properly implement this law and the regulations accurately reflect the risks and business models associated with U.S. insurance companies.

Basic Solvency Principles for Capital Standards

Although U.S. insurers are regulated at the state level, the National Association of Insurance Commissioners (NAIC) and the Board of Governors of the Federal Reserve System are individually developing insurance regulations for large U.S. insurers to meet certain group capital requirements. To help guide these regulators, the Academy's Solvency Committee has created a comprehensive set of basic principles that we believe are essential to the development of effective group solvency and capital standards for insurers. Adhering to these principles will help policymakers and regulators create insurance capital standards that are appropriate for the insurance business model and do not negatively impact U.S. insurance markets or consumers. 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 U.S. 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.

4. Methods should recognize and take into consideration the local jurisdictional environments under which members of an insurer group operates, 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 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.

Last year, the American Academy of Actuaries' Vice President of the Risk Management and Financial Reporting Council, William Hines, provided written testimony² 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 Mar. 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.

International Efforts

In addition to the domestic efforts discussed above, the International Association of Insurance Supervisors (IAIS) is developing group solvency and capital standards that could have a profound effect on internationally active insurance groups (IAIGs), including several U.S. insurers. As such, these international capital standards must be created in a careful, transparent, and meaningful manner. Failure to do so may undermine the ability of U.S. insurers to operate effectively and efficiently and could affect the financial stability of U.S. insurance industry.

The Academy's Solvency Committee strongly believes that any international regulations for insurance capital standards must be consistent with the principles for insurance group solvency and capital standards developed by our committee, discussed above. To provide the

² http://actuary.org/files/RMFRC_HouseTestimonyHines_031114.pdf.

Subcommittee with a more complete picture of the potential impacts of the IAIS’s proposed group solvency and capital standards, please find a summary of the Academy’s Solvency Committee’s response³ to the IAIS on its *Risk-based Global Insurance Capital Standard* (ICS) public consultation document, dated Dec. 17, 2014, below.

Comparability

The IAIS’s ICS should aim to be compatible across varying jurisdictional accounting regimes (i.e., between countries, states, and other international standards) without requiring a common valuation methodology for determining capital standards. Developing consistent valuation principles is likely to be very challenging and such principles are unnecessary to achieve a risk-based, globally comparable ICS. We note that the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have been unable to converge on accounting standards for insurance contracts, as developing a common balance sheet across jurisdictions is fraught with significant challenges. Furthermore, while we agree that it is important for regulators to be able to assess the risks faced by IAIGs, it is unclear whether a single capital ratio or a single risk factor for a similarly labeled product can result in true comparability across national boundaries or different insurance products. For example, the risk in auto insurance in a country with national health care and low incidence of civil litigation is different from the risk in auto insurance in a country without national health care and high levels of claims filed.

Minimize Pro-Cyclical Volatility

The ICS should minimize pro-cyclical volatility so as to avoid unintended and harmful consequences on regulated insurance groups, insurance markets, and the broader financial markets. For example, the business models for U.S. insurers writing long-term business often do not rely on a market-adjusted approach. If such an approach inconsistently adjusts the value of assets and liabilities for changes in credit spreads then, to the extent that the cash flows offset, this would create artificial changes in the capital calculations that are not accurate and could distort and/or hide the real risks that an IAIG might face.

ICS as a Minimum Threshold

The ICS should be a minimum threshold for regulatory intervention. Functionally, a minimum threshold for intervention identifies groups that are financially troubled versus those that are financially sound. By definition, the “minimum threshold” for intervention will be a smaller amount of capital than any additional amount above the threshold that is needed to ensure that a company’s capital is “prudent” or “strong.” Implementing “target” capital levels above the minimum threshold will make comparisons between insurers and jurisdictions more difficult—particularly considering the differences among insurance markets, products, and lines of business globally—which works against the overarching goal of comparability.

³ http://actuary.org/files/Solvency_Committee_ICS_Consultation_Response_Final_020615_0.pdf.

We note that the ICS does not need to serve as the sole capital requirement in every jurisdiction. Some jurisdictions could impose more stringent group capital requirements and others also may impose capital requirements on a legal entity basis. If it is designed appropriately as a regulatory minimum, the ICS need not override these other requirements. Instead, the ICS can serve as a group-level, globally comparable floor on capital. Local requirements that are more sensitive to the particular features of each jurisdiction can define the amount of any capital that should be held above the floor.

Availability of Capital in Time of Stress

It is important that the ICS is developed in a way that ensures assets are both accessible and available during a stressed situation. If capital is held in the location where the risk resides, then regulators and policyholders can be assured that it will be accessible in a stressed situation. In contrast, if capital is in a different location, then it may not be of use for addressing a stressed situation.⁴ This can include situations such as funds subject to currency restrictions and funds held in one jurisdiction, where the regulator in that jurisdiction is unwilling or unable to allow funds to be used in other jurisdictions unless full payment to policyholders or creditors in their jurisdiction is assured.

Thank you for this opportunity to provide our views on proposed insurance capital rules. Actuaries have worked for many years with insurance and other financial sector policymakers to help develop prudent rules and regulations that address insurer solvency, including capital requirements. Actuarial expertise remains crucial to the creation of international and domestic insurance regulatory and capital 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.

⁴ Note that this requires "location" to be defined in terms of regulatory authority, which may include both geographic and sector components.