Statement

Of

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And

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to the

United States

House of Representatives

Financial Services Subcommittee on Housing and Insurance

Hearing on

The Federal Government's Role in the Insurance Industry

October 24, 2017

Good Morning. My name is Paul Ehlert and I am President of Germania Insurance in Brenham, Texas. I also serve as the Chairman of the National Association of Mutual Insurance Companies. I am pleased to provide comments to the House Financial Services Subcommittee on Housing and Insurance on the proper role of the federal government in insurance regulation. We appreciate the subcommittee's focus, and Chairman Duffy's leadership, on ensuring the domestic U.S. property/casualty insurance industry remains vibrantly competitive for years to come.

Germania Farm Mutual Insurance Association began in 1896 with 31 farmers in rural Texas agreeing to insure each other and has grown to a group of companies writing $500 million in personal lines premium and insuring over 200,000 families across the state of Texas. Being a mutual insurance company, Germania exists solely for the benefit of our member policyholders. We remain true to our mission of providing fair and honest insurance protection to our members, and committed to maintaining our stability and financial strength to meet the needs of our policyholders when they need us most.

Germania strongly supports the state-based system of insurance regulation in the United States, and would be opposed to duplicative or increased federal involvement. Therefore, we would urge the Committee to swiftly consider and pass three pieces of legislation:

- Business of Insurance Regulatory Reform Act (H.R. 3746)
- International Insurance Standards Act (H.R. 3762)
- Federal Insurance Office Reform Act (H.R. 3861)

The State-Based System of Insurance Regulation

Congress enacted the McCarran-Ferguson Act (15 USC 1011, et seq.) in 1945 following the Supreme Court decision in United States v. South-Eastern Underwriters Association, 322 U.S. 533 (1944), that ruled that insurance was interstate commerce and subject to regulation by the federal government. The McCarran-Ferguson Act recognizes the local nature of insurance and provides for the continued regulation of insurance by the states.

The state-based regulatory system and the corresponding application of the McCarran-Ferguson Act's limited federal antitrust exemption have worked well to promote and maintain a healthy, vibrant, and competitive insurance marketplace for decades. There are nearly 7,800 insurers operating in the United States, the majority of which are relatively small. Virtually all studies done by academic and governmental entities have consistently concluded that the property/casualty insurance industry is very competitive under classic economic tests.

The national system of state regulation has, for more than a century, served consumer and insurer needs well. It has proven to be adaptable, accessible, and effective, with relatively few insolvencies and no taxpayer bailouts. Each state has adopted laws and regulations tailored to the unique needs of its consumers, yet all states also have a common financial solvency system through uniform accreditation requirements. State regulators and legislators consider and respond to marketplace concerns ranging from weather-related risks to specific economic conditions, medical costs, building codes, and consumer preferences. In addition, state regulators respond and adapt to inconsistencies created by various state contract, tort, and reparation laws.

Property/casualty insurance is inherently local, as opposed to national, in nature. State laws determine coverage and other policy terms. Local incidents of accident, weather, and theft impact pricing. Geographical and demographic differences among states also have a significant impact on property/casualty coverages. Weather conditions – hurricanes, wildfires, earthquakes, tornados, lightening, snow, ice, and hail, etc. – differ significantly from state to state.

The United States has 54 well-defined jurisdictions, each with its own set of laws and courts. The U.S. system of contract law is deeply developed and, with respect to insurance policies, is based on more than a century of policy interpretations by state courts. The tort system, which governs many types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also well developed in state law.

With the ability to respond to unique local issues, the individual states serve as laboratories for experimentation and a launchpad for reform. State regulators develop expertise on issues particularly relevant to their state. Insurance consumers directly benefit from state regulators' familiarity with the unique circumstances of their state and the development of consumer assistance programs tailored to local needs and concerns. State regulators, whether directly elected or appointed by elected officials, have a strong incentive to ensure that insurers deal fairly and responsibly with consumers, and enforce a variety of consumer protection laws and regulations designed to ensure fairness and competitive equity.

State insurance regulators frequently interact directly with consumers. Nationwide, commissioners handle and respond to almost 1.8 million consumer inquiries and over 305,000 formal complaints in a single year. Inquiries range from general insurance information to content of policies to the treatment of consumers by insurance companies and agents. Most consumer inquiries and complaints are resolved successfully.

Public interest objectives are further achieved through review of policy terms and market conduct examinations to ensure effective and appropriate provision of insurance coverages. Regulators also monitor insurers, agents, and brokers to prevent activities prohibited by state unfair trade practices laws and take appropriate enforcement action.

The most important insurance consumer protection is ensuring the ability of the carrier to pay claims at a future date. Thus, ensuring the solvency and financial integrity of the insurer is a fundamental function of state insurance regulation.

State insurance regulators actively supervise all aspects of the business of insurance, including review and regulation of solvency and financial condition to guard against market failure and minimize company failure. The laws for financial condition and solvency are significantly similar from state to state as a result of financial accreditation standards set forth by the National Association of Insurance Commissioners.

A particularly effective feature of insurance regulation in the United States is the state guaranty fund system. Unlike banking and pension interests, insurance products carry no federal government guarantee, but are backed by other insurance companies through the guaranty fund system. This system is a model for anyone concerned about taxpayer bailouts of failing financial institutions.

State guaranty associations provide a mechanism for the prompt payment of covered claims of insolvent insurers. In the event of insurer insolvency, the guaranty associations assess other insurers to obtain funds necessary to pay the claims of the insolvent entity. Insurance companies writing property/casualty lines of business covered by a guaranty association are required to be a member of a guaranty association of a particular state as a condition of their authority to transact business in that state. Guaranty associations assess member insurers based upon their proportionate share of premiums written on covered lines of business in that state. Almost all states and territories have created post-assessment guaranty associations[1], and separate life and health insurance guaranty association systems also exist.

Each guaranty association has established detailed procedures for handling assets, filing claims, and making assessments. The guaranty association laws of most states and territories are based on the NAIC's model law. State legislators and regulators have crafted statutes and regulations regarding the creation and operation of the funds based on the needs of policyholders and in coordination with state laws. The funds operate to ensure payment of claims by other industry companies, rather than utilizing state or federal financial backstops. The insurance guaranty system and the state regulatory and oversight structure function well for insurers and consumers. The system avoids catastrophic financial loss to claimants and policyholders and maintains market stability, without governmental financial guarantees. As such, regulation and oversight of the guaranty fund system is appropriate at the state level and federal oversight is unnecessary in the context of the industry-funded, state-based system.

While the state insurance regulatory system functions very well in many respects, it is not without its shortcomings. State insurance regulation receives justified criticism for overregulation of price and forms, lack of uniformity, and protracted speed-to-market issues. Still, Germania believes that a reformed system of state-based insurance

[1] With the exception of New York, the New York Security Fund and certain funds that cover only workers' compensation utilize a pre-assessment mechanism.

regulation is best suited for the U.S., and we continue to work with state legislators and regulators to modernize the system to meet the needs of a 21st century marketplace.

The Federal Role in Insurance Regulation

Germania has significant concerns with the expansion of the federal role in insurance regulation. New federal regulatory activities or authority, whether designed to replace or duplicate the state system, would likely disrupt well-functioning markets, introduce competitive inequities, and generate confusion among consumers. Unfortunately, since the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), we have seen a growing level of costly, duplicative, and often unnecessary activity in Washington and would strongly urge Congress to consider ways to reverse this trend.

To that end, Germania urges the House Financial Services Committee to take up and pass three bipartisan pieces of legislation introduced recently by Chairman Duffy and some of his Democrat colleagues.

Federal Insurance Office Reform Act – H.R. 3861

Dodd-Frank established the Federal Insurance Office (FIO) to provide expertise and information on the insurance industry to policymakers in Washington, D.C. It was not given regulatory or oversight powers, but was provided some authorities that have created unnecessary duplication.

While not speaking for anyone else today, I believe the vast majority of U.S. domiciled property/casualty insurance companies would be in favor of eliminating the FIO entirely. The National Association of Mutual Insurance Companies, the Independent Insurance Agents and Brokers of America, the Professional Insurance Agents, and the National Association of Insurance Commissioners have all called for the outright elimination of the office. Germania would also strongly support this – the FIO is unnecessary, performs many redundant functions better left to the states, needlessly utilizes administrative capabilities, and does not provide public benefits to justify its cost. In addition to being unnecessary, in many cases the office is actually creating duplicative burdens and negatively impacting the insurance industry.

In the legislative process that produced the Dodd-Frank Act, the FIO was given a dubious statutory mandate to study the affordability and availability of certain insurance lines in traditionally underserved communities. The office has interpreted this mandate to mean it must attempt to objectively define a subjective concept, a project which will inevitably lead to erroneous conclusions about the state of insurance markets without consideration of the actual costs of providing insurance products. State insurance commissioners across the country are committed to ensuring consumers in their state are protected. That is the role of state regulators, not the FIO. Erroneous conclusions aside, the mere act of even conducting these studies has the negative effect of forcing costs on insurers who must comply with annual data calls to produce them.

The FIO further encroached on the state regulators' consumer protection function when it issued its November 2016 report on consumer protections. This report – which has a tenuous (at best) relationship with its statutory mandates and was not requested by Congress – lacked substance, and was thoroughly and simply political, throwing out alarmist conclusions and dubious proposals.

Even in its chief role as an insurance information resource the FIO has added only cost and duplication. The Terrorism Risk Insurance Act reauthorization bill passed in 2015 mandated that the FIO study the terrorism insurance marketplace and identify data to be collected to do so. Under the law, the FIO is required to work to obtain this information from relevant state, federal, or other public sources (31 U.S. Code § 313) before engaging in any mandatory data calls. The National Association of Insurance Commissioners has since launched its own TRIA data collection process and the FIO did not work with the NAIC on a common template that would allow for one data call. Companies writing TRIA-covered lines are currently subject to duplicative data collection/reporting requirements to achieve very similar goals. Germania has been pleased to hear that evidently, there is a process underway to rectify this going forward so companies are not subject to two data calls.

Ultimately, while we would support a full repeal of the statutory language establishing FIO, legislation designed to reform and refocus the office such as H.R. 3861, the Federal Insurance Office Reform Act, recently introduced by Representatives Sean Duffy and Denny Heck, would be a major step in the right direction. As a strong supporter of the state-based system of insurance regulation, Germania believes that it is essential that any federal office dealing with the property/casualty insurance industry be very carefully crafted, its purpose made clear, and its authority strictly limited to that purpose. H.R. 3861 would help to do exactly that.

As a part of the effort to refocus and right-size the FIO, the legislation moves the office under the Treasury Department's Office of International Affairs. This will help keep the mission focused on coordinating federal efforts and representing the U.S. market, insurers, and policyholders abroad rather than attempting to regulate the insurance industry here at home. In an effort to keep the office from getting out of its lane, the bill would also cap the number of employees at five; strictly limit the office's subpoena authority; explicitly prohibit the FIO from participating in regulators' supervisory activities; and require more consultation between the FIO and the functional state regulators. We believe all of these changes would be valuable.

International Insurance Standards Act – H.R. 3762

Over the last several years, the Financial Stability Board (FSB) has become an increasingly important and influential regulatory organization for the global financial services sector. Re-established in 2009 in the wake of the financial crisis, the FSB's core mission is to promote regulatory standards that ensure the stability and soundness of the world's financial system. Pre-crisis, a precursor organization, the Financial Stability Forum, had a role of monitoring, coordinating, and communicating among regulatory jurisdictions. However, the mandates provided in the FSB's charter go well beyond generally-expressed objectives, and require that the FSB assume a direct role in monitoring how various countries implement global rules at home.

The overreach of a group of mostly foreign policymakers exerting their vision of regulation on our banking system is particularly troubling for the U.S. property/casualty insurance industry. During a Senate Banking Committee hearing in July of 2015, Dr. Adam Posen – testifying in support of many of the FSB's activities and decisions – said, "Where the FSB at present is getting things wrong, in my opinion, largely has to do with its approaches to coordinating regulation of the non-bank parts of the financial system." Germania wholeheartedly agrees.

Multilateral organizations like the FSB have always been intended to promote and foster economic growth while maintaining financial stability, not to regulate financial services markets everywhere in the world. Over the last decade, the movement toward more formulaic, prescriptive, and intrusive standard development has accelerated at an alarming rate. FSB decisions are especially impaired in the insurance arena as its membership does not include U.S. representatives with insurance expertise, and it is not transparent in its deliberations. If U.S. property/casualty insurers are not represented or allowed to speak on their own behalf the FSB is bound to adopt ill-informed concepts and push global standards that do not recognize the differences in our business model. One-size-fits all regulation does not work within the insurance industry, and certainly creates challenges when it is applied to all financial institutions.

There are also significant concerns with the FSB's review and guidance of the policy development work of the International Association of Insurance Supervisors (IAIS). Following the financial crisis, the IAIS was directed to begin work on a Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs), also known as ComFrame. The IAIGs are defined only in ComFrame; this category of company was never contemplated nor defined in the Dodd-Frank Act, nor any U.S. government regulatory regime. This new framework, which started as new standards designed to promote cooperation and coordination among insurance supervisors, quickly became a series of new requirements for a segment of insurers.

As an example, in 2013 – without warning or clear reasons – the FSB met with IAIS leadership and informed them that IAIGs should adhere to a global consolidated capital requirement similar to the Basel II and III requirements for banks. The IAIS was ordered to design, field test, and adopt such global capital requirements for the IAIGs by 2016. The pace of this edict was unreasonable and unworkable, but IAIS leaders indicated they had no choice but to comply.

Since the FSB's mandate, the IAIS Executive Committee has made numerous decisions regarding the structure and design of the International Capital Standard (ICS) for the IAIGs without actually stating the problem the FSB was trying to solve, and without explaining why the decisions were made. The most troublesome of these decisions include:

- the insistence on a highly detailed, prescriptive formula for the ICS that would be applied to all countries;
- the requirement that all countries use the same valuation/balance sheet without regard to the costs and implications; and
- the insistence that the capital resources that companies use to meet the obligation be identical even when the capital instruments available to companies vary across countries.

Despite the goal of the IAIS to achieve a comparable ICS for all IAIGs around the globe, the application of the same capital standard to unique companies that come from very different regulatory environments with very different economic and political objectives will not produce comparable indicators of capital adequacy or solvency. Every country has a unique regulatory system with features that influence the solvency of the companies doing business in that regulatory environment. Similarly, every insurance group has unique characteristics that cannot be fully captured by a single, one-size-fits-all formula. In their zeal to achieve comparability, the FSB – through the IAIS – will succeed only in generating unnecessary costs to governments and insurers.

Germania believes that a successful global effort should not create unnecessary competitive asymmetries among companies domiciled in different, but equally well-supervised, jurisdictions. Instead, what is needed is a flexible and dynamic capital assessment that would recognize and improve understanding of diverse, successful approaches to solvency regulation. Such an approach would be principle-based and outcomes-focused. Under this approach, supervisors could achieve the desired goals of policyholder protection and insurer solvency without the costs of implementing new global systems in nearly every country in the world.

To be clear, we believe that American insurers should be positioned to compete in the international insurance market if they so choose. That means participating in international discussions on insurance and insurance regulation, and where appropriate, communication and coordination between international regulatory authorities. Working together will improve understanding of differing regulatory systems and may well result in shared best practices. However, while cooperation and coordination on the regulatory front is a positive thing, it should not result in abdication of regulatory authority to foreign jurisdictions or quasi-governmental bodies. Ultimately, U.S. representatives at international fora should advance policy positions that represent the best interests of U.S. insurance consumers, the insurance markets, the insurance regulators, and the U.S. economy in general.

Congress should support this position by passing H.R. 3762, the International Insurance Standards Act, also recently introduced by Reps. Duffy and Heck. In addition to increasing the transparency of the process when federal officials are participating at international insurance standard-setting bodies, the bill would prohibit those officials from agreeing to new international standards which do not comport with existing U.S. state and federal law. The legislation would also provide a process by which Congress could vote on a resolution of disapproval for any standard or covered agreement that federal officials negotiate. Germania believes that these steps would help to ensure that foreign regulatory standards, inappropriate for our system and markets, would not be unilaterally imported to the U.S.

Business of Insurance Regulatory Reform Act – H.R. 3746

The Dodd-Frank Act also created the Consumer Financial Protection Bureau. Title X of the law explicitly exempted the business of insurance from the purview of the Bureau except to the extent the "enumerated consumer laws" (e.g., Fair Credit Reporting Act) already addresses a specific insurance issue. Essentially, Dodd-Frank reaffirmed the status quo and reiterated that the regulation of insurance had been delegated to the states under the McCarran-Ferguson Act.

Unfortunately, the Bureau has demonstrated its willingness to "tip toe" into insurance regulation and explore the extent of its powers in an open-ended and sometimes confusing manner. For example, the Bureau is willing to keep the door open to regulate a loan to an insurance policyholder arising out of a policyholder's own life insurance policy even though state insurance regulators aggressively occupy the field and consider this the business of insurance. While the probability of such action by the Bureau is likely low, it illustrates that the Bureau reserves the ability to revisit the issue at its convenience.

State insurance commissioners have a strong focus on consumer protection, but they must also balance insurers' solvency needs. Allowing the Bureau to attempt to expand the federal government's role in regulating insurance products would be counter-productive and ultimately could result in the bureau's regulations conflicting with the directives of the functional state regulators. Rather than allow this issue to build and create unintended consequences, we believe it is better to clarify the issue upfront.

To prevent such an eventuality, Germania strongly supports H.R. 3746, the Business of Insurance Regulatory Reform Act. This bipartisan legislation – introduced by Reps. Sean Duffy and Gwen Moore – would simply clarify and reinforce the original intention of the Dodd-Frank and McCarran-Ferguson Acts; namely, that the Bureau should only exercise regulatory jurisdiction over the business of insurance where it has clear authority from Congress and that deference should be given to state insurance regulators when it comes to the business of insurance. In any effort to right-size the federal role in insurance regulation, avoiding the kind of duplication which would be created with the Bureau involved in regulating insurance must be at the top of the priority list.

Conclusion

Germania strongly supports the state-based system of insurance regulation in the United States. Federal and international encroachment into insurance regulation almost always leads to costly and duplicative oversight with no subsequent benefit for consumers. Rather, it typically results in higher costs and fewer choices for policyholders. I would urge the committee to always identify and keep in mind the problems you are trying to solve before supporting any new regulatory regimes or activity as there are inevitably unintended consequences for consumers and markets. For example, the creation of the Federal Insurance Office may have seemed like a good idea at the time, but the experiment has yielded clear evidence that the mission and scope of the office require greater focus and further refinement.

We would urge the Committee to swiftly consider and pass the Federal Insurance Office Reform Act (H.R. 3861), the International Insurance Standards Act (H.R. 3762), and the Business of Insurance Regulatory Reform Act (H.R. 3746). I appreciate the opportunity to testify and look forward to working with the committee going forward.