Kansas Insurance Department
Sandy Praeger, Commissioner of Insurance

TESTIMONY ON
HB 2007

HOUSE INSURANCE COMMITTEE
February 4, 2013

Chairman and Members of the Committee:

I am Kris Kellim with the Kansas Insurance Department. Thank you for the opportunity to testify in support of HB 2007.

HB 2007 would make comprehensive amendments to Kansas insurance holding company laws largely in response to lessons learned from the recent financial crisis. The purpose of Kansas' insurance holding company laws, as well as the amendments in this bill, is to ensure that holding company operations outside of the domestic insurance company do not pose a hazard to the sound operation of domestic companies, and to ensure domestic companies are able to pay their policyholders' claims.

In addition, the amendments are part of the national accreditation standard for financial surveillance laws. Accreditation is necessary for other states to be able to rely on Kansas' financial examinations of its domestic companies. Without it, Kansas companies could be subjected to duplicative financial examinations from other states. Such an increased regulatory burden would deter companies from domesticating in Kansas and would give domestic companies incentive to re-domesticate in another state. Maintaining Kansas' accreditation is a baseline requirement for making Kansas an attractive place for companies to domesticate.

<u>What is an Insurance Holding Company System?</u>

A holding company system is an enterprise that consists of two or more business entities. In a holding company system, a parent company owns or controls one or more subsidiaries. Subsidiaries under the ownership or common control of a parent are referred to as affiliates. Collectively, the parent and subsidiaries make up the holding company system. An *insurance* holding company system is a holding company system that includes at least one insurer. It is common for an insurance holding company to consist of non-insurance companies. Kansas' insurance holding company system laws apply to domestic insurance companies that are a part of an insurance holding company system. Take Berkshire Hathaway, Inc. for example. Berkshire is a large holding company with many subsidiaries, including GEICO, Dairy Queen, Helzberg Diamonds, and BNSF. It also is an insurance holding company system subject to Kansas regulation, as one of its subsidiaries is a Kansas domestic insurance company, Kansas Bankers Surety Co.

History of Insurance Holding Company Regulation

In the 1960's, many companies merged and formed holding companies. Some of the factors involved were new interest in equity-based investments (e.g., stocks), property and casualty insurers' need for additional capital due to a decline in profits, and increased attention to the idea of "one-stop" financial service. The need for supervision of insurance holding companies was recognize early on. Because insurance regulation in the U.S. is state-based, a model insurance holding company law was developed to create uniformity between the various states in which a holding company might operate. The model was issued in 1969, and Kansas adopted laws substantially similar to the model in 1974.

Kansas' insurance holding company laws equip the Department with two basic types of authority. The first type of authority is access to information. The laws give the Department authority to conduct financial examinations and to access information about a domestic insurer's holding company regarding structure, management, financial condition, and ownership. This information helps the Department assess the potential impact of a holding company's activities on the ability of the domestic insurer to pay its policyholders' claims.

The second type of authority allows the Department to protect the capital of the domestic insurer by requiring the insurance commissioner's approval for certain material transactions between the insurer and other entities within the holding company. Money can still flow between the domestic insurer and the holding company, but the Department can assess the risk of large monetary transactions that take funds out of the insurance company's capital reserves. Again, the goal is to ensure the domestic company is able to pay its claims.

Lessons Learned from the Recent Financial Crisis

The importance of state-based, financial surveillance of insurance companies was highlighted by the circumstances involving AIG and the recent financial crisis. In 2008, the AIG holding company was comprised of 71 U.S.-based insurance entities and 176 other financial service companies throughout the world. The AIG Financial Products unit based in London, a non-insurance component of the AIG holding company system, took on huge losses from risky investments. This loss crippled AIG's financial operations and led to the federal bailout of the AIG holding company. State insurance regulators did not directly regulate the AIG holding company, but were heavily involved in the AIG discussions due to the need for funds from the AIG insurance subsidiaries to rectify AIG's liquidity problem. Had it not been for the regulatory protections in the U.S., the funds protecting policyholders of the AIG insurance companies in the U.S. could have been used by the AIG holding company, thereby harming insurance policyholders.

The contagion effects experienced by U.S. insurers in the AIG holding company system's near collapse caused U.S. insurance regulators to reevaluate their holding company system regulatory framework. This experience illustrated the need to better coordinate and enhance the regulatory system. HB 2007 would make a series of amendments to better coordinate and enhance financial surveillance of complex insurance holding company systems, especially those with international operations. However, many of the amendments in HB 2007 are clean-up revisions.

Proposed Amendments

New Section 1 provides the Commissioner authority to participate in what is referred to as a "supervisory college" for any domestic insurer that is part of a holding company system *with international operations* in order to determine compliance with the act. A supervisory college is a meeting. It is a meeting between the various regulators of an insurance holding company system with international operations, which could include other state insurance, federal, and international regulators. The purpose of the meeting for the Department would be to determine whether the domestic insurer is in compliance with Kansas law through communication and cooperation with other regulators. It is an opportunity for the Department to assess the business strategy, financial position, legal and regulatory position, risk exposure, risk management, and governance process of a domestic insurer's international holding company. The goal is the same as with existing holding company laws – to assess possible hazards posed to the domestic company by operations of the holding company – but geared toward international activity.

Subsection (a) authorizes participation in a supervisory college. (p. 1, l. 6-11). Subsection (b) lists the powers the commissioner has with respect to supervisory colleges. These include initiating, establishing, and coordinating a supervisory college. (p. 1, l. 12-24). However, this would only occur in the event Kansas is the "lead state" for regulation of the insurance holding company system. Kansas would likely have lead state status for three companies. Subsection (c) would require the domestic insurer to pay the reasonable expenses, including necessary travel, incurred with respect to the Department's participation in a supervisory college. (p. 1, l. 25-31). Finally, subsection (d) lays out the general purpose of a supervisory college. (p. 1, l. 32-36; p. 2, l. 1-9). It also authorizes the commissioner to enter confidentiality agreements (which will be discussed in depth with regard to Section 8), and makes clear that the Commissioner's participation in a supervisory college is discretionary and that no jurisdiction or authority is delegated to the supervisory college.

Section 2 provides a title for the act, while **Section 3** provides definitions for certain key terms. (p. 2, l. 10-43; p. 3, l. 1-25).

Section 5 amends K.S.A. 40-3305 (p. 9, l. 6), which currently requires every insurer which is authorized to do business in Kansas and which is a member of an insurance holding company system to file a registration statement with the Department on an annual basis. The registration statement includes information about the finances and operations of the insurer and its holding company. This information helps the Department assess the enterprise risk the holding company system might pose to the domestic insurer. Enterprise risk is an activity or event that would have a material adverse effect on an insurer's financial condition or liquidity or its holding company system as a whole. Again, the purpose of assessing enterprise risk is to ensure the domestic company is able to pay policyholders' claims. As with supervisory colleges, the amendments to Section 5 stem from the recent economic crisis and concerns over contagion risk within the financial sector. The Department is concerned with the financial impact that non-insurance entities within the group can have on an insurance company's financial solvency; recall AIG.

The amendments to Section 5 enhance the current registration requirement to better enable the Department to identify enterprise risks posed by an insurance holding company system. A

registered insurer would be required to include in the registration statement financial statements of or within an insurance holding company system, including affiliates, statements attesting to oversight of corporate governance and internal control procedures, and any other information required by regulation. (p. 10, l. 9-25).

The key innovation of Section 5, however, is the new enterprise risk report ("ERR") requirement. (p. 11, l. 35-43; p. 12, l. 1-11). The "ultimate controlling person" ("UCP") of every registered insurer must file the report. In the report, the UCP would be required to identify the material risks within the insurance holding company system that could pose enterprise risk to the insurer. The report would be filed with the lead state insurance department of the insurance holding company system on an annual basis. Kansas currently would be the lead state for 3 companies. The effective date for filing the initial report is May 1, 2015 to provide companies adequate time to comply with the new requirements. In addition, as a result of discussions with interested parties, the Department has included an exception to the ERR requirement for UCP's with total direct and assumed premiums of less than $300 million. (p. 12, l. 4-6).

The amendments in **Sections 4** (p. 3, l. 26) are closely related to the ERR requirement of Section 5. These essentially require an entity that merges or acquires control of a domestic insurer to follow the enterprise risk reporting rules. (p. 6, l. 1-10). The commissioner also would have authority to participate in a consolidated public hearing where a proposed acquisition of control requires the approval of more than one state. (p. 7, l. 38-43; p. 8, l. 1-9). This change could result in large savings of time and money for affected companies. A company that acquires or takes control of a domestic insurer also would be required to restore any deficiency in the domestic insurer's RBC to levels required by law. (p. 8, l. 10-15).

Section 6 (p. 12, l. 12-24) generally requires prior approval by the commissioner of certain material transactions between a registered insurer and its affiliates. The idea is to prevent capital from being removed from the domestic insurer if doing so would harm the insurer. The amendments subject additional types of agreements to prior approval. (p. 13, l. 17-28). Section 6 also has numerous clean-up changes made by the Revisor of Statutes.

The amendments in **Section 7** (p. 16, l. 6) also are related to the ERR requirement of Section 5. These clarify that the Department's examination authority includes any affiliates of a registered insurer in order to ascertain the financial condition, including enterprise risk, of the insurer. (p. 16, l. 16-19). The insurer also would be required to produce information in the possession of the insurer or its affiliates reasonably necessary to determine compliance with the act and to provide an explanation for failure to provide information not in the insurer's possession if the information is accessible. (p. 16, l. 23-36). Failure to provide such information could result in a fine of $1,000 for each day's delay. (p. 16, l. 37-41). Finally, Section 7 gives the Commissioner power to issue subpoenas in determining compliance with the act. (p. 17, l. 11-25).

Section 8 (p. 17, l. 26) regards confidentiality of information shared pursuant to the act. The amendments to Section 8 generally enhance the confidentiality of information shared with the Department, other regulators, and the NAIC. These provisions include:

- Any information reported by an insurer pursuant to Sections 4, 5, 6, and in the course of an examination or investigation under Section 7 is confidential and privileged, not subject to the disclosure under the Kansas Open Records Act, not subject to subpoena, and not subject to discovery or admissible as evidence in any private civil action. (p. 18, l. 1-11);
- Generally, confidential information cannot be made public without prior written consent of the insurer. The commissioner can make confidential information public after opportunity for notice and hearing, if doing so is in the interest of policyholders, shareholders, or the public. (p. 18, l. 12-23);
- The commissioner cannot be required to testify in any private civil action. (p. 18, l. 24-29);
- The commissioner may share confidential information with other regulators and the NAIC with an agreement in writing to maintain confidentiality and privileged status of such information. (p. 18, l. 30-41);
- The commissioner may only share confidential documents reported with the Registration Statement under Section 5 with states having substantially similar confidentiality laws and that agree in writing not to disclose the information. (p. 18, 42-43; p. 19, l. 1-5);
- The commissioner must maintain confidential or privileged status of information received based on the laws of the jurisdiction that is the source of the information. (p. 19, l. 6-16);
- The commissioner must enter into a written agreement with the NAIC governing sharing and use of information, including procedures and protocols regarding confidentiality and security of information shared with the NAIC. (p. 19, l. 17-42);
- The sharing of information does not constitute delegation of regulatory authority by the commissioner. (p. 19, l. 43; p. 20, l. 1-4);
- There is no waiver of any applicable privilege or claim of confidentiality as a result of disclosure. (p. 20, l. 5-8);
- Clarification of the confidential and privileged nature of information in the possession of the NAIC pursuant to the act. (p. 20, l. 9-14); and
- Documents received pursuant to the act are not subject to the Kansas Open Records Act, including K.S.A. 45-229 (p. 20, l. 15-16).

All remaining amendments in Sections 9, 10, and 11 are clean-up revisions.

The purpose of the amendments in HB 2007 is to ensure that holding company operations outside of the domestic insurance company do not pose a hazard to the sound operation of domestic companies so that domestic companies are able to pay their policyholders' claims. The amendments also are necessary to maintain accreditation of the Department's financial surveillance laws. Finally, I would note HB 2007 in its current form is a product of extensive discussions with interested parties. HB 2007 enjoys strong support from interested parties, and the Department is unaware of any opposition to the bill.

We would ask the Committee to recommend this bill favorable for passage. Thank you for the opportunity to appear in support of HB 2007. I am happy to stand for questions.

Kris Kellim
Government Affairs Counsel
Kansas Insurance Department