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Implications of the Financial Crisis for Insurance Regulation

Good morning and thank you for inviting me to speak with you today. This is a tremendous industry forum, and I'm delighted to have the opportunity to share some thoughts with you during what is an historic time for financial services regulation in this country. Change is in the air, and it is important that everyone with an interest in good regulation is engaged in this discussion.

I have been asked to talk about the implications of the financial crisis for insurance regulation in the U.S. I would like frame my comments in three areas. First, I want to share some thoughts about the performance of the U.S. regulatory system during the crisis and lessons we have learned both about its strengths and about opportunities for improvement. Second, I want to briefly hit on some of the international developments that could have an effect on insurance regulation, many of which are an outgrowth of the response to the recent financial turmoil. Finally, I want to touch briefly on the NAIC's Solvency Modernization Initiative (SMI), provide some preliminary conclusions, and give an indication of where it might be headed.

So let's begin with the impact of the crisis on the insurance industry. It is widely recognized that, setting AIG aside for the moment (and that's a big aside, I will grant you), the insurance industry has so far came through this crisis relatively well. The mortgage insurers and financial guaranty insurers clearly had difficulties, and life insurers with heavy concentrations in variable annuities took losses. But only three insurers (including AIG) accepted TARP money, in contrast to over 500 banks. Now I don't mean to say that everything was always rosy. Certainly there were stresses – under the circumstances, it would have been amazing if there hadn't been. But we were doing some fairly intensive monitoring in 2009 – stressing portfolios to see what would happen to capital levels and RBC ratios, watching policyholder withdrawals for any sign of a policyholder run, and so forth. In short, we were looking pretty closely, and we never saw anything that we didn't think the system (including the guaranty funds) could handle on its own. In comparison to other sectors of the financial services industry, the U.S. sector looks pretty good.

That's not to say there weren't some lessons learned. We all learned something about thinking further outside the tail: good risk management means you have to conceive of what might be regarded as inconceivable. Beyond that, we learned some specific lessons about insurance regulation as a result of the problems encountered by AIG.

The AIG situation has been written about extensively, so I am sure you are all well aware of the facts. American International Group (not American Insurance Group, by the way) is a large global, complex financial institution. A significant part of its business was insurance, both in the US and elsewhere, but it also engaged in a range of other activities, including aircraft leasing and other things. Given the wide ranging nature of its businesses, there were a number of regulators involved. U.S. insurance regulators were the functional regulators of the U.S. insurance companies. Other insurance regulators regulated insurance companies in other parts of the world, and the Office of Thrift Supervision regulated a thrift owned by AIG. Because of the bank-centric world in which we live, if a financial institution owns a bank, whether a commercial bank or a thrift, in the U.S., a banking regulator is the holding company supervisor. So the OTS was the holding company regulator at AIG. U.S. insurance regulators focused their energies on the insurance companies and the relationships between those companies and the rest of AIG.

The primary source of AIG's problems was the credit default swap business in the Financial Products (or FP) Division of AIG, a business that was unregulated and (not coincidentally) occurred outside the insurance companies. Much of this business reflected efforts by the banking sector to arbitrage around the capital requirements for credit risk imposed on internationally active banks by the Basle Capital Accord. In mid-September 2008, collateral calls by CDS counterparties generated a massive need for liquidity, and Standard & Poor's threatened to downgrade AIG if it did not find a way to solve its liquidity issues. Because the insurance companies remained strong, AIG asked the insurance regulators to approve sending $20 billion from the insurers upstream to help bail out the holding company. Ultimately, this never happened. It became clear that the problem was bigger; $20 billion wasn't enough to solve it, and the Fed agreed to extend a liquidity facility amounting to $85 billion with an interest rate of 11.3%.

There are a lot of lessons we can take broadly from the AIG situation – lessons about how one supervises systemically important financial institutions, lessons about regulatory arbitrage, about the importance of cross-sectoral regulatory cooperation and communication, and so forth. Much of the debate in Washington about regulatory reform is driven by preventing another AIG. But we learned some specific lessons in the insurance sector, lessons we are using to enhance our system of supervision.

The first lesson is about the importance of group supervision. Traditionally, the focus in insurance regulation has been on preserving the financial stability of the insurer itself. While we looked at the holding company and group as a whole, it was largely through the prism of interconnections and relationships with the regulated insurer. State insurance regulators were ready to "wall" off U.S. life insurers if the financial, reputational or contagion risks of AIG Holding Company threatened their solvency.

AIG reinforced for us the importance of having a better understanding of the risk profile of the group as a whole, how problems at the group level might impact the insurer, reputational risk issues, and so forth. We are in the process of enhancing our approach to group supervision, strengthening our ability to get information from parts of the group outside the insurance company – that is, opening up the "windows" to the other parts of the organization. I'll add that this is a lesson learned by insurance regulators around the world, and there is a lot of attention on group supervision at the moment.

It is important to distinguish this idea of group supervision from what I sometimes hear from large global financial institutions – that they want a single global supervisor and a single pool of capital that they can manage globally. That is not what we are talking about here. This is not group supervision ***instead of*** focusing on the regulated entities. This is group supervision ***in addition to*** focusing on the regulated entities. Another thing we learned in the financial crisis is that corporate structures do matter. When the music stops, it matters where the money is. So we can't ignore the legal structure when supervising regulated entities. But we can do a better job of recognizing the potential risks that are created for the regulated insurer because of its connection to a broader financial services entity, and we are in the process of doing that.

Our second lesson involved the securities lending operation of AIG's life insurance subsidiaries. AIG had created a securities lending operation that was run out of the holding company, but which lent assets of the life insurance companies. The original program approved by the regulators was a relatively vanilla program, where the collateral was invested in short-term high quality securities, like Treasuries. Sometime between 2005 and 2007, the securities program changed in nature, and the company began to invest in longer duration, riskier securities, like RMBS. The insurance regulators discovered this change during an exam in early 2007, and began the process of winding down the program. The program had been wound down by not quite 50% by the time the credit markets shut down in 2008. As a result of lessons learned, we have enhanced the financial reporting around securities lending operations.

Improvements to group supervision and regulation of securities lending operations are two specific changes we are making in response to lessons learned. But I think there are also some broader lessons about regulatory structure that we can take from the events of the past couple of years, and these have strengthened our insistence that federal regulatory changes should not negatively impact the aspects of our U.S. regulatory system that served us well.

One of the major lessons we take from these events is that regulators can make mistakes. There has been a fair amount of discussion recently about regulatory failures and policy decisions that contributed to the crisis. We can go through a litany of areas where the regulators have admitted making mistakes.

And this crisis has taught us they can make big mistakes. But why do regulators make mistakes? That's a basic question as we think about regulatory reform. Throughout history, we have had banking crises. After each crisis, policymakers institute reforms intended to prevent the next crisis. But they don't work. In fact, according to some people, it is the solutions that lay the groundwork for the next crisis. So, if we are going to devise reforms that will prevent regulatory mistakes in the future, we need to understand why they happen in the first place.

The most obvious reason that regulation fails is that regulators are human beings, and human beings are fallible. But that is the easy answer, and there is more to the story. The other reasons are more subtle and relate to incentives and the behavioral aspects of regulation – things like regulatory capture and political influence.

As you know, I spent the last 20 years moving back and forth between academia and regulation. During the four years before I took this job, while I was on the faculty at Drake University, I taught a course on the regulation of financial institutions. At the beginning of the course, we would lay the groundwork about some of the theories about how regulation works, and we would talk about the importance of regulatory capture and political pressures on regulators. The idea of regulatory capture is relatively simple. It's not that the industry puts the regulator in chains and forces him or her to behave in a certain way. It is much more subtle – basically that the regulator begins to think like the regulated industry. Now that can happen for a number of reasons. One reason is that regulators are constantly listening to the companies and industry they regulate, and the bulk of their information comes from that source. That is especially true in the case of a large, concentrated regulator, where contact with consumers is less common. It is not surprising if, over time, that begins to influence how a regulator thinks and views the issues. Add to that the challenge of dealing with a large, politically connected institution, and we have even more disincentives to take action when it might be needed.

Regulatory failure is well recognized as a contributing factor to the financial meltdown. Secretary Tim Geithner, in testimony before the House Financial Services Committee a while back, said – and I quote – "I think we screwed up regulation." He went on to elaborate, "(In) parts of the system people (were) crawling all over these institutions yet didn't prevent excessive risk-taking." The former Federal Reserve Chairman recognized policy errors, when he acknowledged that he was misguided in his reliance on the self-interest of firms to manage their own risk.

The bottom line is that we need to forget the idea of a single omniscient regulator who can scan the market, see the problems, know what to do, and do it. The world is more complicated, and regulation is not that perfect. Regulators may fail to identify problems, they may fail to know the solutions, and even if they know it, they may fail to take action. And any regulatory system, if it is going to be effective, needs to be designed with those realities in mind.

So what does that mean for regulatory reform? First, I fervently disagree with those that say the lesson is that we need to consolidate regulation and regulators for large complex firms. This suggestion is sometimes made in the context of large life insurance companies, where some people believe a single regulator would do a better job of regulating. The theory, presumably, is that a single regulator will enable a single person or group of people to have a complete understanding of the risk profile of the firm, and that person will be able to take action when necessary. In theory, this sounds great. In reality, no such person exists.

My lesson instead is that we need a system that corrects for the possibility of error. That means we need checks and balances, we need a diversity of perspectives – people who have different views of the market and how it operates, people who will look at risk through a variety of prisms, and we need incentives for regulators to take action – things like peer pressure and skin in the game. These are the things you get in a multi-jurisdictional system – one where there are multiple eyes on the problem, multiple people with different philosophical perspectives, and multiple regulators with an incentive to address problems. A multi-jurisdictional system like the one we have in U.S. insurance regulation.

Lately, I have spoke often about why I believe the structure of our national state-based system of regulation drives us to better regulation. Critics of state insurance regulation like to present it as a fragmented system with states all doing their own thing. It's not true, of course, and it is especially not true when it comes to solvency regulation, where we have a highly coordinated, integrated system of supervising our insurers. We have developed extensive data capabilities so multiple states can monitor insurance companies, and that helps us catch each other's mistakes. Our process of developing policy, where we have to balance the diverse perspectives of regulators in different states, tends to drive us to centrist solutions, reducing the tendency to over- or under-regulate. And we put pressure on each other to do a good job. Over the years, we have built extensive systems of peer review – the financial analysis working group, where regulators from other states offer advice and counsel in potentially troubled company situations, our accreditation program, and other mechanisms. If a regulator in a given state fails to act in the presence of a troubled insurer, he or she knows that there are other states with the ability to act, and that is a powerful incentive.

A multi-jurisdictional system is not an easy one to create. There has to be a culture of free-flowing information. Regulators have to be willing to engage in frank discussions, to share their dirty laundry. It took us decades to create that culture and the systems to enable it. But if you can create that dynamic, it can provide powerful incentives for good regulation. And that, to me, should be a key goal of regulatory reform.

Sir Callum McCarthy, the former chairman of the UK Financial Services Authority, was quoted in the Financial Times a year ago saying the following:

> "At present, national supervisors do not challenge each other's decisions often or fiercely enough."

And I agree with him completely. They don't. And part of that is because they don't share the information that is needed to allow challenge to occur. It is only with a well-structured multi-jurisdictional system with free flowing information among supervisors that such a culture can be created. And our experience is that no one does this information sharing as well as we do. We have a long way to go to get to a culture of free and open information sharing among supervisors globally.

This view about the strength of our system drives our positions on much of the debate occurring in Washington. We generally resist any reforms that will have a tendency to diminish the checks and balances we have created in the state system, and we are suspicious of the ultimate impact of allowing the federal government to have jurisdiction over insurance regulatory matters. It is clear that prior banking reform efforts have not been successful in preventing banking crisis. There is no guarantee that current reform proposals will be any more successful. So our attitude is, "Yes, you have a sickness. But let's be careful that in the process of trying to cure yourself, you don't inadvertently infect us with the very illness that you haven't yet figured out how to cure."

So, while we are open to the Federal Insurance Office having a role in the international arena, we want to carefully limit the scope of its ability to preempt state law. We oppose the inclusion of insurance in the CFPA because of the potential that it would eventually become an avenue for preempting state law. Any Federal Reserve authority over systemically significant financial institutions with insurance operations should require cooperation and consultation with insurance regulators, and two-way sharing of information. Finally, in the case of a failing institution, the Resolution Authority should not be permitted to access insurer assets without the consent of the relevant insurance regulator.

In fairness, those of us that believe our system has certain inherent strengths are not oblivious to its problems. For years, the criticism of our national system of state-based regulation was that it is inefficient, and I'll give that one to you. It is not the most efficient system. But as one of my staff likes to say, "Dictatorships are very efficient. That doesn't make them good." Still, we need to constantly work to reduce the inefficiencies, and certainly there is much more that can be done.

We also need to make sure that we effectively carry out our responsibilities in the international arena, as global policies are being developed that can impact our sector. The financial crisis has led to a plethora of activity around financial supervision and regulation, new policies being driven in international groups like the G20, Financial Stability Board, Joint Forum, and the various sectoral organizations – the IAIS, IOSCO, and Basel Committee on Banking Supervision. Most of this is focused on banking, reflecting the role of banks in the crisis. But there are aspects that will affect insurance regulation – things like the creation of supervisory colleges, enhancement of group supervision, creation of a common framework for the supervision of internationally active groups, international accounting standards, and global capital standards. It is important that we in the U.S. provide appropriate leadership on the development of international standards that can affect insurance, and that we communicate effectively with our colleagues in other parts of the world. This is a very high priority for the NAIC and its members, and something we are actively pursuing.

Finally, let me update you briefly on the NAIC's Solvency Modernization Initiative or SMI. Announced in June 2008, the SMI is a critical self-examination of the United States' insurance solvency regulation framework in light of emerging global developments and lessons learned from the crisis. I want to emphasize that this isn't being done because we have some concerns that our system didn't work or needs to be fixed. Rather, it just reflects that fact that it's good public policy to periodically look at what you are doing and whether you can do it better, and this is a good time to do that, given emerging global developments. As part of the SMI effort, the NAIC is reviewing international developments regarding insurance supervision, banking supervision, and international accounting standards and evaluating their potential use in U.S. insurance regulation.

The SMI will focus on a number of key solvency areas: capital requirements, financial analysis, international accounting, insurance valuation, reinsurance, corporate governance, risk management, and group supervision. Other areas may be identified as the project proceeds.

In December 2009, the NAIC released two consultation papers: (1) *Consultation Paper on Regulatory Capital Requirements and Overarching Accounting/Valuation Issues for the Solvency Modernization Initiative* and (2) *Consultation Paper on Corporate Governance and*

Risk Management. An interim meeting was held in March to discuss the responses and plan next steps.

During the March meeting, we had an extensive discussion of the role of regulatory capital requirements. What is the purpose of regulatory capital? For U.S. regulators, the main value of RBC is to provide a clear, indisputable threshold for regulators to take action or to assume control of the firm. To prevent their having to argue to a court that a threshold has been triggered. That means the objective nature of the RBC thresholds is a critical feature of the system, and RBC is viewed as only one weapon in the regulatory arsenal, and not even the most important weapon.

I can contrast that with the perspective that underlies much of the discussion in Solvency II, where capital requirements are framed as a way to incent firms to manage risk effectively. This has led to a strong emphasis on capital requirements – Pillar 1 – and to a movement to internal models to try to match risk and capital requirements, so as to create the proper incentives.

In contrast, U.S. regulators tend to emphasize having robust analysis and examination systems to detect risk concentrations. Or, to put it in European parlance, robust Pillar 2 processes. We spend millions on the data and analysis tools that we have, on the checks and balances and peer review processes that support that analysis. Our experience tells us that is where the real heart of supervision lies. That you need to look at and for risk in many different ways to identify risk concentrations.

Personally, I think it is asking a lot of regulatory capital for that to be the thing that creates risk management incentives. And I have a healthy skepticism of the ability of regulatory capital requirements to prevent risk concentrations, whether based on internal models or not. I was recently in a meeting where a banking regulator said, "We need to eliminate regulatory arbitrage." And I thought to myself, "Good luck with that." The reality is that there will always be regulatory arbitrage; companies will always be one step ahead of us. That is why other tools – examination and analysis – are so important to detect emerging risk concentrations. And ultimately, this is all about detecting and preventing risk concentrations.

Clearly, the role of regulatory capital is an important question to be answered. The answer to this question will drive much of the direction of the SMI work related to regulatory capital requirements. Regardless of the answer to this question, it seems clear that work will be undertaken in modernizing the NAIC's system of regulatory capital. U.S. regulators recognize that internal models are useful for certain risks, as indicated by the NAIC's embracing the use of internal models for certain elements of the life risk-based capital formula. There is considerable interest in expanding the use of internal models to certain catastrophe risks (e.g., hurricane, earthquake). We need to make some decisions on regulatory accounting, the current factors in the models will have to be studied to determine whether they should be recalibrated, and the overall calibration of the RBC formulae will be studied. The current 1 to 6 credit risk rating of assets may be made more granular. We are moving toward a different model for assessing the credit risk of structured assets like RMBS and CMBS. Following the implementation of RBC C-3 Phase 2, regulators have identified some issues with the recognition of hedging arrangements, and that will be revisited. Consideration will be given to more formally incorporating stress tests into the regulatory framework and to requiring that firms provide regulators with their Own Risk and Solvency Assessment (ORSA). Other ideas will undoubtedly emerge as the process continues.

I began by saying these are historic times for regulation and supervision in financial services. The next couple of years will be a time of self-examination in insurance, both domestically and globally. No system is perfect, and there are always opportunities for improvement. But fundamentally, this system has worked well. And that's an important thought to keep in mind as we look to the future.

Thank you for your time.