"Supervising Internationally Active Insurance Groups"
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Good afternoon, and let me begin by thanking Sean for inviting me to be here in this historic place. As a professor, I used to talk to my students about the history of the industry, and Lloyds has played such a large part. So it is a real pleasure to be here.

As Sean said, I don't intend to focus my comments on the advertised title – a relative critique of Solvency II and the U.S. system. We have been following with interest the development of Solvency II, and I will just say that we in the U.S. understand the challenges of developing a uniform risk-based capital system. Major regulatory change typically comes with differences in opinion between supervisors and the industry they supervise. So it is not surprising that Europe is working through a number of difficult issues as they near the adoption of Solvency II. In fact, the rhetoric sounds quite familiar to me, not unlike things we hear when we try to make changes in the U.S. But, in my experience, these differences generally get resolved, and we hope you have the same success with your discussions around Solvency II. We must all acknowledge that there is no perfect regulatory system out there, be it Solvency II or our U.S. system. If there is anything that the recent financial crisis taught us, it is that regulatory systems fail, and regulators are fallible. We should be appropriately humble about our ability to supervise a very dynamic, very complex marketplace, and we can all learn from each other.

What I was really hoping to do today is to talk about how we look at the supervision of internationally active insurance groups, or IAIGs. The supervision of IAIGs is a subject of considerable discussion internationally. In particular, the IAIS has a major project underway to define a Framework for the Supervision of Internationally Active Insurance Groups, a project known as ComFrame, and I would like to offer some observations on that.

But in order to do that, I have to first delve a little into the structure of the U.S. system, because the lessons we learned as we built a multijurisdictional system of regulation and supervision in the U.S. have a strong influence on how we view the multijurisdictional challenge internationally. So my plan is to spend a few minutes talking about the structure of regulation in the U.S., a few minutes talking about our Solvency Modernization Initiative, and a few minutes talking about how that influences our views on supervising internationally active groups.

So let me begin with a brief overview of our U.S. system. The U.S. system is often described as a state-based system because regulatory authority rests with the states. But this is only part of the story, and that description tends to miss key aspects of the system. Over the years, our U.S. system has become increasingly uniform and coordinated, with a variety of checks and balances that act to constrain the discretion of a single state. This has been something of an incremental process, but one that really took off in the early 1990s – about 15 to 20 years ago – with the NAIC's Solvency Policing Agenda. Given the ubiquitous nature of multistate interaction in our system, it's more accurate to describe this as a national system of state-based regulation.

Over the years, the states, through the NAIC, have built a uniform accounting system, known as statutory accounting, and a uniform financial reporting system. We have national expectations for examinations, financial analysis, and communication with other states. We do multistate examinations of companies, and we have intensive multistate interaction when problems are identified.

We have a set of laws and regulations, including a uniform risk-based capital system, that states must adopt to be accredited, and all states are currently accredited. Under the accreditation program, the NAIC does on-site reviews every 5 years and off-site reviews every year to ensure that a state has the necessary regulatory authority, but, equally importantly, to ensure that its practices related to examinations, analysis, qualifications of staff, and communication with other states are effective.

Beyond that, we have built extensive centralized processes to enable states other than the home jurisdiction to monitor the financial condition of insurers operating in their states. Our central database of comprehensive financial information, along with a variety of analysis tools, is made available to all states. While not all states look at host companies in detail, some do, and when they identify issues, they are not hesitant to raise them with the home state. We also have central tools to allow states to track regulatory actions that are being taken, and we maintain the expectation that home states keep the host states informed about developments.

Backing up this multistate oversight, we have central staff and processes at the NAIC, known as the Financial Analysis Division, that work on behalf of all states, constantly scanning the market and nationally active insurers, in an effort to identify trends, outliers, and emerging issues. We collect extensive financial data, and process those regulatory filings through a battery of quantitative tests, including benchmarking various metrics against other insurers. We watch credit spreads and short sales of the companies' stock, follow public filings and analyst reports, integrate our data with other publicly and privately available data in further efforts to identify anomalies, all in an attempt to find outliers or firms that need additional attention. This robust data-driven analysis of individual company and market-wide data is regarded by the IMF as world-leading (according to our recent FSAP report).

When a potential problem is identified, it is referred to a group known as the Financial Analysis Working Group, a group that is comprised of the top financial regulators from around the country. These individuals, who have lived through the wars, serve as an advisory panel and form of peer review for the home state's actions. The FAWG meets constantly, interacts with home state supervisors, and offers guidance and support.

And finally, all of this multistate oversight and interaction rests within a structure of accountability that is key to its success. Host states tend to defer to the home state to supervise its companies, but there is always a hook. That is, the host states reserve their right to take action independently – to revoke or restrict a license, for example – if the home state fails to take appropriate action. This provides a powerful incentive for the home state to cooperate and collaborate with the host states.

These checks and balances – multiple eyes and voluntary deference – help to counter the potential for regulatory failure in the home state, whether due to poor judgment or to incentive problems. It results in a system in which home state supervisors have a certain amount of discretion, but it is constrained by the willingness of other states to accept the actions taken by the home state. To use a term that is fashionable in international circles today, it is a system of constrained discretion.

Most of this activity – the multistate coordination, cooperation, and peer review – is invisible to the regulated entity. And I am not going to tell you it always works perfectly. But it generally works pretty well, and it is constantly improving. And a key reason that it works is because of the checks and balances. These checks and balances give the home jurisdiction the right incentives, host jurisdictions have enough information to judge whether they are comfortable with what is happening, the deference given by host jurisdictions is voluntary and constantly subject to the threat of revocation, and that threat constrains the discretion that home jurisdictions have. All of those pieces motivate the structure of coordination that has been and continues to evolve in the U.S.

And it probably won't surprise you that those are key elements to what we envision as a structure for supervising internationally active insurance groups. But, before I come to that subject, I want to speak for just a few minutes about our Solvency Modernization Initiative.

As I hope you have already heard, the NAIC announced in 2008 its Solvency Modernization Initiative (SMI), an effort to step back and evaluate lessons learned for U.S. insurance regulators from recent global developments, international standards, and the financial crisis. It is worth noting that, in contrast to Solvency I, SMI is not driven by any sense that something is wrong with our system. Certainly, we learned some lessons from AIG about the need to look beyond the regulated insurance entities, and I will come back to that. But even in the case of AIG, the insurance businesses were fundamentally sound, and the problems with AIG were not so much about insurance regulation as about conglomerate supervision. As I suspect you already know, the U.S. Office of Thrift Supervision, a federal banking regulator, was the body charged with supervising the AIG holding company. When it came to the insurance subsidiaries – the purview of the insurance regulators – the current system worked reasonably well. Certainly improvements are possible, but SMI is not so much about wholesale change as about incremental improvements, about considering changes that can further enhance and strengthen the existing framework.

SMI is focused on 5 key areas: Group supervision, reinsurance (basically thinking about how to best implement reduced collateral requirements for credit worthy reinsurers from approved jurisdictions), accounting & financial reporting (including an assessment of the implications of IFRS for our statutory accounting system), capital requirements, and governance and risk management. I will briefly touch on 3 of those areas – group supervision, capital requirements, and risk management – and let me begin with Group Supervision.

One of the main lessons for us from the financial crisis – AIG in particular – has been the need to do a better job in the area of group supervision. In the U.S., as in many countries, we have traditionally taken a single entity approach to supervising insurance companies. While we did look at the holding company, that work tended to be primarily focused on interactions between the insurer and holding company. That is, we focused on maintaining the walls around the insurance company, and on monitoring and restricting transactions between the insurer and its affiliates. AIG taught us that we needed to pay more attention to the risks that are created by activities going on outside those entities – the reputational and contagion issues that could exist.

So enhancing our systems for group supervision is a very high priority for us. In December, the NAIC adopted changes to the Holding Company System Act and Regulation to strengthen and clarify our authority to gather information from the holding company, and to require new disclosures. We are creating a new Form F in which firms will identify and report their enterprise risks. In addition, we are looking at how to implement group capital assessment through an ORSA requirement.

There are two fundamental beliefs that underpin the NAIC's work on group supervision.

The first is that group supervision complements, but does not replace solo entity supervision. Another thing the crisis taught us is that corporate structures matter. When the music stops, it matters where the money resides. To use the NAIC's terminology, it's about walls and windows: maintaining the walls of the legal entity approach, but opening up the windows into the group.

Second, our approach to group supervision is informed by our understanding of the importance of incenting supervisors. So, rather than empowering a single group supervisor, we favor a system of checks and balances – multiple eyes, strong information sharing, and voluntary deference to a lead supervisor, with the threat of revocation. A key element is that the lead supervisor is accountable to the other supervisors, not the other way around.

Turning to the subject of regulatory capital requirements, the SMI (as I noted earlier) is also considering ways to improve our regulatory capital requirements for both individual legal entities as well as for groups.

As background, our current risk-based capital requirements were initially adopted in the mid-1990s and were probably one of the more sophisticated approaches at that time, something that was largely facilitated by the NAIC's very detailed statutory financial data capture. While the formula has been periodically updated over time, it has retained its basic structure and features. It captures risks on both asset and liability sides of the balance sheet. Although it is largely factor-based, it recognizes the relative riskiness of different asset classes and liabilities and was certainly more granular than other regulatory capital approaches at the time. It considers concentrations of asset risk, as well as diversification across lines of business and across risk buckets. It takes into account a company's own experience and, if that data is not fully credible, supplements it with industry experience. It is applied on a legal entity basis, but addresses ownership in downstream subsidiaries. It contains offsets for risk sensitive business lines, as well as additional charges for companies that were experiencing excessive growth.

More recently, on the life side, we started introducing internal models for targeted risks while decreasing reliance on rating agency models for other risks, specifically credit risk charges for RMBS and CMBS, and just adopted a credit for derivatives qualifying as effective hedges.

I could go on, but I think what sometimes gets lost when we explain our approach to others is the fact that RBC has a specific purpose for us. It was developed to be a minimum capital requirement, one that is uniformly applied, and calibrated to identify weakly capitalized companies. It was designed to be an additional tool in our regulatory tool box, and not even necessarily the most important. For many regulators, the importance of RBC was that it created a "non-debatable" threshold for regulatory intervention. It is not about incenting effective risk management, or making efficient use of capital, or about determining the optimal capital level. It's not about how a company manages its capital and risk. It is our tool, for our purposes.

I often have an experience in discussions about regulatory capital requirements where someone will say something like: "If we align regulatory capital requirements with the true risk of the firm, firms will have an incentive to manage risk better." And boy, that sounds really good – if it could be done. But I have to say that I'm skeptical that regulatory capital requirements can ever achieve such lofty goals. Companies can take risk in many ways, and it's not possible for regulatory capital systems to capture all of those. To incent proper risk management, it would mean that regulatory capital requirements have to be constraining, and it would mean that we have to get the risk charge exactly right at the margin for every risk at every time. That's a pretty tall order. And just because the company thinks it's the right charge, just because the company's internal models say this is the right answer, that doesn't mean it's giving us the right incentives. If we learned anything from the financial crisis, I hope we learned that.

I think the best they can do is to lay some basic ground rules and then look hard – really hard – for the unintended consequences. And there will always be some. Regulation affects behaviors. Most observers agree that regulatory arbitrage played a role in the recent financial crisis. Where regulation is constraining, it influences company behavior, and those changes in behavior will change the risk profile of the industry. Risk is thus dynamic and ever-evolving. And one of the ways it evolves is in response to the structure of regulation.

So what are the implications? Well, for me, the implications are that risk-based capital, no matter how much we try to refine it, will always be a blunt tool. We cannot micromanage firm behavior through regulatory capital requirements. In fact, the more we try to do so, the greater will be the unintended consequences. Instead, regulation is about creating some basic rules, defining the playing field so to speak. And more important is what you do beyond that – how you referee the game. So in part, this is about balance – what is the balance between Pillar 1 and everything else a supervisor could be doing to understand how risk is evolving? Given limited regulatory resources, how should we allocate them? In the U.S., I have the sense that we put less emphasis on Pillar 1.

One of the goals of SMI is to look at how RBC can be improved. We are thinking about things like incorporating changes to better reflect catastrophe risk and changing our treatment of diversification. We have, of course, also looked at whether some aspects of Solvency II make sense for us. And I think what they are finding is that there are elements of Solvency II we ARE actively considering incorporating into our tool box, but not necessarily in Pillar 1 or the RBC formula. For us, RBC will always be about minimum capital requirements and about regulatory intervention.

And that brings me to the third area I wanted to mention, and that is risk management.

As I said, we have been looking at Solvency II to see what we might learn from it, and there are some interesting ideas that we are likely to embrace – a greater focus on ERM, for example. As part of the NAIC enhanced risk focused surveillance process, financial examiners are already required to assess risk and the insurers' management, but there may be ways to improve on that.

There may be value to looking more at how the company is evaluating its own risk. Do they have economic capital models? Do they have effective ERM systems? We recently released a proposal for an Own Risk and Solvency Assessment or ORSA, something that is a component of Pillar 2 in Solvency II. While we already make extensive use of stress testing, particularly on the life side, we are looking at whether there are improvements that can be made there. Corporate governance may need attention, and, then, of course, there is group supervision, which we have already discussed. Many of these tools could be useful additions to our toolbox. I think it's also fair to say that insurance regulators see value in looking at a firm's economic capital model, but it's really more about where this best fits into the regulatory tool box, and the regulatory reliance placed on those models. In the language of Solvency II, I think U.S. insurance regulators see a bigger role for a firm's economic capital models in Pillar II.

Now – finally – let me turn to the subject of supervising internationally active insurance groups. The lessons about group supervision are lessons insurance supervisors all over the world have learned. It is an element of Solvency II, and is a key part of the equivalence discussion. It is being discussed at the IAIS by a number of groups. As you may be aware, the IAIS has embarked on a project to create a Common Framework for the Supervision of Internationally

Active Groups. This is a key focus for the IAIS, and a project to which the NAIC is committing significant resources.

When thinking about the supervision of internationally active groups, I think it is important to get to agreement on the problems we are trying to solve. The most common argument I hear is that we need a global system of solvency regulation because the industry is more global, and we need a regulatory system that matches the structure of the industry. But I find that argument incomplete. The argument should go something like this: The industry is more global, the current solvency regulatory system does not work for that increasingly global industry because…, and therefore we need a new global solvency regulation system.

Which raises the question: what is that missing piece? What is the problem we are trying to solve? The first revolves around the problem of regulatory competition and geographic arbitrage. This is the fear that other jurisdictions will compete to attract insurers, and this will facilitate regulatory arbitrage and create what some call "regulatory black holes, " where insurance sector capital and risk become concentrated in particular, less well-supervised jurisdictions. Basically, these are global standards to guard against a race to the bottom.

The second problem, one that tends to be raised by internationally active firms, is the inefficiency of having to comply with multiple sets of regulations and a fragmented regulatory system. This argument is very familiar to us in the U.S., as we have spent decades working through differences across the states to try to make the system more efficient for the companies. More recently, I have heard a variation on this theme that focuses on group supervision. Unfortunately, as insurance supervisors around the world are implementing group supervision, we are not doing this in a well-coordinated way. Companies are being asked to provide various reports to supervisors in a variety of countries. Our information requests, formats, and focus are different, and, from what I can tell from some companies, this lack of supervisory coordination is creating frustration and unnecessary administrative costs. As we all try to figure out how to supervise insurance groups, we need to figure out how to do this together. In the worst case, we will all create different sets of requirements, and make it impossible for internationally active groups to function.

Third, let's take as a given that any common framework for supervising internationally active insurance groups has to address the AIG problem – the problem of risk concentrations that are created in unregulated entities.

Finally, I hear a set of arguments that are less about creating a global standard because it is good for insurance supervision and insurance markets and more about pressure from those outside our sector. Examples include: the banking sector has a global capital standard, and we look like we are behind if we don't. The Financial Stability Board has said we need one. The IMF has pointed to differences in regulatory capital requirements as a problem. While we can't ignore outside pressure, I find these arguments less compelling. In the discussion over financial stability and systemic risk, we are working hard to get policymakers in other sectors to understand the differences between banking and insurance. Our first job is to make sure we understand what makes sense for our sector, given, of course, that insurance is part of the broader financial services marketplace and has certain interlinkages with banks and other financial firms. But then it is our job to sell that, and not to have those who have a more limited understanding of the insurance sector drive the answers.

So let's assume we are trying to solve the first three problems: the potential for regulatory arbitrage because of jurisdictional competition, inefficiencies for companies from fragmented and diverse regulatory requirements, and the AIG problem of unregulated affiliates. Now let me turn to the IAIS ComFrame project and offer some thoughts.

ComFrame – the Common Framework for the Supervision of Internationally Active Insurance Groups – is a key project for the IAIS, one that involves numerous committees and subcommittees. At this point, it is still in its embryonic stage, and there is much work to be done to define just what it is. While I can offer some preliminary perspectives from the U.S., it is fair to say that discussions continue, and we expect that we will all continue to learn from each other. With that caveat, let me offer my personal observations on how ComFrame should evolve.

Observation #1: Incremental change is better than revolutionary change. I reach this conclusion for several reasons. First is the sense that the system generally is not broken as much as it is experiencing some growing pains. Second is the recognition that regulation inevitably has unintended consequences, and I tend to think that it is easier to manage those if you take them in bite size bits. But finally, wholesale revolutionary change is very hard to achieve. Incremental change is possible, and incremental change over time can have real lasting effects. Having some incremental successes can promote trust among supervisors around the world, which can serve as the basis for continued improvements in the future. That means to me that we shouldn't try to create some grand new system of group supervision, trying to reinvent the various aspects of solo entity supervision at a group level. Let's identify some key things that we need to do better when it comes to groups. We need to do a better job of understanding the interactions among the group, the gaps and interlinkages. We need to understand the risk posed by unregulated entities. We can collaborate to address geographic arbitrage. And we should find a way to do this in a coordinated way, so we minimize the burden on the companies that we supervise.

Observation #2: We need to have the proper balance between regulation and supervision. For all of the reasons I mentioned earlier, we should not put too much faith in global capital requirements. More important than global capital requirements is a system of robust supervision, including giving supervisors the right incentives. Unfortunately, defining a capital regime is, in some respects, easier to do. Supervision is amorphous. It can't be defined. It's a process. It's much harder to assess the quality of supervision. But that doesn't mean it shouldn't be or can't be done. Supervisory colleges are certainly a start to greater collaboration in supervision, but I think it is fair to say that these have a long way to go. There is great opportunity for us to share processes globally, and at a practical level, to try to coordinate our information requests and oversight. Recognizing the importance of increased collaboration in supervising internationally active groups, the NAIC has proposed the creation of a Supervisory Forum at the IAIS. This is a body that would be comprised of actual on-the-ground supervisors, sharing information on what they are doing and seeing, sharing best practices, and trying to foster more consistency and coordination in how we approach internationally active groups. In some respects, it is modeled after our coordination efforts in the United States, but on an international scale.

Observation #3: We need to have the right relationship between the group or lead supervisor and the other supervisors. This is critical to getting the incentives right and to giving host supervisors faith in the process.

When talking about group supervision and the role of a group supervisor, I have heard it said, "Someone has to be in charge." I have to say I don't agree – a group can be in charge, as in a board of directors, for example. But the more important question is who is accountable to whom. The incentives of the home and host jurisdictions are not necessarily aligned, and in many cases, it is the host jurisdictions that have more to lose. It is essential that a global system of regulation empower host jurisdictions to halt behaviors that are potentially harmful to their markets. And that means the group supervisor has to be accountable to the other supervisors, not the other way around. That is the only way to create a structure that is efficient, seamless, and has the right incentives. So I come back to the concept of voluntary deference that we have in the United States. This is not about empowering a group supervisor. This is about holding the group supervisor accountable.

Finally, observation #4: And this may be the hardest part. We cannot achieve that level of coordination internationally without a consistent benchmark for measuring. Let me explain what I mean. At the moment, approaches to valuing assets and liabilities, including technical provisions, are so dissimilar, that the barriers to effective communication across jurisdictions about financial condition and performance are immense. I don't know if that means every jurisdiction has to have identical accounting systems. Any accounting system has its strengths and weaknesses. But if we have a common benchmark, we can come to understand the strengths and weaknesses and the ways in which deviations matter. But we need a starting place. In the U.S., that is our statutory accounting system. On occasion, states will deviate from statutory accounting, but those deviations are fully transparent to all of the other states. I don't know what that benchmark measuring system will be for internationally active groups, but the logical candidate at this point is IFRS, something that has certain growing pains of its own.

Let me close on a personal note. Much of my career in insurance regulation has been about trying to make the U.S. system more efficient without making it less effective. ComFrame is a very exciting project for me personally, because it is a project I think I understand. I see it as something that is good for both supervisors and the regulated industry. It's a win/win, and that's why we in the U.S. are so committed to its success.

I do think we can have some evolutionary change that is good for insurance regulation and supervision that enhances our abilities to monitor our markets, and that makes it more efficient for companies operating internationally. While some of this is about regulation, I tend to think, on balance, it’s less about regulation, i.e., about developing a single set of rules, than it is about supervision and better supervisory cooperation. Done right, ComFrame has the potential to create a multijurisdictional approach to supervision that is built on collaboration and coordination, emphasizes robust oversight, maintains the proper balance between home and host jurisdictions, and is seamless from the perspective of regulated companies.

And with that, I will thank you again for inviting me, and I look forward to your comments and questions.