

## **Group Supervision and the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)**

Comments to the NAIC Solvency Modernization Initiative (SMI) Task Force

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March 28, 2011

As I'm sure you already know, there is currently an active international discussion on the subject of group supervision in insurance. As a result of AIG and emerging international standards, countries all over the world are increasing their focus on group supervision. It is an element of Solvency II, and it is a key part of the equivalence discussion. It is being discussed at the IAIS by a number of groups.

The IAIS is working to create a Common Framework for the Supervision of Internationally Active Insurance Groups or ComFrame. While the exact nature of ComFrame is still under discussion, the intent is given by its name – a Common Framework. -- something that further articulates the IAIS core principles for supervision - - with specific attention to their application in the context of internationally active groups -- and something that defines how we are going to work together to supervise internationally active groups. ComFrame is still in the embryonic stage of development, and the details will emerge over the next several years. Those of you that were at International Solvency meeting heard Ramon briefly describe some of the challenges. This is a key focus for the IAIS, and a project to which the NAIC is committing significant resources.

So, as you can see, we are at a critical period for the evolution of a structure for supervising internationally active insurance groups.

I was recently invited to speak at a forum in London on the subject of the supervision of internationally active insurance groups, and that forced me to crystallize some of my own thoughts on this subject. Director Urias and Kris DeFrain invited me come here today

and share some of these thoughts, which I am happy to do. I am not going to repeat the entire speech, given the time constraints here. My comments here are derived from that original speech, but somewhat shortened and updated.

The U.S. is in a unique situation when compared to other jurisdictions around the world because we have actually had to work on how one might go about supervising cross-border groups. I am the first to say our national system of state-based regulation is not perfect. It is a work in progress. But over the years, we have made good progress in building national standards and coupling them with collaborative systems for supervision. Much of this was done in response to failures over the years, illustrating the process of continuous improvement in which we engage. It is important for us to share what we have learned with others as we all work together to create a system of supervision for internationally active groups.

And with that introduction, I would like to make some high level observations on the subject of the supervision of internationally active insurance groups.

**Observation #1: We should be clear on the problem we are trying to solve.**

When thinking about the supervision of internationally active groups, I think it is important to get 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? We must know the problem if we are to assess whether the solution

works or whether, as is also possible, it only makes the situation worse. Let me offer three of the problems that I have heard mentioned. .

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, this is international standards and supervisory processes 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 US, 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. This is something, for example, that we should be aware of as we pursue the creation of an ORSA requirement and corporate government standards in the U.S.

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 in unregulated entities.

Beyond these three, I sometimes 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. There are a number of ways this could be done, and as we think through this internationally, we need to be clear about our views on how this could work.

**Observation #2. This is more about supervision than regulation.**

Those of you that have experience in actually supervising large, complex groups know that one has to be flexible and adaptive. It sometimes seems, however, that much of what is going on at the IAIS and other places is heavily focused on the development of principles and rules, with less attention given to the actual process of supervision. Rules have a place, but the real magic in what financial regulators do is to use the knowledge and intuition they have gained over the years about how companies operate -- and the various ways they can get into trouble -- to try to identify developing problems before they get serious, and to take action. That's the hard work of supervision. The best

regulators aren't looking at compliance with rules. They are looking at much more. Our risk-focused approach to supervision is fundamental to what we do in the U.S.

**Observation 2.1: We should not place excessive reliance on regulatory capital requirements as the solution.**

We need to be careful that we don't put too much faith in global capital requirements as the answer to regulating and supervising internationally active groups. We should have a healthy awareness of their limitations. Let me explain. I often have an experience in discussions about regulatory capital 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." That is something you often hear in Europe, and, in fact, is one of the fundamental concepts underlying Solvency II.

Now, that idea sounds really good. It's about giving companies the right incentives, and I'm all for that. 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.

The reality is that regulatory capital requirements, no matter how much we try to refine them, will always be a blunt tool. Certainly they should not create the *wrong* incentives, but we cannot micromanage firm behavior through regulatory capital requirements. There are diminishing returns to pursuing precision in regulatory capital requirements.

Which brings us back to the importance of supervision. 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. I think the best we 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.

What does that tell us about how we should allocate limited regulatory resources? In Solvency II terms, what is the balance between Pillar 1 and everything else a supervisor could be doing to understand how risk is evolving?

When I compare our system in the U.S. with the tenor of discussions around Solvency II in Europe, for example, I have the sense that we put less emphasis on Pillar 1. One of the reasons our system has been successful is the wide variety of tools we have, and risk-based capital is just one of them. As the SMI Task Force has already pointed out, RBC is simply one tool in our toolbox, and it serves a specific purpose – identifying undercapitalized companies and providing triggers for intervention. But there are other tools, and these serve equally important roles. For example, we find our data-driven analysis to be particularly valuable, and, according to the IMF, it is world-leading. We have a robust risk-focused examination process and many other tools that are designed to identify emerging issues and trigger further review and action. We know that we can't put all of our eggs into the Pillar 1 basket.

**Observation #3: The relationship between the group or lead supervisor and the other supervisors should create the proper incentives.**

This is an area where I think the U.S. has some real lessons to offer. While our structure is often described as a state-based system, it is the high level of coordination – both in the

development of standards and in the process of regulation and supervision -- that makes it a *national* system of state-based regulation.

As I have already mentioned, we have some great tools – data, analysis tools, risk-based capital, risk-focused exams, holding company regulation, etc. And we have great regulators in the states who use these tools along with their knowledge and experience to do the hard job of supervising. We pair that individual state oversight with collaborative processes such as multistate exams, the Financial Analysis Working Group, and the general expectation of multistate coordination and communication. But there is also a structure of accountability that all of this rests in, and I think this structure of accountability is critical to our success.

What do I mean by this structure of accountability? What I mean is that we generally tend to defer to the domestic regulator. That is, we tend to rely on each other. But that deference is conditional. The host states retain the right to intervene if they are not satisfied with what the domestic state is doing. They can always take action independently – revoking or restricting a license, for example – if the domestic regulator fails to take appropriate action. This creates powerful incentives for the domestic state to cooperate with other states. Through this structure, the other states hold the domestic state accountable for its performance. In a sense, they aren't empowering the domestic state as much as they are outsourcing supervision to the domestic state.

The result is a system in which the domestic state has a certain amount of discretion in its supervision, but that discretion is constrained by the willingness of the other states to accept it. Let's call it a system of "constrained discretion", to use a term that is fashionable in international circles these days.

**Observation 3.1: The Group Supervisor should be accountable to the other supervisors.**

When talking about group supervision and the role of a group supervisor. I have often 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. Most specifically, the host country supervisors should not be limited in their ability to go around the group supervisor to get information or to protect their market if their concerns are not met.

**Observation #4: Particular attention needs to be paid to creating mechanisms that facilitate information sharing.**

Our robust centralized information sharing processes are critical to making this structure work. These include central databases, some common analysis tools, and accreditation requirements that focus on communication. We require domestic states to notify other states when issues arise, and our accreditation process checks to make sure this is happening. It is through this robust information sharing that other states have the information they need to monitor what the domestic regulator is doing. We are constantly working to improve our processes here, to make it easier for companies to operate on a multistate basis. As with everything, it is not perfect, but we have come a long way over the years. We have gotten better at centralizing the collection of multistate information through a single source, whether it’s the NAIC or a single state that shares it with other states. If we are going to develop an efficient and effective system for supervising internationally active insurance groups, we must develop mechanisms to facilitate robust information sharing among supervisors.



**Observation 4.1: We need a consistent benchmark for measurement.**

And this may be the hardest part. I do not believe we can 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 that this means all jurisdictions have to have identical accounting systems. Any accounting system has its strengths and weaknesses. But we need a starting place. If we have a common benchmark, we can better understand the strengths and weaknesses of a particular jurisdiction's system, and the ways in which deviations matter. In the U.S., our statutory accounting system serves as that common benchmark. 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. That is what makes it so important that we be actively involved in the development of international accounting standards.

**Observation #5: 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.

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. Those of you who were at the International Relations Committee meeting on Saturday afternoon heard a report from Elise Liebers about the creation of a Supervisory Forum at the IAIS. The US brought this idea to the IAIS, and encouraged the creation of this group, which will be composed of senior supervisors actively engaged in supervision. A big part of our motivation was to change the discussion from one that seemed almost entirely focused on developing rules and standards to one that better reflects the complexity of supervising this very diverse, complicated industry we regulate and the practical challenges of supervision. We envision the Supervisory Forum as a place where actual on-the-ground supervisors can share information on what they are doing and seeing, share best practices, and try 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.

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.