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Director of the Federal Insurance Office, U.S. Department of the Treasury
Hearing entitled "The Impact of International Regulatory Standards on the Competitiveness of the U.S. Insurers"

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Chairman Neugebauer, Ranking Member Capuano, Members of the Subcommittee, thank you for inviting me to testify today on projects at the International Association of Insurance Supervisors (IAIS) regarding systemic risk and group supervision as well as collaboration between the EU and U.S. on insurance regulatory matters.

My name is Michael McRaith, and I am the Director of the Federal Insurance Office (FIO) in the U.S. Department of the Treasury.

The Federal Insurance Office has the statutory authority to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the IAIS. FIO does not conduct day-to-day oversight of the business of insurance. Rather, FIO has the responsibility to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system.

In discharging its statutory responsibilities, FIO has been engaged with the Financial Stability Oversight Council (Council) on the Council's activities, and has been advising the Secretary on insurance matters of national importance. FIO also will shortly publish its first annual report on the state of the U.S. insurance industry. The annual report reviews the financial performance of the industry and significant regulatory developments. The report also identifies important trends in the insurance industry that merit continued scrutiny. FIO expects to produce a number of additional reports this year, including the report on how to modernize and improve the system of insurance regulation in the United States and, separately, on the breadth, scope and role of the global reinsurance market. Finally, per its statutory mission, FIO has been active representing the United States in international forums on prudential aspects of international insurance matters.

I would like to take a moment to emphasize what I have stated many times in that past, namely, that we recognize the role of state insurance regulators in the day-to-day oversight of the U.S. insurance sector, and value the work of insurance regulators in each of the 56 independent jurisdictions that are members of the National Association of Insurance Commissioners (NAIC). During more than six years as the Director of the Illinois Department of Insurance, many challenging issues and long days provided me the opportunity to work with dedicated regulators who serve in state insurance departments around the United States. Commissioners balance many demands within each state, confronting challenges ranging from workers' compensation markets to natural catastrophes. Just as I did, state commissioners work closely with state legislators and governors. All of this, of course, is in addition to collaborative work accomplished through the NAIC. We at FIO remain committed to working with the state regulators.

With respect to the international matters that give rise to today's hearing, our involvement begins with the law that established FIO and our activity has been shaped by the circumstances, events, and demands of the last two years. My testimony today will focus on our work at the IAIS involving the designation of global systemically important insurers, or G-SIIs, and the development of the Common Framework for the Supervision of Internationally Active Insurance Groups, also known as ComFrame. I will also address the EU-U.S. Dialogue Project, which is a collaborative project begun in January 2012.

IAIS – Global Systemically Important Insurers

As you are aware, the IAIS is an international insurance organization formed to promote effective and globally consistent supervision of the insurance industry, to maintain fair, safe and stable insurance markets, and to contribute to global financial stability. The IAIS has members from nearly 140 countries representing approximately 97% of global insurance premium volume, and is the international standard setting body for the insurance sector. Thus, the IAIS has similarities to the Basel Committee on Banking Supervision, which deals with banking issues, and to the International Organization of Securities Commissions, which addresses securities matters.

The IAIS is not a supervisor, and does not have any legal authority to direct or affect the structure or manner through which any jurisdiction regulates its insurance sector. Rather, the IAIS establishes standards with which jurisdictions may then elect to comply. Therefore, whether and, if so, when and how to modify an existing regulatory structure are issues left to the discretion of the proper authorities of the IAIS member to decide.

The IAIS decision-making process is consensus driven. Through consensus, the IAIS develops insurance core principles (ICPs) which, as the title implies, provide broad direction and framework for country supervisory regimes. Though it is consensus-driven, the IAIS process does not allow one member to forestall a collective process or decision. For example, if a jurisdiction opts not to engage in a certain discussion, the other members will nevertheless continue to develop applicable standards.

The International Monetary Fund’s Financial Sector Assessment Program (FSAP) is a comprehensive and in depth assessment of a country’s financial sector. For countries in which the FSAP evaluates the insurance sector, the IMF examines compliance with the ICPs. The FSAP process results in a written report describing whether the country complies with the ICPs. For those areas of non-compliance or unsatisfactory performance, the jurisdiction is encouraged to make changes within a generally prescribed time frame (*e.g.* near term or medium term). A central objective of the FSAP is to rate the quality of bank, insurance, and financial market supervision against accepted international standards; and evaluate the ability of supervisors, policymakers, and financial safety nets to respond effectively in case of systemic stress.

Heightened emphasis on international standard-setting activity is important for two reasons. First, the financial crisis illustrated that, globally, our financial regulatory oversight regime should be more robust and comprehensive in scope, and that jurisdictions should share a commitment to global standards. These commitments are reflected in the pronouncements of the G-20 and in the work of international bodies, including the Basel Committee, IOSCO, IAIS, and others. Second, specific to insurance itself, international developments in insurance supervision are driven by the changing international insurance market. Although the United States and the combined nations of the EU constitute the largest market participants in terms of global premium volume, opportunities for the insurance industry to achieve significant organic growth are more promising in developing economies. The populations of the developed economies in the United States and the EU are retiring at unprecedented levels, and insurers operating in these markets compete aggressively for marginal market share growth. Conversely, developing economies have rapidly growing middle and upper classes with potentially significant demand for insurance. This shift has dramatically increased the percentage of revenue that an internationally active U.S. or EU insurer derives from outside its home country, and that increase is expected to continue.

In 2010, the Financial Stability Board (FSB) directed the IAIS to develop a methodology to identify G-SIIs, recommend which of those firms should be designated for enhanced supervision, and define the enhanced prudential measures to be applied to a designated G-SII. The IAIS's Financial Stability Committee, in which FIO has participated since July 2011, has sought to respond to the FSB directive by engaging in a process that essentially has involved three phases: data collection, application of data to the methodology, and supervisory judgment and validation. The IAIS collected non-public data from approximately 50 firms, 14 of which are U.S. based. The IAIS has been applying the methodology by using this data to evaluate the firms. The IAIS methodology will result in a relative scoring of one firm against all the other firms from which data was received. Each firm that then has become subject to the supervisory judgment and validation phase—that is, a firm that is under consideration for possible designation as a result of the application of the methodology—has had an opportunity to engage directly with the IAIS Financial Stability Committee regarding that firm’s unique circumstances, including to explain whether they believe that firm should be designated.

I would like to pause briefly on the methodology. The IAIS has worked diligently to improve and refine the methodology so that risks presented by firms are properly assessed and so that the results are accurate. The issues are complex. For instance, the IAIS has to be thoughtful about whether it is overstating the risk presented by firms that have portfolios of variable annuities. Some firms offer variable annuity products similar to traditional insurance while others offer variable annuities with features that are more like a security or bank product. The IAIS is committed to sorting through these difficult data and complex definitional (*i.e*. how does the risk of one variable annuity product compare to another) issues.

The FSB, of course, is not a regulator and does not have authority to impose any enhanced measures on a G-SII. Rather, a G-SII designated by the FSB would then be delegated to the national authority for consideration. At present, consistent with the FSB Chair’s letter to the G-20 Finance Ministers and Central Bank Governors in February 2013, the IAIS expects to complete the G-SII methodology, results of the methodology and proposed policy measures before the end of this month. Once the IAIS meets this deadline, the FSB will then determine how and when to proceed with designation of G-SIIs and further work for the IAIS on this issue.

IAIS – ComFrame

The Common Framework for the Supervision of Internationally Active Insurance Groups, or ComFrame, is a workstream at the IAIS compelled by the changing international insurance marketplace in which firms are increasingly global. U.S.-based insurance firms, in particular, are pushing into new markets in new ways and to greater degrees every year. I serve as Chair of the IAIS Technical Committee which oversees the development of ComFrame.

The objective of ComFrame is to improve the comparability and commonality of supervisory approaches so that regulators from jurisdictions around the world have an improved understanding of an internationally active insurance group (IAIG) and increased trust and confidence in one another. As with other IAIS standards, ComFrame will be incorporated into local regulatory approaches in the form appropriate for each jurisdiction.

ComFrame will have both qualitative and quantitative components. At an IAIS hearing in Basel in March 2013, officers of several IAIGs expressed support for ComFrame but expressed support for a less-prescriptive approach to matters such as economic capital modeling. A revised draft of ComFrame will be released later in 2013, likely in conjunction with the IAIS Annual Meeting in October, and will indicate significantly greater emphasis on appropriate principles for the industry-specific features.

For the quantitative aspects of ComFrame, the objective is modest: establishing a common, basic process by which to assess the capital strength of an IAIG. The challenges to this objective are significant, in no small part due to the varied accounting and insurance asset and liability valuation approaches from the Americas to Europe to Asia. Nevertheless, an industry-funded center for the study of insurance risk and economics surveyed its members, and reports nearly all of the surveyed members reconcile these differences and assesses their own group capital position. In addition, the credit rating agencies evaluate the capital position of an insurance group. Through the IAIS, the international supervisory community is committed to working closely with leading industry participants so that ComFrame reflects these practical and business realities and delivers meaningful value to supervisors and to industry. For this reason, testing ComFrame in the field, receiving direct feedback from leading industry participants, will significantly influence these important quantitative aspects of ComFrame.

Separate from ComFrame, the IAIS has established a capital framework in ICP 17 ("Capital Adequacy"). And, the IAIS should respond to the demands and expectations of the supervisors of developing markets, in particular, by developing a capital standard for those countries to incorporate into a regulatory regime. For countries with embryonic or evolving insurance regulatory systems, consistency in capital oversight could serve as a linchpin for efficient regulation harmonized with other host jurisdictions (countries in which an insurance firm participates in the market, but is not domiciled or based).

EU – U.S. Insurance Dialogue Project

Finally, the EU-U.S. Insurance Dialogue Project (Project), first hosted at Treasury in January 2012, has provided a new template for interaction between important financial services regulatory regimes. At the outset, I commend the state regulators, led by Commissioner Kevin McCarty of Florida and the NAIC's Therese Vaughn, for their roles in this project. The Steering Committee for this project includes a representative of the European Commission, the European Insurance and Occupational Pension Authority (EIOPA), the Bank of England, the state regulators, the NAIC, and FIO.

The work of the Project has been enormously positive and constructive on many levels. In 2012, through a work plan negotiated by the participants, teams of insurance regulatory experts from the EU and the United States compared the alternative approaches to insurance oversight across the jurisdictions. This stock-taking and gap analysis culminated in a report published in September 2012, which then led, in December 2012, to negotiation and agreement on a set of high level objectives to be pursued over the next five years. These objectives are:

1) Promote the free flow of information between EU and U.S. supervisors under conditions of professional secrecy by removing the barriers to the exchanges of information.
2) Establish a robust regime for group supervision, under which there is:
    a) a clear designation of tasks, responsibilities and authority amongst supervisors, including a single group/lead supervisor;
    b) a holistic approach to determining the solvency and financial condition of the group that is consistent with the way companies manage their business, that avoids double counting of regulatory capital and that monitors risk concentrations, considers all entities belonging to the group and is complementary to solo/legal entity supervision;
    c) greater cooperation and coordination amongst supervisory authorities within colleges; and
    d) efficient enforcement measures at the group and/or solo level that allow for effective supervision of groups.
3) Further develop an approach to valuation which more accurately reflects the risk profile of companies, is sufficiently sensitive to changes in that risk profile and which has capital requirements that are fully risk-based, based on a clear and transparent calibration and that cover similar categories and subcategories of risks to which companies are exposed.
4) Work to achieve a consistent approach within each jurisdiction and examine the further reduction and possible removal of collateral requirements in both jurisdictions in order to ensure a risk-based determination for all reinsurers in relation to credit for reinsurance.
5) Pursue greater coordination in relation to the monitoring of the solvency and financial condition of solo entities and groups through the analysis of supervisory reporting. The exchange of information is facilitated by the joint exchange of best practices for analysis and an evolution towards a greater consistency of reporting.

6) Ensure the consistent application of prudential requirements and commitment to supervisory best practices through different peer review processes that ensure an independent view of the jurisdiction being examined.
7) Ensure consistency and effectiveness in the supervision of solo entities and groups.

In 2009, the EU adopted Solvency II, a framework for unified oversight of the EU's insurance sector. Solvency II is a well-constructed and thoughtful approach to insurance regulation that, once refined, should work well for the EU. Even though Solvency II has not yet been implemented in the EU, many of its provisions have been adopted in other jurisdictions. For example, the World Bank has entered into a partnership with EIOPA to aid with the development of insurance regulatory approaches for developing economies. At the same time, the United States has primarily a state-based, solo entity approach to insurance oversight reflective of historical practices and structures. While the differences between the two approaches are now better known and understood, both jurisdictions should work toward a degree of compatibility.

The EU and United States are the two largest insurance jurisdictions both in terms of premium volume and in terms of internationally active firms. The importance of the insurance industry in both jurisdictions warrants supervisory regimes that are converged and harmonized, where appropriate, and clarity on those areas where convergence is not practical or possible. The improved regulatory compatibility between the EU and the United States will establish processes and supervisory approaches that can influence the insurance sector throughout the world, including at the IAIS.

The U.S. insurance sector is diverse and that diversity is reflected in the views of its participants. FIO's priority, however, will always be the best interests of the U.S.-based insurance consumers and industry, and jobs and prosperity for the American people. FIO is and will remain open to all views and all stakeholders in order to advance the ideas that best serve our nation and the American people.

Thank you, Chairman Neugebauer, for the invitation to discuss these important insurance matters. I look forward to answering your questions.