Testimony of the
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Introduction

Chairman Reed, Ranking Member Crapo, and members of the subcommittee, thank you for the opportunity to testify today. My name is Terri Vaughan. I am the Chief Executive Officer of the National Association of Insurance Commissioners (NAIC). The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and the five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. Our members, working together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

Our system has a strong track record of protecting consumers and maintaining effective solvency oversight. The insurance sector in the U.S. weathered a devastating financial crisis and remains resilient in coping with equally devastating natural catastrophe losses across the country. Comprehensive data collection and analysis, rigorous hands-on supervision, and transparency for consumers and investors are the hallmarks of the U.S. system.

Over the past few years we have made several enhancements to the regulation of insurance. Some of these refinements were implemented to address, in part, certain aspects of the financial crisis such as new securities lending reporting rules, a reduction of a regulatory reliance on credit ratings, and increased focus on non-insurance affiliates and their potential impact on the insurer and its policyholders. Other changes are being driven by the evolving business of insurance. Today, insurance markets are becoming increasingly global and interconnected, and this trend is likely to continue.

For these reasons, the NAIC's international involvement has been increasingly focused on the supervision of insurers that operate in multiple countries, or internationally active insurance groups (IAIGs). In light of the financial crisis and the evolving insurer business model, insurance regulators recognize it is vital to improve coordination and collaboration to better supervise IAIGs, and we are developing structures and tools to better identify internal and external risks to the insurance sector. These new tools will enable us to better anticipate risks that are evolving beyond our borders and outside our respective jurisdictions. Today, I would like to discuss recent improvements to our state-based system and our efforts abroad.

International Standard Setting

The NAIC participates as a founding member in the International Association of Insurance Supervisors (IAIS), which was established in 1994. The IAIS is the international standards setting body for insurance, similar to the Basel Committee on Bank Supervision (BCBS) setting international bank standards and the International Organization of Securities Commissions (IOSCO) setting international securities standards. State insurance regulators or their NAIC representatives are active members in all of the major IAIS committees and subcommittees. We also worked within the IAIS to ensure that the new Federal Insurance Office would be a voting member of this body. While IAIS activity is nonbinding on its member jurisdictions, the scope and importance of the IAIS work and its potential impact on U.S. insurers has increased significantly since the financial crisis, and subsequently our involvement at the IAIS has increased to ensure that the U.S. regulators' perspective is reflected in its projects.

In particular, we are actively working on revisions to the IAIS Insurance Core Principles (ICPs), which set out the fundamentals to effective insurance supervision. The ICPs are of paramount importance in that they form the basis of the International Monetary Fund's (IMF) Financial Sector Assessment Program (FSAP), which is designed to assess a particular jurisdiction's regulation of financial institutions. Such assessments are conducted periodically on a rolling basis; the United States' system of insurance regulation was most recently assessed in 2010. In that FSAP, the IMF found that U.S. insurance regulators observed or largely observed 25 of the 28 international standards, and noted the overall resilience of the insurance sector through the financial crisis. The IMF stated: "There is generally a high level of observance of the Insurance Core Principles. Aspects of regulatory work such as data collection and analysis in relation to individual insurance companies are world-leading. There are mechanisms to ensure individual states implement solvency requirements effectively." The IAIS is currently revising the ICPs, and we are working to ensure strong U.S. regulator input into the process.

The NAIC is also active in the development of the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups, or "ComFrame." This project aims to make group-wide supervision of IAIGs more effective by creating a multijurisdictional approach that emphasizes robust oversight and supervisory cooperation while maintaining the proper balance between home and host authorities. While the ultimate role of ComFrame remains under discussion and development, the intent is given by its name – a common framework – one that lays out how supervisors around the globe can work together to supervise internationally active insurance groups. ComFrame is neither intended to be a forum to create prescriptive ways to promote a particular means for solvency standards, nor to create additional layers of regulation.

While all regulators have a vested interest in harmonizing regulatory approaches with their international counterparts where appropriate, we cannot abdicate our responsibility for U.S. insurance companies and consumers. We must remember that there are different regulatory systems and approaches around the globe, so regulatory convergence must involve arriving at common outcomes and not necessarily at universal standards or structures. Moreover, global convergence should heavily focus on information sharing and include mechanisms for peer review. Imposing national or regional concepts unilaterally is particularly counterproductive as it undermines the ability to achieve common regulatory goals.

Identification of G-SIFIs

In the aftermath of the financial crisis, regulators in the United States and around the world have been increasingly focused on identifying systemic risks to the financial system. In the United States, the Financial Stability Oversight Council (FSOC) is developing criteria to identify and designate systemically important non-bank financial institutions (SIFIs) for heightened supervision by the Federal Reserve – potentially impacting some insurers. The insurance regulator representative to FSOC is John Huff, Director of Missouri's Department of Insurance, Financial Institutions, and Professional Registration. Director Huff has been an active participant in FSOC discussions since he was selected by his fellow insurance regulators last year. He has been working closely with the new Director of the Federal Insurance Office, Michael McRaith, and he is looking forward to working with insurance expert Roy Woodall if and when he is confirmed by the full Senate. Of critical importance to Director Huff and his fellow regulators is highlighting the distinctions that exist between banking and insurance to ensure that FSOC decisions don't create detrimental unintended consequences for the insurance sector, while ensuring that any potential for systemic risk, however remote, is identified and mitigated.

The U.S. is not alone in wrestling with the challenge of systemic risk. Finance ministers, central banks, and regulators from around the globe convene through the Financial Stability Board (FSB) to address systemic risk issues through the identification of global systemically important financial institutions (G-SIFIs). As part of this work, the FSB has asked the IAIS to develop indicators for identifying global systemically important insurers. U.S. insurance regulators have extensive input into the IAIS process as the NAIC chairs the IAIS Financial Stability Committee work on this issue.

In both the FSOC and FSB efforts, it is critical for members making systemic designations to access unique expertise in particular subject areas. Such knowledge helps ensure that appropriate methodologies are being considered, and gives participants the insights of hands-on regulators with unique expertise in assessing the systemic relevance of certain products or activities.

The U.S., represented by the United States Treasury Department, Federal Reserve Board of Governors, and the Securities and Exchange Commission, is a member of the FSB, which is engaging directly with the IAIS on critical issues including G-SIFI identification. The involvement of insurance regulators is essential as the FSB is a bank-centric organization, yet its decisions have an impact beyond banking. Through the IAIS, we continue to stress that the insurance business model needs to be distinguished from the banking business model when discussing and applying any new regulatory requirements.

Additionally, the Treasury Department coordinates input from the various functional regulators or their representatives on FSB projects and priorities, and we have been active and constructive contributors to those discussions. The FSB has taken on an increasingly active role in attempting to coordinate regulatory developments around the globe. However, some activities have raised questions of coordination, such as how the timing and outcomes of the FSB's process for identifying G-SIFIs relates to domestic processes like FSOC's to identify systemically important financial institutions within our country. I would encourage federal regulators and legislators alike to be mindful of both the scope and speed of the board's activity, and work to ensure that appropriate deference should be provided to the regulatory authorities of member nations.

Communication, Collaboration and Cooperation among Supervisors

Beyond identifying systemic risk, the day-to-day supervision of insurance in the U.S. requires extensive coordination among our regulators. We have a long history of coordination through the NAIC, and have embedded systems of peer review into our processes to promote consistent oversight. Similar efforts to coordinate at the international level are evolving, so U.S. regulators along with their international counterparts are redoubling efforts to strengthen supervision through enhanced coordination.

Insurance regulators are involved in technical exchanges, training programs, and other forms of regular dialogue. We actively pursue necessary bilateral and multilateral information agreements or Memoranda of Understanding that provide the foundation for these regulatory exchanges. U.S. regulator leadership in these efforts help us understand the various supervisory practices and cultures that exist, and better appreciate the global risk trends that may impact domestic insurers and policyholders. This type of increased cooperation has been discussed internationally for some time, particularly with a focus on improved efficiency and teamwork among regulatory systems, but the recent financial crisis has accelerated the current efforts on developing and implementing best practices to eliminate the risk of systemic threats.

Increased international supervisory coordination and collaboration has taken a variety of forms. A key initiative to increase coordination is the IAIS Supervisory Forum, which the NAIC chairs. The objective of this forum is to strengthen insurance supervision and to foster convergence of supervisory practices through exchange of real-world experiences. The work of this group will also contribute to the development and operationalization of ComFrame.

U.S. regulators also participate in supervisory colleges; forums for enhancing supervisory cooperation and coordination among international regulators relating to a specific insurance group. U.S. and international regulators are in the process of developing best practices for participating in these discussions, including guidance on the coordination and communication of information to cross-border and other functional regulators and through international roundtables.

Beyond these formal structures and tools, increased collaboration hinges on establishing trust and relationships among regulators. To help foster such an environment, the NAIC engages in recurring regulator-to-regulator dialogues with representatives from the EU, North America, China, Japan, Switzerland, and other jurisdictions around the world. We also participate in similar international dialogues with our fellow U.S. financial regulators and agencies, such as the Treasury Department, Federal Reserve, and the Securities and Exchange Commission. We provide technical assistance to foreign regulators in the form of training, and have hosted more than 143 foreign insurance regulators from 24 countries in our International Fellows program. Furthermore, we recently provided training to Thai regulators on the importance of data to perform automated financial analysis on the solvency of the insurance industry, and to South Korean regulators to help them identify and prevent insurance fraud. We also have conducted similar training here in the U.S. for Armenian regulators, coordinating with the Treasury Department's Financial Crimes Enforcement Network and the Federal Bureau of Investigation. These efforts promote best practices abroad and are critical as U.S. insurers branch into new markets.

Just last week, a delegation of state insurance regulators, NAIC staff, and a representative of the Federal Insurance Office traveled to Frankfurt, Germany to engage European counterparts on international regulatory issues. The dialogue was especially timely as the European Union (EU) and the U.S. both continue to modernize insurance regulation; Europe through Solvency II, and the United States through our Solvency Modernization Initiative (SMI). Together, the U.S. and the EU oversee more than 70 percent of the global insurance market. Last week's agenda included discussions on regulatory developments, Solvency II implementation and U.S. equivalence, and the process for designating global systemically important financial institutions (G-SIFIs). Both sides agreed that this continued engagement was critical and further agreed to establish joint working groups to resolve various technical issues before the next dialogue in early 2012.

In particular, I would like to highlight our discussions on equivalence. The Solvency II initiative requires an assessment of "third countries" to determine if their levels of solvency supervision are equivalent to Solvency II, notwithstanding that Solvency II is still a few years away from being operational. To the extent that Europe does not find our system of supervision equivalent, it could have negative implications on U.S. insurers doing business in Europe and European insurers doing business in the U.S. Europe is committed to assessing other jurisdictions on an outcomes basis, where they review the overall objective of protecting policyholders and ensuring strong solvency oversight, rather than requiring adoption of Solvency II itself. Although the U.S. insurance regulators do not intend to implement Solvency II in the states, and there are clear differences between the regulatory and legal structure of our markets, we do believe that our system of supervision is at least equivalent to Solvency II on an outcomes basis. The IMF assessment of our system and the performance of our market relative to other sectors during the financial crisis reinforce this view. We strongly encouraged our European colleagues to review our system on an outcomes basis and find our system equivalent to avoid any disruptions in the transatlantic insurance market.

Domestic Improvements to Insurance Regulation

Representatives from the NAIC have frequently testified before Congress on our continuing efforts to improve the state-based system of regulation. While this work was underway well before the financial crisis, that event certainly underscored a need for state insurance regulators to enhance and improve policies and processes in a number of areas.

In June 2008, state insurance regulators commenced the Solvency Modernization Initiative (SMI); a critical self-examination of the U.S. insurance solvency system. While the existing system helped protect the relative stability of the insurance sector during the financial crisis, no regulatory system can remain stagnant in a world of constant change. The SMI project is focused on several major areas: (1) group supervision; (2) capital requirements; (3) governance and risk management; (4) accounting and financial reporting; and (5) reinsurance. Under SMI, we are examining international developments regarding insurance supervision, banking supervision, and international accounting standards in order to consider their use in U.S. insurance regulation. We believe that, ultimately, this open and transparent process will drive changes to our overall regulatory system. We must learn from international developments and collaborate where appropriate, but we cannot abdicate our responsibility for U.S. insurance consumers and companies.

One key area of focus for the SMI project has been enhancing our system of group supervision. Our experience with AIG taught us that we needed to increase our scrutiny of areas outside the regulated insurance company to better understand the risk that exists in other areas of the group.

Traditionally, insurance regulators have mainly focused on ring-fencing the insurance company to protect it from risk that exists in other parts of the group. While we still have an appreciation for the importance of these "walls," we also recognize the need to look through the "windows" to identify risks that could pose a contagion to the insurance company.

In December of last year, the NAIC adopted revisions to the *Insurance Holding Company System Model Act* and the *Insurance Holding Company System Model Regulation with Reporting Forms and Instructions*. These revisions are intended to provide regulators the ability to better assess the enterprise risk within a holding company system and its impact on an insurer within the group. Ultimately, this enhanced "windows and walls" approach should provide greater and much-needed breadth and scope to solvency regulation while maintaining the highest level of policyholder protection.

We are undertaking a comprehensive review of our risk-based capital requirements. We are also looking at incorporating a review of a firm's group capital assessment as a part of a requirement that firms conduct their "Own Risk and Solvency Assessment" (ORSA).

During the past two years, we have made significant changes in the way we assess risk and capital requirements for structured securities. The financial crisis revealed that insurance market participants and regulators overly relied on credit ratings issued by the Nationally Recognized Statistical Rating Organizations (NRSROs). In an effort to reduce our reliance on these rating agencies, the NAIC acted to more closely align the capital requirements for residential mortgage-backed securities (RMBS) and for commercial mortgage-backed securities (CMBS) with appropriate economic expectations. These two asset classes represent over $300 billion in carrying value of invested assets for the U.S. insurance industry.

The NAIC developed alternative methodologies for evaluating CMBS and RMBS investments, and the new process results in a more accurate reflection of the risk of loss for each specific insurer that is then mapped to a risk-based capital factor. At the conclusion of our most recent year of effort in this regard, the NAIC made available projected expected losses on a list of approximately 19,500 residential mortgage-backed securities and 5,200 commercial mortgage-backed securities to insurers, the Federal Reserve and other federal agencies. While the NAIC continues to use the NRSROs for other asset classes, our Valuation of Securities Task Force, as well as our Rating Agency Working Group, are monitoring these other asset classes to determine whether continued reliance is appropriate.

One concern for insurance regulators during the financial crisis was over securities lending activities by AIG; work that was separate from the non-insurance problems at the AIG Financial Products Division overseas. U.S. insurance regulators had discovered the change in AIG's management of the securities lending program in 2007 during a regular financial examination, and immediately began working with the company to wind down the activity and provide additional public disclosure of the structure and risks facing the program.

In the time since the AIG Securities Lending discovery, insurance regulators have taken a number of actions to ensure transparency in any such activities at insurance companies in the future. We improved the guidance for such activity in 2008, as well as annual financial statement disclosure requirements in order to obtain summary information on the duration of when related collateral is required to be returned to the counterparty. This allows regulators to more readily identify if an insurer's securities lending program could cause excessive liquidity strains under stressed scenarios. Furthermore, the NAIC adopted a new Schedule DL in 2010 to strengthen transparency in securities lending agreements utilized by insurers by requiring detailed disclosure of the program's collateral instruments.

Conclusion

While much work has been done to enhance insurance supervision over the past few years, regulating IAIGs through the creation of common standards and enhanced coordination is an area that regulators here and abroad will continue to focus on to ensure that approaches keep pace with the insurer business model. It is also equally critical that the uniqueness of that model be acknowledged internationally, since regulatory approaches used for other types of financial institutions may not be appropriate for insurance. We continue to refine our system, mindful of and engaged directly in developments abroad. Our goal is to constantly improve our system for the benefit of insurance companies and consumers. We have spent a tremendous amount of time and energy on these issues and will continue to do so in the coming months and years.

Thank you again for the opportunity to testify today. I would be happy to answer any questions.