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Remarks by Connecticut Insurance Commissioner Thomas B. Leonardi at The Geneva Association's Regulation and Supervision Seminar, 24 March 2014, Geneva, Switzerland

The financial crisis highlighted a number of weaknesses in the oversight of our financial system. During the crisis, we witnessed some institutions suffer from a high degree of leverage and insufficient capital, while others suffered from an inability to liquidate assets to settle obligations as quickly as they came due. Some companies suffered from all these symptoms, combined with an unhealthy dose of arrogance. The crisis in turn unleashed a whole host of regulatory initiatives, including: 1) the analysis of the causes of systemic risk and an attempt to identify companies that may pose systemic risk going forward; 2) the recognition that regulators and company management both need to have better tools to assess enterprise risk; 3) the nearly universal use of supervisory colleges to reduce any gaps in supervision; and 4) more recently, the decision to pursue group capital standards for large International Active insurance Groups (IAIGs).

In short, for the past five years, policymakers, regulators, and standard setters have been wrestling with how to ensure that we address the factors that led to the last crisis, without creating a supervisory approach that exacerbates or brings about the next one.

Which brings me to the question of global capital standards for large IAIGs. The feasibility of implementing a global standard broadly depends on its adaptability to the realities in our jurisdictions. For example, a regulatory system that allows a holding company discretion to move capital from a more conservatively regulated area, like insurance, to a more risky area like derivatives trading, may need a different regulatory approach than a system where there are clear legal walls to control such capital flows. In the United States, the authority of the state insurance regulator is a reflection of the decentralized, functional approach to regulation in the US, so any additional authorities or tools we seek to create must fit within this federalist framework, a framework that is a fundamental component of our system of government.

Now some of you may be surprised to hear me say that there are some valid arguments for a group capital standard…these include:

- First, having a uniform measure to assess the relative capital adequacy of IAIGs;
- Secondly, a group capital standard might be useful in assessing the capital adequacy of un-regulated entities, or entities that are not currently subject to capital rules;
- Third, it may provide a view on risk that reflects diversification across the group or, at the other end of the spectrum, that shows concentrations of risk within the group;
- And lastly, it could provide comfort that there is a cushion or buffer within the group to absorb losses.

Notwithstanding these points, as many of you know, I have often questioned the need to move forward aggressively with a Global Capital Standard (GCS) right now, for three key reasons:

- What's the problem we are trying to solve,

- How can you have a GCS without a Global Accounting standard; and
- There are different solvency regimes across the globe, and some are not fully implemented yet.

In addition to these points, we also need to be aware of other the potential pitfalls of group capital assessments: For example, in the US we regulate insurance on a legal entity basis. We expect insurers operating within our borders to meet US Risk Based Capital requirements as well as other solvency tests. If the liabilities are in the US, we expect the assets and capital that support the US business to be here as well. So one needs to be very careful about drawing conclusions from group capital assessments. Assets from US insurers may not be available to absorb losses in non-insurance parts of the group or in other jurisdictions for that matter. In most cases there is no legal obligation of the holding company to move money to a weak affiliate. Perhaps the strongest protection to the financial system and policyholders might well be that each legal entity, including the holding company, holds capital commensurate with its risks. But you can't always tell that from a consolidated group view.

We also need to keep in mind that the larger the size and scope of the group, the more difficult it is to develop meaningful capital standards. Do you develop capital standards for an electronic company? An auto company? A railroad? Or all the other activities that might be undertaken by affiliated entities that are part of a large insurance group?

Notwithstanding all of these questions, my colleagues at the NAIC and I continue to work with the international regulatory community in the hope of achieving an appropriate construct that does not harm companies or consumers, and we have devoted substantial resources to that effort. But we also need to be sure that as we move forward, we do so in a deliberate manner. We need to recognize that these are incredibly ambitious time frames. In fact, when I testified in Congress last month, I suggested that these time frames bordered on reckless. We are attempting to develop, test and implement a Backstop Capital Requirement (BCR) this year, the Higher Loss Absorbency (HLA) next year, and the GCS by year end 2016, and all of this while the Field Testing Task Force (FTTF) for Comframe (which includes testing the BCR, HLA and the GCS) is ongoing. We are not allowing time to take the lessons learned from the FTTF and incorporate those lessons into the BCR before moving headlong into the HLA. We have limited resources in many jurisdictions, and at the IAIS, to achieve this and so many other high priority initiatives.

Beyond the practicalities of implementing a capital standard remain the details of what exactly it includes. My good friend Gabrielle Bernardino delivered an important speech in Brussels a couple of weeks ago, and many on our side of the Atlantic, both from the US industry and regulatory communities, interpreted his words to mean that there must be one single capital standard worldwide, and that Solvency 2 should be that de facto international standard. I can appreciate Gabrielle's point of view and his desire to validate the system he and his colleagues have been diligently seeking to build. But for a global standard to have relevance beyond Europe, it must be implementable in the US and in emerging markets. It should raise the bar and foster compatibility and comparability across jurisdictions, without being unattainable or requiring Equivalence. Indeed, if the global capital standard is just a debate for the largest and most sophisticated markets, what then is the relevance of the IAIS on this issue if only 3 or 4 jurisdictions are capable or willing to meet the standard?

I cannot predict the outcome of the IAIS's work, but application of a global capital standard for insurance in the US, if we decide to go down that path, will require it to wrap cleanly around the legal entity standards that have served our industry and policyholders so well. It must acknowledge the walls that exist to protect policyholders, and the different accounting treatment that exists in the US. I know that many of our international colleagues do not understand or like the state-based system, but it works and has worked for more than 150 years. And yes the Fed will regulate two or three of the largest US-based IAIG's and a handful of insurance groups that own thrifts, but keep in mind that there are over 6000 other insurance companies in the US that will remain the sole province of state regulators. And the Fed, as the consolidated regulator of those few large companies, will still be working very closely with state regulators who are accountable to policyholders in the regulation of the very large domestic insurance legal entities that comprise those large groups.

I know I have said this on many occasions at international events, but many of my colleagues still seem to think that somehow the Federal Insurance Office, or the Fed, or some other federal agency, can make GCS or Comframe the law of the land in the US. They can't. When I met with President Obama in the Oval Office for nearly an hour back in November, he could not have been clearer in his unqualified support for our state based system of regulation. And a number of governors, including my boss, Governor Dan Malloy a Democrat from of CT, and Governor Terry Branstad, a Republican from Iowa, have expressed bilateral support for state regulation. You will likely be hearing vocal support from other Governors in the days ahead as well. This is an issue that both Democrats and Republicans, blue states and red states, are in strong agreement.

The bottom line is that currently, there are only two ways that these international standards can be adopted in the US: One is if Congress effectively repeals McCarron Ferguson, the Federal law, passed nearly 70 years ago, that cedes the authority to regulate insurance to the states. If you view the congressional hearing I referred to previously, you will know that there is no appetite in Congress to do that any time soon…in fact several of the questions from the committee members were focused on their concerns that we not abdicate our regulatory authority or our system that has worked so well for the past 150 years, to international standard setting bodies. That's not me saying it…that's members of the US Congress saying it. The second way in which international standards can be incorporated into the US insurance regulatory regime (again be it Comframe or GCS) is if a super majority of 42 state insurance regulators vote to support it, and then their state legislatures pass laws to codify it, and subsequently our governors agree to sign those measures. Without that broad level of support, they will not become law in the US, the world's largest insurance market.

So what we do need to do is find a practical and acceptable way to achieve global convergence in the long run, as opposed to pushing forward with suggested changes now that will not be adopted by several jurisdictions that regulate large sectors of the worldwide market. Thank you.