THE BROOKINGS INSTITUTION

GLOBAL INSURANCE REGULATORY DEVELOPMENTS AND THE IMPACTS ON U.S. CONSUMERS AND INSURERS

Washington, D.C.

Tuesday, October 14, 2014

Introduction:

MARTIN NEIL BAILY
Director and Senior Fellow, Initiative on Business and Public Policy
The Brookings Institution

THE INSURANCE INDUSTRY AND ITS REGULATION, POST-CRISIS:

Moderator:

MARTIN NEIL BAILY
Director and Senior Fellow, Initiative on Business and Public Policy
The Brookings Institution

Panelists:

SENATOR E. BENJAMIN NELSON
Chief Executive Officer
National Association of Insurance Commissioners

VIRAL ACHARYA
C.V. Starr Professor of Economics, Department of Finance
Stern School of Business, New York University

DAVID SAMPSON
President and Chief Executive Officer
Property Casualty Insurers Association of America

GLOBAL CAPITAL STANDARDS: IMPLICATIONS FOR THE U.S.:

Moderator:

DOUGLAS J. ELLIOTT
Fellow, Economic Studies
The Brookings Institution

Panelists:

MICHAEL F. CONSEDINE
Insurance Commissioner
Pennsylvania Insurance Department

SVEN GENTNER
Counselor, Economic and Financial Affairs Section
Delegation of the European Union to the United States

MARCUS STANLEY
Policy Director
Americans for Financial Reform

Concluding Remarks:

DOUGLAS J. ELLIOTT
Fellow, Economic Studies
The Brookings Institution

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P R O C E E D I N G S

MR. BAILY: I'm Martin Baily. Welcome to Brookings and this forum. I'm a senior fellow here at Brookings and the director of the Initiative on Business and Public Policy.

Today we are going to look at global insurance regulatory developments and the impacts on U.S. consumers and insurers. I think we should give to Doug Elliott who has done the lion's share of organizing this event, together with help from Brookings staff. The event today is made possible by a contribution to Brookings from the National Association of Insurance Commissioners. This is the organization that represents insurance regulators in each state. As you know, Brookings prides itself on its independence, and we organize our forums to encourage a diversity of opinions, and we encourage everyone in today's events to express their own views without restriction.

I just want to give a personal note to let the audience know that I have served for about 10 years on the Board of the Phoenix Companies and Insurance and Asset Management Company. Any remarks that I make today will be my own views and not those of Phoenix.

Although the worst of the financial crisis is behind us, we're still very much in the process of creating and absorbing the new regulatory framework. Now, I wrote that sentence and then I reflected a little bit on the rather precarious state of the global economy and the Euro area specifically, so maybe I should have said, hopefully, the worst of the financial crisis is over. Certainly, the situation in the U.S. economy has improved greatly.

The insurance industry today does face a challenging environment. Traditionally, life insurers have invested in bond portfolios whose maturity is pretty well matched to the structure of their liabilities. Whole life policies have been attractive to consumers in part as a way of passing on wealth to their heirs, but interest rates have been so low for so long that this business is now a tough one to be in. In Germany, interest rates have been even lower than those here, and insurance regulators have, at least for a time, required payout rates to policyholders that are higher than the insurance companies can earn on their bond portfolios.

The property and casualty industry faces its own challenges. Whatever your views on the causes of climate change, it appears that an increased number of large-loss events are taking place, and that number may rise as sea levels rise. As well as natural events, the danger of terrorist attacks has increased.

Insurance is a vital industry to the health of the U.S. economy and the global economy. It has been highly regulated here in the U.S. for a long time with most of the regulation done at the state level. Going forward, what are the right roles for federal and state regulators? What is the case for and against SIFI designation for large insurance companies? And how is the industry being affected by new global capital standards? What will the industry look like in the future?

We are fortunate in having two outstanding panels to discuss these and other issues today. The format is that each panelist will make remarks lasting about 10 minutes, and this will be followed by a group or panel discussion and questions from the audience. I'll moderate the first of those. Doug will introduce and moderate the second.

Our speakers are lined up in alphabetical order, so I'll give briefly their bios in that order. I think you have the more expanded bios available.

Viral Acharya is the C.V. Starr Professor of Economics in the Department of Finance at New York University's Stern School of Business. He is the program director for financial economics and a research affiliate at the Center for Economic Policy Research and a research associate of the National Bureau of Economic Research. Viral completed his Bachelor of Technology in Computer Science and Engineering from the Indian Institute of Technology, and his Ph.D. in Finance from the Stern School.

Senator Ben Nelson became chief executive officer of the National Association of Insurance Commissioners in January of 2013. Prior to this appointment, Senator Nelson served two terms in the U.S. Senate representing the State of Nebraska from 2001 to 2013. Earlier in his career, Senator Nelson was governor of Nebraska. In 1994, he became the first Nebraska governor to be elected to a second term in two decades. Senator Nelson has extensive experience in the insurance sector and started his career in insurance law. He served as CEO of the Central National Insurance Group, as chief of staff and executive vice president of the NAIC, and as director as the Nebraska Department of Insurance. Senator Nelson earned his bachelor's, master's, and law degrees all from the University of Nebraska.

David Sampson is the president and chief executive officer of the Property Casualty Insurance Association of America, which represents more than a thousand homeowners, auto, and business insurance companies that write 39 percent of the nation's property and casualty insurance. He was named to the Insurance Newscast list of the 100 Most Powerful People in the insurance industry. Previously, David Sampson served in Governor George W. Bush's administration as chair of the Texas Council on Workforce and economic competitiveness, and vice chair of the Texas Strategic Economic Development Planning Commission. He also led the Arlington, Texas Chamber of Commerce as the president's chief executive officer. Sampson is a graduate of David Lipscomb University and earned his doctorate at Abilene Christian University.

All right. So we'll start with Viral. Thank you.

MR. ACHARYA: Thank you, Martin. And thank you, Doug, for inviting me to be giving some remarks on whether the insurance sector is systemically important, systemically risky. Much of what I say is based on some joint work I've been doing with my colleagues at NYU Stern. Notably, Matt Richardson. In fact, there's a book coming out of NYU Stern called *Modernizing Insurance Regulation*, and some of the things I'm going to talk about today are from a chapter based in it.

I just wanted to offer -- I have three things to say. First, I wanted to give you my sense of what is systemic risk. Two, why on many measures of systemic risk the insurance sector looks comparable to the banking sector. And three, even if one gives some credence to the argument that the insurance sector is different, why there are three recent trends in the insurance sector that make me pause when someone says that the insurance sector is not systemically risky like banks. So those are the three things hopefully I can accomplish.

So what is systemic risk? There are two views of systemic risk. One is the domino view, which is that when a large firm fails, it's going to bring about failure of a large number of other firms. So this view, the contagion view as I call this, the micro prudential view, it's focused on one entity failing causing a contagion. And most people would argue that based on the very narrow definition of systemic risk, it doesn’t seem that individual insurance firms are really systemic. They are not that tightly connected to bring about a domino effect.

But there's another view of systemic risk, which is what I like to call a tsunami view, which is that you get hit by a 30 percent house price decline in the country, there are losses all across, and now it doesn't matter whether you cause someone else to topple or not; if all of you get into trouble at the same time or get swept away by the tsunami, it's a catastrophe at large because all the intermediation comes to a halt.

Now, these two views are not necessarily separate from each other. The second view I like to think of as a more macro view rather than an individual entity view. In fact, the macro view can amplify the micro view, which is that if you have a large firm, a connected firm failing when there is a tsunami, it's going to be much worse. The domino effect is much worse. But what is important is to recognize that contagion can arise without actually interconnectedness, without an entity being connected to other entities.

So let me give you one example that I think would be relevant for the insurance sector. So let's say you are in fall of 2008. A lot of insurance balance sheets are not doing great. Many of them are lining up in TARP to get capital from the government, and at this point essentially -- just think for the time being that the government support is not coming in. So the insurance sector is bleeding, they are not buying the corporate bonds in the market at the right prices. They need very depressed prices in order to provide intermediation to the corporate sector.

Now, firms like GE Capital or others that are very reliant on bond market financing, suddenly seeing that even for a very high rating the yields on the bonds are going to be very high, are now going to turn to their lines of credit and start drawing them down from the banks. So what seems like -- it seems like on the face of it the insurance sector is not connected to anything, but everything in financial plumbing is connected to each other. If you don't get your funding here, you're going to go and seek it somewhere else. So if you can't issue bonds in the market at the right price, you're going to start drawing down on the lines of credit from the banks. So if the insurance sector is depleted of capital, there's going to be an immediate withdrawal of lines of credit and that's going to be a liquidity and capital drain on the bank balance sheet.

So I think just the fact that there is no explicit interconnection from the insurance sector to the rest of the plumbing in the economy is not in my opinion a good enough argument to argue that for the insurance sector functions in the vacuum out there.

Now, let me mention -- come to the second point, which is that when we study systemic risk in academia and everyone has their different measures, you know, you need to use a metric in order to quantify systemic risk otherwise you can see everything is systemic or you can always come up with exceptions to say nothing is systemic out there in the world. Someone has to discipline oneself.

So we recalculate it and measure it, and (inaudible) Stern call S risk. And what do we estimate? I won't bore you with a lot of detail, but essentially, we try to estimate if there is a global market correction of 40 percent over the next six months, and let's hope that's not going to happen as Martin just suggested, but suppose there was just a correction, we try to estimate would a financial firm's balance sheet look as healthy as that of JPMorgan or HSBC in fall of 2008? Would you still have 8 percent market equity relative to your non-equity liabilities?

And if you don't, recalculate how much are you short by. How much capital are you short by in meeting this threshold requirement. And when we look at this metric, we call it S risk, systemic risk contribution of an individual firm, then when we look at this metric we find that the insurance sector really doesn't seem that different from the banking sector.

So I'm going to go through a few graphs quickly. But let me just explain what are the two key ingredients of this measure. Of course, I need to know, if there's an aggregate correct of 40 percent, how much is the insurance firm's equity or a bank's equity going to lose value by? So that's like an exposure to the downside risk of the market. If you want, it's like a downside beater. Statistically, one uses a concept called marginal expected shortfall, but just call it downside market exposure.

And the second thing, I need to know where is your market equity today relative to the book value of liabilities? Because book value is what you need to meet. Your market value of equity is what you can raise in the market, whether you like it or not. If you're going to lose your market equity, your capacity to raise funding in the market is diminished.

So when we look at these top five in the banking and the top five insurers, then usually when we look at our top 10 in the United States, it's always split up as five banks/bank holding companies and five insurers. We always have five insurers figuring in our top 10. And they are listed over here. And in fact, MetLife improved in terms of their capital shortfall to this massive global correction. They sort of look on the same ballpark as JPMorgan or Bank of America, about 353 or 343 billion -- sorry $35 and $34 billion. And in case of Bank of America and JPMorgan, it's $44 and $47 billion. So similar ballpark numbers.

Now, if you look at the time CDs of this capital shortfall trajectory, the top two lines are Met and Pru, and you can just focus on those since they are the somewhat bigger numbers. You can see that since fall of 2008, somewhat surprisingly, the capital shortfall estimates for MetLife and Prudential have actually been rising; whereas, in contrast, if you look at the banking sector, it hovers up and down for a while, but especially in the last two, three years, there's a steady decline in this estimate of the capital shortfall that we would see.

Now, you can break this up further into the two measures, the leverage and the downside risk, and we find that neither has the downside risk of the insurance sector come down as much, nor have their book liabilities relative to the market value of equity.

I'm going to skip some of these things. You can see them in the presentation if you want to see.

So the questions that I come up with when I look at this thermometer of the systemic risk of the financial sector and I see insurance firms actually rising in their risk rather than declining, I ask myself the following question. Why did market values of insurance firms go up so much in the fall of 2008? Why did some of these firms need TARP? If these firms are so capital-secure, if their assets and liabilities are so well matched that no one really needs to worry about the risks, how come the market values of equity just collapsed completely? Why are the downside risk estimates of insurance firms as high as those of banks and bank holding companies? Why were insurance firms owning banks, making guaranteed financial products? First, I'm referring to MetLife and its Met Bank making guaranteed financial products. I'm referring to Hartford selling CDS. I'm referring to AIG financial products. And I think most disturbingly, why does the capital shortfall for MetLife and Prudential show an increase post-2010 than banks are actually deleveraging? The thermometer seems to be dipping down in terms of the reading for banks whereas it seems to be rising for the insurance sector.

Now, the usual counterargument over the insurance sector's liabilities are very stable. But the flipside of that is that if the liabilities are more stable, won't they take advantage of that and keep less equity on their balance sheet relative to others? And this is sort of the reason why I think that their liabilities are much higher compared to the market value of equity right now than their banks. And I think if the market values collapse, as they did in fall of 2008, won't they actually seize from the corporate bond market and the academic evidence does seem to suggest that the prices of bonds were indeed affected if an insurance firm that was a big player or a big holder in that bond actually had significant capital shock during this time.

Now, let me come to my third point, last set of points. So let's leave all that aside and let's just try and understand what has the insurance sector been doing in the last five years? So I'm going to talk about three academic studies, and the reason why I've picked these is because they have not been as widely appreciated. I think they're trying to say something very important, but they've just not hit the policymaking discussion as much.

So first is a study by Bo Becker and Victoria Ivashina. It's a Harvard Business School working paper. And what they find is that the insurance firms have been systematically searching for (inaudible) in the corporate bond holdings. And the way they studied this is to see within a rating class you can look at bonds of different risk categories. So within say an AA or AAA or BBB rating class -- so you can look at NAIC rating class -- you can look at the bonds that are the safest and you can look at the bonds that are the riskiest.

And what do you find? So here is an example of bonds which have -- so in each category -- so these are by NAIC categories -- within each rating category there are further four subcategories. The rightmost has the highest probability of a downgrade. And when you repeat this year after year into holdings of insurance sector, what you find is that they are systematically skewed at the edge of the ratings. They are always going for the highest risk bonds within each particular rating class. In fact, the study is quite serious. It shows that if you looked at the exposed performance of that category of bonds, there's no evidence that these bonds delivered a higher return; it's just higher risk as these downgrade probabilities seem to suggest.

You find exactly the same evidence on the upgrades. This essentially looks like regulatory arbitrage in a world in which capital requirements are based on ratings. In industry, the term I've heard in banks is called capital efficiency. We are trying to run it as minimal regulatory capital as possible while maximizing our return on the other side. If you are on the other side, I call it regulatory arbitrage, which is that ratings are imperfect, so you want to seek as much risk as you can, given what the regulators allow you to do.

Now, what is interesting is that this phenomenon of searching for real is stronger in economic expansions and it's engaged in more by those insurance firms which are closer to meeting the regulatory capital requirements and surplus calculations. So this evidence is very similar to banks. This is exactly what people have documented banks to be doing. They are always eating at the corners of capital requirements in any way possible.

The second piece of evidence, and this is perhaps maybe more disturbing than the first one. So in another paper, Ralph Koijen and Motohiro Yogo -- this is a Federal Reserve Bank of Minneapolis working paper -- what they document systematically is that insurance firms have been finding ways to park their liabilities into off-balance sheet vehicles. And how does this take place? Enron did this, banks did this into off-balance sheet conduits, and the insurance sector has been doing this as well.

How do they do this? You essentially set up an affiliated reinsurance company. So technically we think of reinsurance as when an insurance sells its liabilities to someone else outside of its balance sheet. But here they set up an affiliated off-balance sheet which in some senses and organizationally is really within the original parent company, but the risks are all parked into this off-balance sheet vehicle which is much likely regulated. How do you get it to be likely regulated? It's the same trick as banks use. You organize this vehicle in a setting where capital requirements are light. So you do it in South Carolina or in Vermont, or you do it in the Cayman Islands or somewhere else.

Now, why is this important? So just to give you a sense, MetLife owns an affiliated firm that reinsurances MetLife. It seems sort of paradoxical but that is exactly what the economic contract here is. So there is no risk transferred here because it's all MetLife's risk. But you must be doing it then for something else, and what is that something else? It's for capital relief. This activity has grown from $11 billion in 2002 to $363 billion in 2012. This is the off-balance sheet parking of liabilities. And the A.M. Best ratings, while giving ratings to individual insurance firms don't take into account these off-balance sheet liabilities. So the study shows that if these off-balance sheet liabilities were taken into account, many ratings would get corrected by three notches if A.M. Best took account of these extra liabilities.

So it looks a lot like how banks got into problems; setting up balance sheet liabilities actually being more levered than what the regulators -- regulatory capital requirements are. And in fact, the study does something interesting. It says that suppose take only the on balance sheet liabilities and calculated expected losses to stay at guarantee funds, and instead, take into account these off-balance sheet liabilities, you would come up with a number that's higher by $15 billion.

So there's something strange going on here. You can see this graph. This is the affiliated reinsurance versus unaffiliated, which is flat. Most of the reinsurance is taking place -- the increase is taking place through affiliated (inaudible) so it's not really reinsurance. It's there in life insurance as well as annuity reinsurance, and even as a function of the capital base of these companies, this activity is on the rise.

And the very last piece of evidence, and I think this is the most disturbing to me overall, this is a paper by Bo Becker and Marcus Opp. This is a University of Berkeley Haas working paper. And if you talk to industry -- so after I saw this paper, I spoke to some people in the structured bonds market. You know, someone at Citibank, for example. And he said, "Yes, this was the biggest thing that happened in the structured bond market -- structured MBS market."

Let me tell you what this is. There was a change in the capital treatment for insurance firms in 2009 that practically allowed the insurance sector to invest in riskier residential mortgage-backed securities without any increase in the capital requirement. So until 2009, there was a ratings-based capital requirement. If you went into a lower rated RMBS holding, you were to hold more capital. But something happened in 2009; I'll explain it in detail, which is that first, there was a movement away from ratings to expected loss calculations by PIMCO and Black Rock. But more importantly, the capital calculations started being based on the book value of asset rather than on the risk. So in a normal time market, if you just buy a bond and record it at the price that you bought, you are to essentially hold no further capital in order to keep this RMBS on the market.

Now, what is somewhat peculiar about this capital relief is that this capital relief was provided only for residential mortgage-backed security and for no other asset class. So it's not like there's any economic justification for doing this. This happens only in the residential MBS.

So what do I mean by this capital relief? So the yellow line shows you what would have been the pre-2009 calculation of capital requirements. So that's the risk-based capital requirement. The black line is what the new capital requirement is. And when you're moving from left to right, you are basically seeing, given the new RMBS that are being purchased, is that any change in your capital calculation.

Now, you can see this relief is entirely in the RMBS with no relief in CMBS, government bonds, et cetera. And what is most peculiar is the second point, which is that on the top here you see the share of different asset classes held by investment, by insurance firms, which are investment grade. So the circles are mortgage-backed securities, crosses are other asset-backed securities, triangles are corporate bonds, and squares are municipal bonds. And each line shows you within that asset category what fraction of the asset held by the insurance sector is investment grade.

And what you see in 2010, there is a regime shift in the RMBS holdings of the insurance sector, which is that in 2009-2010, the share of investment grade mortgage-backed security tranches (RMBS) falls from 94 percent to 46.4 percent within a year and it's steady there. Essentially, they have swapped 50 percent of their RMBS into noninvestment grade category. And the reason why this is happening is, of course, the previous graph, because the capital requirements are flat and not subject to the fact that because you are investing to subinvestment grade, you should have actually been subject to a higher capital holding on your balance sheet.

So this worries me a lot because it looks like a capital relief. Maybe this could be justified in 2009. I'm not sure why, because there was already TARP money that was provided to the troubled insurance sector, but this is a capital relief. It amounts to over $15 billion in terms of capital freed up on their balance sheet, but I don't see why this should be permanent. Why is this nonrisk sensitivity to assets that you hold a permanent feature of deregulation of the insurance sector?

So let me wrap up. In conclusion, I think it's fair to say that the jury is still out on whether insurance firms are systemically risky or not. However, the historical behavior of the risk matrix that I showed you and the current behavior in terms of the capital treatment and the risk-seeking strategies of the insurance sector don't give us the confidence that they are not SIFI candidates. In fact, my sense is that this behavior of capital relief and risk seeking looks exactly like what was happening to banks in the pre-2007 era. In fact, there's this one interesting quote which was done when the 2009 capital relief was introduced by the NAIC that, "They take one class of securities and change the rules to give insurers capital relief. Let's just hope they aren't picking something out that results in inadequate capital."

So in my view, I still think that the large insurance firms should be under the purview of something beyond just the insurance sector. I think something like FSOC or the SIFI classification is a good way of ensuring that there aren't leakages there. I kind of have this quote that I always give whenever someone says that we can regulate ourselves, which is that "self-regulation is to regulation as self-importance is to importance."

Let me stop there. Thanks.

(Applause)

MR. NELSON: First of all, I want to thank you all for the opportunity to be here today, and thank you for the kind welcome. It's an honor to be involved with such a distinguished panel. I look forward to continuing the lively discussion on a number of issues that we'll be facing.

When we talk about the insurance industry in a global context, it's easy to think of the U.S. as just another seat at the table. But that limited view belies our strength, size, and experience. U.S. states make up more than 24 of the world's largest 50 largest insurance markets, and we have nearly a third of the global market share of premium. U.S. consumers pay more than $1.8 trillion per year on insurance, and regulators monitor more than $8 trillion in insurer assets.

The bottom line for the work of the National Association of Insurance Commissioners, and ultimately my responsibility as CEO is to ensure that state regulators have the resources, information, and tools they need to regulate this exceedingly complex marketplace and safeguard consumers should we experience another financial crisis.

Now, we're not short on resources. Both at the NAIC and in individual state insurance departments. A vast network supports the 56 chief state and territorial insurance commissioners with nearly 12,000 skilled regulators nationwide, and 470 NAIC staff, all working individually, and collectively as well, to protect policyholders.

As for information, the NAIC is home to the world's largest insurance financial database. The IMF has called our data collection analysis world-leading. Regulators have access to the most sophisticated financial information available anywhere to support their departments.

And as for the tools, our regulators have more than a toolbox. Each state is home to a veritable workshop. Regulators monitor insurers' compliance with laws and regulation, and a company's financial condition, through solvency, surveillance, and examination mechanisms.

This system served us well in 2008, when other areas of the financial system nearly collapsed. And since then, we've only continued to advance. Since the financial crisis, we've undertaken and completed many modernization initiatives, including enhancements to our supervision of groups through broader assessment procedures, establishing supervisory colleges for all U.S.-based international firms, implementing new processes surrounding collateral requirements for foreign insurers, new reporting for securities' lending activities, and better methods for assessing corporate governance practices of insurers.

State insurance regulation works because it is specific to the industry's unique risks. States are able to evaluate specific company risk with different methods for life, health, and property and casualty insurance, giving difference to unique demographic and geographic factors.

Unfortunately, some in the U.S. and overseas, who don't understand or appreciate the sophistication of our system, seek to overhaul the current structure.

Proposals include adding burdensome and costly layers of regulation while stripping away the flexibly that has served consumers in the industry so well. As we have seen with the Financial Stability Oversight Council (FSOC), those regulators with banking expertise and experience are treating large insurers like banks. As the old saying goes, "If all you have is a hammer, everything looks like a nail."

Now, it's not surprising that the bulk of regulators on the council are treating all financial companies the same. But they do so to the detriment of a system that has proven to be effective. This kind of homogenous approach may actually encourage questionable investment risk-taking in the industry.

For example, consider a life insurance company that invests primarily in fixed income securities to generate the predictable cash flows the firm needs to pay benefits. Under state insurance regulations, the company would hold less capital for top-rated corporate bonds and more capital for high-yield bonds with a risky rate of return. But under bank capital rules, all corporate bonds receive the same risk weight regardless of credit quality, thereby incentivizing risky behavior. That is just one example of how a lack of understanding of the state-based regulatory structure could hurt consumers.

Insurance regulation is evolutionary as well. I'm not suggesting we shouldn't look to new models and methods and best practices or add to our regulatory regime when warranted. What I am saying though, and I feel strongly about this, is that our changes to our system should originate with the state regulators and legislators to ensure that those changes fit within the existing framework and don't add unnecessary cost or confusion. Every decision made by regulators through the NAIC goes through rigorous analysis and debate. Our process includes consumer representatives, stakeholders, interested parties, and policymakers to weigh in as well. Changes are vetted thoroughly to ensure that they're in the best interest of the U.S. consumers and marketplace.

Policymakers, standard setters, and other financial regulators would be well advised to learn not only from the failings during the 2008 crisis, but from the success stories as well.

Thank you.

(Applause)

MR. SAMPSON: Thanks to Brookings for the invitation to be here today.

I want to make clear that PCI, we represent the property casualty insurers. There is another trade that represents the life insurers. So most of my comments are going to be focused around the property and casualty industry. And I think if you look back over the last two decades in the U.S., we faced down catastrophic terrorism, a collapse of the housing and financial markets, record hurricanes and floods, and boom and bust economic cycles. And throughout these challenges one thing has remained constant. The presence of the property and casualty industry to be there to pay for those claims throughout all of that combination of catastrophes, and also the robust competitiveness of the U.S. property and casualty insurance industry.

If you watch TV at all, you probably see just how competitive the property and casualty industry is. It's a very diverse, many actors, national players, international players, but also a number of niche and single state riders. In fact, with all the new risk-linked securities coming into the sector, with the world in turmoil, there has been a capital flight to the safe harbor of the home, auto, and business market.

So I think there is broad agreement that the "too big to fail" regulation that led up to the financial crisis in the banking industry clearly failed. Which makes it a bit ironic that many of the same global leaders are now trying to graft bank holding company type regulation onto insurance, replacing decades of success in policyholder protection with a misplaced "one size fits all" bank regulatory template. And what perhaps is even more ironic is that as demonstrated by PCI's quarterly industry survey, both property casualty surplus and premium to surplus rations are at record levels for our sector. In the case of premium to surplus or property casualty surplus, up 47 percent since the beginning of the financial crisis, I think clearly underscoring that there is no legitimate capital deficiency that the new regulatory proposals are trying to solve. And yet calls for radical reforms have never been greater.

Most of these calls are not for necessarily a centralized regulatory system that works better in recognizing different business models and approaches, but rather as Senator Nelson referred to, add on of a secondary or tertiary layers of federal or international standards for holding company regulation beyond our current consumer-focused legal entity oversight system.

Before we rush headlong into a political agreement on the supposedly inevitable globalization of a secondary or a tertiary layer of insurance regulatory standards, I think we need to ask the question, "What is it exactly that we're trying to solve here? What is the problem that we're trying to solve?" And secondly, does the proposed solution offer the best cost-benefit value to consumers?

Now, I would say that in response to these questions, I think the U.S. Congress has expressed a great deal of skepticism on a bipartisan basis. Over the last six months, there have been a number of bipartisan letters, hearings, and legislation introduced, and I expect that the congressional and marketplace opposition will grow much stronger next year as the IAIS tries to marginalize public scrutiny and participation in its deliberations, a process that would never be tolerated in a U.S. domestic regulatory body.

So the U.S. regulatory system I think has proven effective at protecting consumers and encouraging competition for nearly 150 years now. It is a system that is evolving and improving, I think primarily because it is accountable, it is transparent, and it is governed by the rule of law. Inherent in the notion of competitive markets and capitalism is the possibility of failure. We cannot be so risk averse that we try to design a system to eliminate the possibility of failure altogether; rather, policymakers should strive to develop regulatory controls that make the consequences of failure manageable. And in the U.S. that looks like the state regulation of legal insurance entities to protect policyholders, while I recognize that in other sectors or in other countries there is a cultural or economic imperative to protect broader groups of stakeholders, and imperative to prevent failure altogether.

Too often in global convergence discussions, the post-crisis effort to increase oversight of systemically important companies has bled far beyond that justification with little consideration of the ultimate cost to consumers in creating solutions in search of a problem.

Now, PCI supports efforts by the U.S., Europe, and other global leaders to work towards mutual recognition of each other's systems and explore how regulatory systems can be harmonized and streamlined. But I would suggest we need to thoroughly reach consensus about the underlying goal and solution before taking a set of rules from one regulatory segment and imposing it on another, which would be like mandating the same power cords in the U.S. and Europe when the underlying electric voltages are different. Other sectors, or other countries' regulatory systems may very well work for their marketplace, but not necessarily be suited to the U.S. marketplace, nor do they reflect our commitment to competitiveness, to transparent proceedings governed by the rule of law in an open administrative process, and to the ultimate benefit of consumers as is illustrated by our guarantee fund system in the U.S. So the best regulatory regime for one sector or country may not be the best for another, just as the best competitive model and structure for one insurance company may not be the same business model for all insurance companies. A greater role for federal and international organizations, I think, threatens the creation of new layers of regulation on top of the state's existing regulatory architecture, and that all adds potential additional cost to consumers.

So in summary, with respect to global regulatory convergence, while we welcome the efforts by the states, the federal government, and international leaders to improve regulatory harmony and mutual recognition, I would just caution that regulatory sameness, rather than harmony, is not an intrinsically desirable goal and may even enhance systemic risk.

As I was preparing my comments for today, I read an op-ed in yesterday's *Wall Street Journal* in which the author cited Nobel economics laureate Friedrich Hayek's warning about the pretense of knowledge, the idea that anyone could know enough to engineer complex societies successfully. And in all such endeavors, such as moving toward global regulatory convergence, I would suggest a little humility is appropriate. Or as Hayek warned, "We shall not grow wiser before we learn that much we have done was very foolish."

Thank you very much.

(Applause)

MR. BAILY: Okay. Mics are on. All right. Let me just, in the order in which you spoke, let me try a question here.

Viral, you painted a picture in which insurance companies are sort of using regulatory arbitrage in order to take on more risk, and that seems to be very much in contrast with what your fellow panel members indicated. So let me ask you first of all, are you seeing any consequences of that actual risk in terms of default rates in the assets? Or is this something that you think is sort of over the horizon that we're likely to get? How dangerous is the situation that you're looking at?

MR. ACHARYA: So I think that's a great question.

You know, the second part of my talk was trying to understand why is it that when we do these risk calculations, why are MetLife and Pru, for example, significantly exposed to the downside risk of the economy? And of course, you know, that metric that I showed is a very aggregate metric at the level of the insurance firms. So to believe it, one would really like to understand what is it that's going on in the balance sheet that might actually be causing this to be the case? And when I saw these studies, they are potentially providing an answer. One would have to do the analysis to really confirm this, but my conjecture is that based on what I've seen in the discussions from Citigroup structured products advisors that the insurance sector, since 2010, has become the buyer of last resort for subinvestment grade RMBS. Structured products are close to 20 percent of their balance sheet. It’s not small. It's next in the total size only to the corporate bond holdings. And I'm stunned by the fact that just for that particular asset class there is this capital relief, and I think I agree with the senator that the corporate bonds would actually have a risk-based corporate rating. But then I'm surprised. Why is that not the case for RMBS? Why is that particular asset class treated such that the capital requirement is essentially flat regardless of the risk? And I'm concerned that such permanent deviations in capital requirements from what is economically a sound principal, that capital requirements should be higher for a riskier asset, producer a concentration of a particular asset class on the balance sheet of a sector which, in my opinion, means that the insurance sector is much more exposed to housing sector risk than it was in the period prior to 2009. Because prior to 2009, as I showed, 95 percent of the structured product holdings were of investment grade RMBS. Now only 50 percent of them are investment grade RMBS. It's going to take a much lower housing market shock to produce losses to the insurance sector balance sheets. And I think that is what the risk metrics are picking up. We haven't seen this loss thankfully in the United States, but I think this is exactly the job of FSOC in my view, which is to understand if there's an aggregate market correction, how is that going to produce a significant or damage to some parts of the balance sheet?

Now, I would be the last person to say that we need everything to be done at the federal level, we need everything to be done in a centralized manner rather than a decentralized manner, but the concern I have is that the secular housing market correct and its fallout is something that is primarily going to be born as a social cost at the federal level. State guaranty funds simply cannot meet the failure of MetLife. I think this is a federal problem. MetLife cannot be supported through individual state guaranty fund contributions. And so I think this is a federal problem. It's a federal taxpayer liability, and I think it must be dealt with in terms of risk control at the federal level.

MR. BAILY: So let me throw that to you, Senator Nelson. Do you agree that the state regulatory system cannot support a failure of the scale of a company as large as MetLife or Pru?

MR. NELSON: Well, I guess I would answer it this way. I don't think we expected that to occur. So let's go back to what Viral is mentioning here in terms of the use of captives off-balance sheet reserves. We've already undertaken at the NAIC, and the states are working very diligently on principle-based reserving to move away from (inaudible) reserving, which has contributed significantly to laying off reserves from balance sheet through captives. The risk doesn't go away necessarily, but because of the captive situation.

On the other hand, with what's being done at the present time to develop a principle-based reserving system, you are going to see, I think, less use of the captives. I don't think you'll see off-balance sheet reserving, and what you'll see is reserving that's based on risk within the company's risks as opposed to a formula that's sort of a "one size fits all" formula for setting reserves. So he's pointed out an anomaly that is being worked on right now and I think will be corrected, and can be corrected at the state level.

Now, the guaranty funds are there to protect against the loss of an insurer. I don't think even Viral would contemplate that somehow Met or Prudential is all going to go down, or if there is this tsunami, that it certainly wouldn’t be limited to the insurance industry. It would have a greater effect than that, and the problems would be larger than whether or not a guaranty fund works at a particular point in time if we're looking at a tsunami.

So the system works. It has worked. 2008 showed that even in the case of AIG, which was not an insurance failure but a thrift failure at the holding company level, which was regulated by the Office of Thrift Supervision I think it was called. It's now been absorbed in another way. So if you take a look at what worked during the worst financial crisis since the Great Depression, the industry was really, I think, well regulated by state-based regulators and that it survived in the companies of AIG because of the walled-off assets and the lack of fungibility of assets to take out the assets and move them around, the companies survived. And so it wasn't an insurance failure; it was an AIG failure. So I think what we need to do is look more at the reality of how regulation has worked over all these years. It might be 140 to 150 years old, but it doesn't use techniques from those days. It is modern, dynamic, moving forward daily, modernizing with best practices being absorbed all the time.

MR. BAILY: So let me turn to you, David.

You say that having federal regulation involved will add another layer of cost, and I understand that. We don't want to have everything be too much regulation, too much bureaucracy. But when you're talking about really large companies, including some of the large P&C companies, isn't it something that taxpayers may want to say we want a federal organization to take a look and work with the state regulators, but let's make sure that everything's okay so we're not caught paying the bill later down the road?

MR. SAMPSON: Yeah, I think that it is important to raise the issue not only -- I mentioned in my opening remarks of what's in the best interest of consumers. I could very easily have said, and I think it's legitimate to say what are the interests of taxpayers as well, and I don't think it is in anyone's interest to create additional liabilities for taxpayers in the insurance spaces as has occurred in the banking space.

I think Viral has raised a number of very interesting questions. I would just say I would be very cautious about overstating the very different business model in the property and casualty sector than the banking sector. They are very different business models. P&C companies are not nearly as leveraged as banks are. I think even in light of the interesting studies that he pointed out, the investment portfolios of the P&C industry as compared to the banking industry is much, much more conservative and liquid in nature, and I would point out is regulated statutorily as to what insurers can invest in.

The third fundamental difference in those models, which I think mitigates against creating a federal bailout structure for insurers is the fact that insurance failures are not correlated with financial crisis. I mean, here is where we have decades of real-life experience to look back on, and we know from that that the instances of insurance failures are not procyclical. They're just not correlated. And in those instances where there have been failures, unlike in the banking sector where resolutions take place. They start on a Friday night. Monday morning they opened as a different organization. In the insurance space, runoffs take place over many, many years. So I'm not diminishing the very interesting, and I think worthy of further investigation of the studies and the questions that were raised earlier, but I just want to be careful that we not overstate the similarities between banking and insurance in the P&C space particularly, which I think is the source of many of our concerns about a bank-centric model imposed on insurance.

MR. BAILY: So let me just ask another question to Senator Nelson and David Sampson.

Within the bank space or that's been developed by the Federal Deposit Insurance Corporation is the so-called single point of entry approach to failure resolution, which does seem to many of us to have been a breakthrough approach to how to deal with potential failure, that you require the bank holding company, or it would be the insurance holding company, to carry a certain amount of equity and long-term unsecured debt, and then if the institution gets into trouble, that holding company is lifted off and the subsidiaries, which would be the actual insurance subsidiaries would be continuing to operate. And so taxpayers would not be on the hook for the losses that were incurred, and they might have been incurred in the subsidiaries, but they would be impacted to the equity and debt holders.

So I'm wondering, is that single point of entry approach something that could be used? Because you mentioned you particularly we don't want too big to fail, and we don't want too big to fail institutions of any kind. Do you think that's potentially where we might have a role for using this strategy?

MR. NELSON: Well, it's tempting to say that anytime that you have a single point that that somehow is preferable to having multiple entries. So, but when you look at the reality of what the regulatory scheme is, we've already begun to take a look at the holding company law in the U.S. to look at what we might do to gain more authority for group supervision. Having said that, I don't think that that equates to what some might suggest is a single point of entry. But we don't see that we ought to decide to layer capital in there just in case until what we have done is done a study of what the reality is of the industry and the companies. Risk-based capital matters. If a regulator decides that a company has potential contagion, a regulator -- it wouldn't take a federal decision -- FSOC or some other group to decide that, Fed Reserve or whatever -- but the regulator is going to monitor that capital of the legal entity. And we are dealing with legal entities which I think is an important point to make. We're not dealing with fungibility of assets of insurers, which might be more in line with what a single point of entry might otherwise be. You can't have a single regulator start pulling assets from one insurer to another to shore up others. I know that something akin to that happens in the bank-centric regulatory system, but this is different, and I think if you're trying to protect the policyholders, which the state-based regulation has done over all these years, you're going to be very cautious about having any single point of entry when you have state-based and walled-off assets of insurers. That doesn't mean there's not cooperation. That doesn't mean that you don't have cross-border supervision, which you do. But at the end of the day, I think you have to be very cautious about trying to change that system.

MR. SAMPSON: I do think that one of the lessons coming out of the financial crisis is the need for oversight of holding companies who are engaged in systematically important activities, and I think we've been supportive NAIC efforts to enhance supervision of the holding companies and such. But the point I want to make is the distinguishing feature of holding companies that are engaged in systematically important or systemically risky activities. You know, I think that Governor Tarullo that testified earlier this summer before Congress that the traditional business of the insurance he did not consider to be systemically important or systemically risky activity.

And I think we have always said regulate the systemically important activity as opposed to trying to capture an entire industry. So that's, I guess, the distinction that I would make.

MR. BAILY: Viral, let me ask you about how you see the future of the industry. Now, we know that some insurers have withdrawn from the U.S. market. There are private equity entities that are buying insurance assets, so it is a changing industry. I think maybe not all the risks are in the large companies. There may be issues in some of the small companies as well. So looking at what you think the regulatory structure should be, how do you see the future of this industry and its viability going forward?

MR. ACHARYA: Yeah. I think I'll also try and respond a little bit to, I think, some of the issues you raised.

So I don't like to view any entity in the financial sector as per se an insurance entity or a bank. I think they're all doing intermediation. Intermediation involves collecting savings from households and channeling it to productive uses. So why do I think therefore that in some essential sense bank and insurance sector is similar which is that I put my savings in to banks? I put my savings into insurance companies. The insurance company gives me my savings back in a very state contingent manner based on some catastrophic events that might take place. The bank gives me the money back on a more liquid basis as in when I want. But most of the times, even when I think about why I've kept some money in my current account, which is much larger than what I need on a day-to-day basis, it is actually to cover my emergency medical expenditures, because I don't want to be drawing down on my health insurance beyond a certain size, et cetera, et cetera.

And I think when one sees it this way, I think the reason why this perspective is useful is because one implication of this perspective is that whenever one part of the financial sector is going to be restricted from doing an activity, an intermediation activity, it's going to simply switch over to the other parts of the financial sector. There is just nothing that can help that. I think I don't know the genesis of why NAIC has lowered the RMBS capital requirement across board regardless of risk in contrast to I think what one sees in corporate bonds. But the only explanation I can think would make sense is that banks were getting crammed down for their mortgage-backed securities holdings and therefore, the insurance firms lobbied their state regulators to lower the capital regulators to lower the capital requirements for RMBS. This is exactly how the financial sector risk transmission works. If it's expensive for one sector to take on a risk, another sector goes and lobbies for it saying, "Let's lower our capital requirements. There is a huge killing to be made over here."

So the way I see this process is that if we don't harmonize some core principles of regulation between the large part of the intermediation sector which is banking and another large part of the intermediation sector, which is the insurance sector, what is going to happen is that what activities we don't want banks to do or want them to do less, we are simply going to be transferring those risks to other parts of the financial sector.

Now, we may call them insurance firms, but why are they holding such huge chunks of RMBS which are risky? I think it begs that question. Why are they trying to hide their liabilities into the shadow of balance sheet vehicles? I think to me this is a sign that at a time when the banking sector is deleveraging, there is an opportunity for someone else who can lever up to make a killing, and I think that's what is going on right now in the insurance sector. So my sense is in an ultra-low interest rate environment that we are in right now, if we don't harmonize the core principles of regulation between banks and the insurance sector, I have no doubt that the insurance sector, a very large parts which I think can do these activities, and I agree that life firms are doing this a lot more than property and casualty, they are going to look like the bigger shadow banks, and I think that's my concern.

So that's the way I see it evolving, which is we have two choices right now. Either we harmonize the core principles of regulation for large entities; otherwise, MetLife and others are going to be owning the riskiest tranches of the MBS, not the banks. There will be a housing market correction in the future. I don't know if MetLife will fail at that time or not, but I can guarantee you that over two decades there will be a housing market correction at some point, and those who are owning the riskiest RMBS pieces will be hit first if that is what (inaudible).

MR. BAILY: Well, I'm going to take questions from the audience, but I think I need to give my other panelists just a chance to maybe reiterate or respond to what Viral said.

MR. NELSON: Well, I understand Viral's concern about the captive situation for setting off assets and liabilities in some fashion or other, but it goes back to the question of are the reserves adequate? That's really what this boils down to, and that's what principle-based reserving is about. There may not be 100 percent agreement about principle-based reserving, but there seems to be no question that the formulaic approach is inadequate given the experience. It's outdated. It's a "one size fits all" approach. And if you're going to go to trying to determine whether or not an individual company -- we can talk about the industry in generalities, but if we're going to talk about specifics of an insurance company, the question is are the reserves adequate? And then are the assets there sufficient? Will their duration match or whether their determination about when obligations are going to come due, those are all important. So I don't see the specter that Viral sees here. I see a concern that has some appearance issues, as well as how do you fix what is driving the creation of these captives? And so the NAIC is on it, and moving forward as rapidly as you can, I think as carefully and cautiously as is necessary as well.

MR. BAILY: Good. All right.

I'd like to take some questions from the audience. There's a hand up at the back there. We do have microphones. If you could identify yourself and make it a question and relative short, please.

MR. ENGLEHART: Hi, Joe Englehart with Cap Level Partners.

I have two questions for Viral. First of all, thank you for taking the ambitious effort in trying to quantify systemic risk. It's very hard, and I want to commend you for doing that.

I have two questions. One is you criticized the move from using reliance on credit rating agencies to using Black Rocks' expected loss methodology, and you particularly criticized the use of book value as opposed to market-to-market or something. But given that insurers have long-term liabilities, and this gets to David Sampson's point about you can't really compare banks and insurers because it's not on the asset side which you mentioned; it's on the liability side. They have longer term liabilities, so it's quite possible for an insurance company, for instance, to buy up all the RMBS when they're very low priced, and if you look over the market for the last five years, they may have had $30 billion of paper losses, but that's all back and now their increased exposure has actually gained them additional tens of billions of dollars. So it's actually been a tremendous investment for the insurers. And also on the social policy point of view, you want someone to be buying RMBS; otherwise, they're going to be selling at the same time. So from a financial stability point of view, shouldn't we want to be taking advantage of the longer term structure of insurers' balance sheets?

And that goes to the second question. You referenced in your study the S risk. You used equity, which I assume you used sort of a bank definition of tier one common equity. Again, given insurers longer term liabilities, it's not clear that's the appropriate ratio. And so if you had a separate ratio for insurers, I'm not so sure they'd come out as negatively in your S risk calculation.

MR. BAILY: Okay. Do you want to give a --

MR. ACHARYA: These are very good questions.

So on the first point, I would say I think I agree that we need someone to buy the RMBS. So let me sharpen my criticism of the NAIC's treatment of the RMBS capital rate calculations.

I think the question of whether you have more stable liabilities or less is important, and I think that can explain why the level of capital requirements should be lower for the insurance sector than it is for banks. I think I would concede that. What I don't see is why it should be risk insensitive. Why is the capital requirement for a subinvestment grade RMBS the same as it is for an investment grade RMBS? You can keep it at 2 percent of the risk adjustment. You can keep it at 4 percent of risk adjustment. You can keep it at 8 percent of risk adjustment. I think the question about stable liabilities related to the banking sector is a question about the level of capital requirement. I think there is no economic principle which says that the capital requirement should be the same whether the risk is high or the risk is low. I think this is just a blatant violation of the simplest principle on any calculation.

And I think the conception flaw is the following. You reserve against expected losses. What do you do against unexpected losses? You have to have a capital cushion. Now, if there were the claim that no unexpected losses should have any capital cushion against them is a claim that there is never going to be any liabilities that have to be paid out when other losses exceed the expected losses. And I think this is the problem. I think the switch to PIMCO and Black Rock's expected loss calculations is just going from ratings to expected loss, but I think the bigger problem is that you have to worry about unexpected losses.

And I think let me give you a counterargument. So if we don't use tier one equity, we don't use book values of equity, we use market values of equity. So my conjecture is the following, which is that if it was the case that when you have assets such as RMBS corporate bonds on your balance sheet, and suppose they are declining in value. So suppose they have lost 30 percent of their value, economic value. But because my liabilities are stable, I should have actually no problem whatsoever. Then there should be no impact on the market value of your equity, at least in a world in which people understand what the insurance business is and that these are truly long-term liabilities, the market value of equity for all these funds should remain very stable because these losses are going to happen down the road. Liabilities are very stable. But I think what I showed you is that in the fall of 2008, market values of equity were collapsing for all of the insurance firms.

Now, it begs the question of why this is happening. Now, you might say it is pure panic, and that's the reason why investors are penalizing the insurance sector, but I think it's irrelevant. The question is the following. When an insurance firm's market value of equity is collapsing, is the CEO going to ignore the collapse of the market value of equity? The answer is no. I've asked the insurance firms what were they doing in fall of 2008, and they said we were not using our premium to do as much intermediation as we were doing before. This is exactly what banks do when they are hit with by a market value of equity loss. They engage in a credit crunch because they want to save whatever premium they have to buffer for their losses.

So I think I appreciate the argument that market value of equity may be much worse for a bank if it collapses because it is run like liabilities, but I'm not convinced that an insurance firm will not react to that at all. I think they're going to reduce the intermediation business. They are going to require much higher ratings on the corporate bonds that they are buying. They are going to require much higher ratings on the RMBS that they are buying in the market if the market value collapses, and that's an intermediation loss that's going to get transmitted to those who are making mortgages to those who are issuing corporate bonds to fund themselves and so on.

MR. BAILY: So I don't know whether you want to make any comment to that or should we take another question?

MR. NELSON: Let's take another question.

MR. BAILY: Let's take another question.

Okay. Question here. Can you just wait for the mic?

MR. CARRIS: How you doing? I think you'd find it -- Marty Carris -- Martin Carris Consulting. I've been in the business for 50 years, 35 years as a regulator, 15 years with AIG.

I think what you would find interesting is -- because quite frankly, market value of assets for the insurance industry has no relevance whatsoever. But I think what you should do is to understand the beauty of the statutory system which uses a cost basis for debt-type securities rather than market consistent valuations. And I think what you would find interesting is that if you looked at the write-downs of the RMBS in the 2008 to 2010 period and then look at the loss in cash flows that the industry actually suffered, I think you would find it interesting that the industry virtually lost no cash flows. None. And its cash flows, that's what's important in evaluating an insurance company. Because after all, the key is whether the cash inflows that are projected will exceed the cash outflows that are projected.

The second part of my question is you're kind of indicating that there is some sort of likelihood that Pru or MetLife would fail. Well, the BCR that's being developed is at something like 99.5 percent, which is basically investment grade. Basic investment grade. These companies have multiples of risk-based capital no matter how you calculate it, well above BCR levels. There's almost no likelihood of Pru or Met failing.

And the third point I would make to you is that you cited some large numbers, the amount of liabilities funded off to captive insurers at $15 billion, but what you didn't put in there and into all your numbers is in context, what is the surplus of the industry? What's the capitalization of the industry? It's 100 times that. That's like a small percentage of the total capitalization of the insurance industry. I really don't understand this fear of systemic risk for insurance companies. There's virtually none.

MR. BAILY: You've had a good chance, so let me just give the other panel members a chance to comment or agree.

MR. SAMPSON: For a little bit of perspective, I referenced the 47 percent increase of policyholder surplus from the beginning of the recent financial crisis. That number actually now stands at $672 billion to kind of put in perspective the point that you were making.

I think I recall that in determining systemic risk, I believe that Dodd-Frank included a matrix of multiple factors that the FSOC was supposed to use in determining systemic risk, and it's a much broader analysis than just looking at how much holdings do you have in residential backed mortgage securities. And so I would say that I know there was a lot of thought that went into that matrix that was included in Dodd-Frank to determine systemic risk. One would hope that the FSOC is taking that very seriously. So I guess that's the only other point that I would make.

MR. BAILY: Yes, Senator.

MR. NELSON: Two points. I don't think Viral is going to apply to be chief risk officer for a group of insurance companies anytime soon. But the second point --

MR. BAILY: I don't know; he might.

MR. NELSON: He might; I don't know. But if he does, he'll --

MR. ACHARYA: I think there will be no takers.

MR. NELSON: But the second point is you could have a little bit more confidence in what FSOC is doing if it was transparent and if you had, first of all, the laundry list of conditions going back to Dodd-Frank, having had a seat at the table with Dodd-Frank, to take a look at what was being outlined there as to what would constitute systemic risk, and then analyze their conclusions about those categories, and then deal with such terms which seem to me to be more like the "too big to fail" doctrine as a carryover in which they start talking about a run-on on an insurer without understanding that the likelihood of that seems very, very low, if at all, given the fact that if that would have happened, wouldn't 2008 have been one of those test times for that to occur? So I think we don't know enough about what FSOC is doing to feel as comfortable as we'd like to about how the determination of a SIFI in the case of Pru and potentially in the case of the Met. So hopefully more transparency and a better understanding will maybe give us some insight into that and we're hoping for that. What I've been persuaded by is the, if you will, the dissent by Roy Woodall, the voting member of FSOC, and by Director John Huff from Missouri, the nonvoting NAIC consumer, commissioner representative. Because I think it begins to tell the story about what considerations are being made in determining whether or not an insurer is systemically important or risky, and given the fact that Governor Tarullo has made it very clear that he thinks traditional insurance is not in itself systemically risky.

So I think we're caught in a situation here where it seems to be "one size fits all," not clear on what is happening, and it makes it very difficult. But I know this, the regulators of the states that are involved in this are consistently looking for quality and consistency in the regulation of those insurers without respect to whether or not they're considered by FSOC systemic risks.

MR. BAILY: I'm going to give you another word, but I just want to maybe -- because we've only got a few minutes left, I'll take one or maybe two more questions together and then give each panelist a chance to respond.

Yes?

MR. SCHARDIN: Hi, Justin Schardin, Bipartisan Policy Center.

Real quick for the professor. Are you seeing the systemic issues that you're concerned about more concentrated in certain segments of the market or certain sizes of companies?

And then for everyone, BPC has pointed out in the past that the Fed is not responsible just for AIG, MetLife, and Prudential. They also have thrift holding companies that have insurance companies under them, so it's a good chunk of the industry that a lot of people don't know about. And I'm wondering if you could all comment on how the Fed should approach insurance regulation.

MR. BAILY: Let me see if there's another question.

Yes? Another question back there. Could you just -- and then we'll collect both of those questions and get final words from each of the panelists.

SPEAKER: Yes. This is a question on the comment suggesting that banking and insurance are very similar. It's somewhat puzzling. People buy property and casualty insurance because they're required to, usually by law. You have to buy auto insurance to drive a car. You have to have homeowners insurance to get a mortgage. So there's very little volatility in their revenue even during the financial crisis. You don't have a lot fewer people driving just because there's a crisis. So you don't have runs on auto insurance. Very different from banking where it's not just the liability risk but you have a panic risk of people pulling out their deposits and that really makes it a very different industry.

So I guess my question is are you suggesting there could be in your second category of tsunami risk some sort of tsunami collapse on auto insurers because of a change in the housing market which seems somewhat unlikely?

MR. BAILY: All right. So I'm going to go down the line here. We've sort of run out of time, so if you could keep your final comments short. And I guess I'm speaking to you Viral since you --

MR. ACHARYA: Okay. So I'll try and address these things very, very briefly.

So I think MetLife can fail. I'm willing to actually say that with some likelihood because if it could not fail, it should be able to borrow in the market at the United States cost of borrowing. The United States Government cost of borrowing. Credit before swaps on insurance firms trade in markets and they are not priced at zero. There is a noncredit default risk of every single insurer that is out there. It is priced by the market every day and it fluctuates when risk rise and it goes down when risks diminish. One can see the price in the market. And the CDS on insurance firms rose dramatically during fall of 2008. This is actually documented in our chapter book. So I'll just stop at that.

I agree with you that the RMBS loss realizations would be small in the crisis of 07-08, but I was mentioning to the switch to the subinvestment grade portfolio to about 50 percent of their total structure product holdings since 2010. The losses on subinvestment grade portfolios are going to be much worse than they were on the investment grade in 08-09.

The point about surplus guaranty funds is a good one, but as I was saying earlier, it's all based on calculation of expected losses. Crisis is not about expected outcomes. Crisis is about unexpected outcomes. It's about losses on RMBS which go beyond the projections that we use to calculate our reserves. That is what capital is for. That's what loss varying capacity is for. Where do we see more of this? I do think life insurance firms are doing much more of both captive activity as well as going into the riskier -- searching for (inaudible) activities than property and casualty companies in my view, so I think they are probably at the more forefront.

And the last question, I'm totally with you that there won't be runs, but the scenario you're to visualize is like fall of 2008 where market values of equity collapse for all the insurance firms. They may not be experiencing runs right away but they would stop the intermediation activity. They would not actually be buying corporate bonds in the market. They would not be buying RMBS market. As far as the rest of the economy is concerned, that is an externality that you've created by not having larger buffers of equity cushion to continue providing intermediation in fall of 2008.

MR. BAILY: Senator, last comments?

MR. NELSON: I'll be brief.

2008, under your scenario, I don't think, for the insurers, was not a capital problem. It wasn't a capital problem. It might have been a capital problem for the thrift AIG because of the thrift holding company or the failure of the thrift regulators to take proper precautions. It's still based on the insurance commissioners --

MR. ACHARYA: They went to TARP.

MR. NELSON: Pardon me?

MR. ACHARYA: They were at the TARP.

MR. NELSON: No, I understand that. But I'm just saying that if the thrift supervisors had been doing their job of regulation, I doubt that AIG's parent company could have engaged in all the swaps that they did.

So 2008 wasn't a capital issue for the insurers. If it wasn't a capital issue for the insurers at that time, it's hard to imagine a scenario where it might be at some point in the future. But if that is the case, it's going to be settled on risk-based capital within the insurance operations and the regulators are on top of that.

The second answer to Mr. Gordon is no.

I said I'd be brief.

MR. BAILY: You'd be brief. You are.

MR. SAMPSON: With respect to the Fed, I think the Fed is being very thoughtful. They've hired some very good people with real depth of insurance knowledge, both from a business side as well as from the regulatory side that we've met with recently. I'm very encouraged by the quality of people they've recruited to think deeply about this.

I guess my advice to them would be to be thoughtful and careful about the application of bank-centric standards on insurers because we've seen this movie before. We've seen how it ended. We've looked at what the impact has been on banking, especially regional and community banks with the cram down effects of Basal I, Basal II, Basal III, Dodd-Frank, and the market share of the five largest banks is now two and a half times what it was prior crisis relative to community and regional banks. I think that's moving in exactly the opposite direction than it probably should go, and certainly, we do not want to see that same thing happen in the insurance sector, to have a regulatory induced consolidation in a highly competitive -- which I mentioned at the very top of my remarks -- a highly competitive property and casualty industry that is innovating and it provides very competitive pricing structures to consumers. And so that would be my main concern and advice.

The third point I would make, there are many insurance companies who are relinquishing their thrift status because the current environment, regulatory structure is one that just does not make sense in terms of the regulatory burden compared to the service that it provides to their consumers.

MR. BAILY: Well, we have run out of time. I would like everyone to thank our panelists. Thank you very much.

(Applause)

(Recess)

MR. ELLIOTT: So, good afternoon, and welcome to our second panel. As Martin mentioned, my name is Doug Elliott, and I'm a scholar here at Brookings. I focus principally on financial regulation, and I'm moderating the panel we are about to have on Global Capital Standard for Insurance, and their implications for the U.S. We're privileged to once again have three excellent panelists.

In the interest of time, I'm going to introduce them just briefly. You have their bios to have the rest of the information. So, our first presenter will be Commissioner Michael Consedine. He is the Commissioner of the Pennsylvania Insurance Department, and Vice President of the National Association of Insurance Commissioners. At the NAIC, he plays a number of roles that are directly relevant to today's discussion, and I'll let him mention those to the extent that he'd like to.

Our second panelist is Sven Gentner. He is a counselor in the Economic and Financial Affairs section of the European Union's Delegation, here in Washington. He is well placed to present the views of European authorities on these issues.

And then our final panelist is Marcus Stanley. He's a policy director of Americans for Financial Reform. That's a coalition that advocates for reform of the financial sector. So, I will briefly introduce the topic, for those of you who are less familiar with it, and then we'll have opening presentations just as we did with Martin's panel. I'd like to preserve time for Q and A once more, since there's clearly lively interest, so I've asked everyone to hold their comments to ten minutes, and I apologize in advance. I will cut them off after a decent interval, once they go beyond ten minutes.

After the opening remarks, we'll do the same thing as Martin did. I'll ask a few questions to the panelists, and then we'll go to a discussion with the audience. So, before we start, let me just briefly describe the topic.

Insurers and other financial institutions are important, both to their customers and to the larger economy, as was shown clearly in the case of banks -- clearly in the case of banks and the global financial crisis of 2007 -- 2009. Once crucial protection for customers and for society is for financial institutions to keep a buffer of capital.

Now, capital is a complex topic, but the simple version is that is represents the difference between what an insurer or bank owes, and the larger amounts of assets that it holds. This difference is primarily supplied by common stockholders, also often called equity holders. We have little reason, as a policy matter, to directly care whether stockholders lose their investments or not, and therefore the funds that they supply serve as a buffer to protect everyone else.

Now, this buffer capital is such an important protection, that regulators set up specific minimal capital standards that insurers must follow. We already have such standards in the United States, and they are coordinated across the states through the National Association of Insurance Commissioners. So there are minor differences in the standards, because they are based on state law, but in general, they are very, very similar.

Now, the discussion today is about nascent attempts to establish new International Capital Standards, so I should say Global Capital Standards, and we'll try to compare them to U.S. Standards, talk about what those new standards should be, how they should be integrated into U.S. regulation, and what effects that will have on the industry and it's consumers. Now we're going to go in alphabetical order, but that's actually complete coincidence. I thought it would be good to start with the Commissioner, then get the European view, and then get a Consumer Advocate's view. So, Commissioner.

MR. CONSEDINE: Thank you for the introduction, and it is a real honor for me to be here today. In fact, we are having our Consedine Sunday dinner with my mom and my kids and wife, and mentioned on Tuesday to everybody, I'm going to be at Brookings, and my mom was like, that is wonderful. When you're there, can you pick me up one of those inflatable neck pillows that plays music, and I'm like mom, that's Brookstone. That's complete different -- that has nothing to do with -- but once I explained it to her, she too is duly impressed with the opportunity that we have today to talk about this very important topic.

At the heart of today's discussion are really two important questions, and perhaps a few others. First, how much should insurance regulators rely on capital as the be all and end all of regulatory tools, and second, would development of a Global

Insurance Capital standard leave policy holders, or the financial system any safer, and if so, at what cost. I hope we can explore those fundamental issues today, and as the state insurance regulator on the panel, let me start where things are in the U.S. currently.

America's insurance regulatory framework was responsible for the protection of insurance consumers and companies during the U.S. financial crisis, and has only improved in the six years since. We have increased our dialogue with foreign regulators, including participation in supervisory colleges, gained a better understanding of how other financial companies are or aren't regulated, and recently completed the solvency moderation initiative, all in about five years, and all of which strengthened our systems while preserving the elements that fundamentally worked well.

Today, more than ever, we are better equipped to identify and reign in activities that could put policy holders and the financial system more at risk. Capital is an important part of our system. Following a number of insolvencies in the 1980s and 90s, we set to work on building capital risk based system and improving the financial reporting and analysis that goes with it.

We ensure that all legal entities within the group are separately capitalized, so that there are assets to pay policy holder claims, regardless of what might be happening within the group. This legal entity approach is like multiple bulkheads in a ship, ensuring that losses of damage in one area does not spill over to another's helping to keep the entire enterprise afloat.

This was critical to our success during the crisis, particularly when insurers were connected to other activities, that in some cases, like credit default, required no capital at all, and which were -- weren't subject to insurance regulatory oversight. So we understand the importance of capital, but we are worried that fixating on capital is a mistake.

I come to this discussion on Global Group Capital Standards with a healthy dose of skepticism, and insistence that any change to the U.S. Regulatory Systems are carefully reviewed and implemented pragmatically. American consumers demand nothing less. We must also be mindful that we are a market, and that there are market consumer consequences of anything that regulators decide to do.

Here's a critical point, that is often lost in the sometimes academic and arcane discussion on Global Capital Standards. It's policy holders consumer, you all, that ultimately underwrite the cost of any changes that we impose, and will further be impacted over our actions -- lead to consolidation, less competition, fewer product choices, and higher prices.

There has been, in my opinion, far too little attention to the cost of whatever benefit we hope to achieve at the international level. That's not to say that I, nor the NAIC, as a body, oppose Global Set Standards. We are often painted as the just say no crowd, and I think that is an unjust characterization, because we have taken steps. While we have taken steps to expand our group supervision and in holding company authorities, we also believe it makes sense to examine whether assessing the capital needs of the broader group is a necessary complement to our current approach.

Nevertheless, there are core considerations that we must work through before advancing any new proposal, and what is useful within our system may not mirror what other jurisdictions feel is necessary. As I asked at the outset, will a Global Capital Standard make policy holders, or the financial system more secure? The answer to that question is not simple at all, or we wouldn't be here today at Brookings.

A Global Insurance Capital Standard alone will not protect one company or their broader economy, just as the existence of Basel banking standards did not prevent hundreds of banks from failing during the financial crisis. Compare that to our experience on the insurance side, where, during the financial crisis, you cannot point to a single example of a large insurance company failing due to financial pressures during that period of time.

Moreover, it could cause harm if overly burdensome requirements inhibit product offerings and developments, raises prices for consumers, add layers of regulation or otherwise discourages appropriate risk management. I do see value in the IAIS working to ensure that all markets, particularly the emerging markets that are often left out of this very important discussion, and that really represent the future growth center for our industry, have sufficient capital regimes in place, and providing a measure of consistency across the globe. Of course, we need to make sure that foreign firms are meeting the regulatory benchmarks in the jurisdictions where they sell policies, and those policy holders are protected, just as they would be by domestic insurers.

We must stand vigilant that any standards do not disadvantage U.S. firms operating in foreign markets. I'm also concerned about the process, as was touched on in the earlier panel, for the development of the Global Capital Standard. Any international standard should not favor one regulatory approach over another. Instead, it should represent the best outcomes that solid regulations provide, and leave it to individual jurisdictions to develop their own best way forward.

Given the difference in regulatory structures, authorities, accounting, and legal environments, a single uniform standard is unlikely, and I would argue unnecessary if we can all work towards a high level of consistency while preserving the diversity in regulation that makes for stronger, more resilient marketplace. It's critical to remember that if a global standard is developed, it carries only so much weight as the value that the regulators around the world are willing to give to is. Just as the IIS is shutting down open meeting and limiting stakeholders and observer engagement, they are also seeking buy in from regulators. NAIC meetings, for those of you who attend, aren't always pretty, and our members will often disagree, as they should, on issues of regulatory policies. But that debate, that clash of ideas and airing of grievances in a public forums gives us confidence that when we reach a conclusion, the finished product is in the best interest of the marketplace and our consumers. My last concern remains with the timing of an international capital standard. Any timeline should be driven by the regulators in the room. The IAIS members, based on the resources available to deliver high quality results.

For example, how can we have a global capital standard before we have a global accounting standard? What mechanisms are in place, or need to be created to reconcile the differences. State insurance regulators have an obligation to be at the table, internationally, to help answer these questions, but right now, there are far more questions than there are answers. I look forward to today's discussion and hope we can shed light on the necessity, process and timing of a Global Capital Standards. Thank you very much.

MR. GENTNER: Thank you very much, Doug. Thank you very much, Brookings, for inviting me here today. I'm very grateful for the opportunity to give an EU, a European Union perspective on this whole debate. I wanted to say a few words about where we are in the European Union at the moment on the implementation of our new insurance framework, and then talk a little bit about the U.S. issues, and then finally, the Global Standards as well, and I'll keep it brief.

As you're probably aware, the European Union is in the process of implementing a huge revision of its complete insurance framework, called Solvency 2. To be clear, this project actually started before the financial crisis, but this of course benefiting in part from the experience of the financial crisis, and we think that with this new framework--it's being implemented now--we will have a robust, modern, up to date framework for the insurance industry.

Only last week did we publish a large number of implementing standards that will deal with things like evaluation of assets, methodology, calibrations, securitization and all of that. So we're in the middle of this process but the new system will go live on the first of January 2016.

Under Solvency 2, there are very clear provisions on how third country -- what we call third country, non-European Union (inaudible) can keep access to the European Union marketplace. The first very clear message is the European Union is an open market, and we value engagement of insurance companies from all around the world in the EU. Reinsurers can provide directly service inside the European Union. Direct insurers need to establish a (inaudible) depending on what kind of business they do. And it is the European Union, triggered by the European Commission that decided whether third countries jurisdictions outside the European Union are considered equivalent to our regulatory regime.

Now, as I said, in general, the regime is open (inaudible). You can do business based on branch and subsidiaries, but if the jurisdiction where you actually come from is considered equivalent to the framework that Solvency 2 puts in place, lots of the requirements under Solvency 2 are not directly implemented, which means you can actually operate under home country's supervision, which is a concept that is very typical for the European Union. They whole integration of the European Union's internal market to a large degree is based on that concept. I know it's sometimes a bit foreign or a bit strange maybe, to a U.S. audience.

We have lots of discussions also with other regulators in the U.S., and the securities area, in other areas. This whole issue of reliance difference to another framework, but we think it's something that is very helpful in the international context, because given that we are operating in very international business and very international segments of markets, we always have different frameworks. We always have international frameworks, different jurisdictions have different frameworks, and it's important to find a way to make these different frameworks work together, (inaudible), and I think this way of relying on each other is one way forward.

As concretely, what does this mean for the various area of insurance? As I said, it is the European Commission that can trigger this process. We are particularly interested when it comes to the U.S., to trigger this process in the area of re-insurance. As you may be aware, in the U.S. there are certain requirements on Re-insurance companies to (inaudible).

The European Union, only two states have these requirements. We would be interested in getting rid of all these requirements, both in the European Union and in the U.S., and for that, we are looking to find some kind of agreement with the U.S., which could be done under the vehicle, which is called a covered agreement, which was introduced under Dodd Frank, and we're heartened by the support we're seeing, both from the treasury and the NAIC, who said that they would want to take initial steps to conclude (inaudible) agreement already this year.

Now, very briefly, on Global Capital Standards, we support the process that is underway, because we feel that the experience of the crisis has been, yes, insurance is not banking, and they are two different industries, but nevertheless, we have seen how ripple effects can go across industries around the globe. How an event in one country can lead to effects in another country, and how all these markets are integrated to a certain extent.

So we feel that a certain basis, a global basis for regulation and supervision of insurance companies is useful. We support the efforts that are underway, to particularly deal with globally systemically important insurers, and we feel that there should be some basis for groupwide supervisions, effective resolution, capital standards and loss absorption. This is also why we support the preliminary results that were found on basis capital requirements in the FSB, and the work that is ongoing on the higher loss absorption capacity. I think I'll leave it here.

Maybe just one more word on Internal Capital Standards. This is of course the next step beyond that -- I mean, the basic requirements that are being developed in the FSB would only apply to a systemically important insurers. We're moving beyond (inaudible), has been mentioned already, International Capital Standards are a useful concept in our view as well, but I agree with what has been said before -- it has of course taken into account the difference in regulatory frameworks that we have across the world. We feel that the Solvency Two, the European Union is introducing a framework that is up to date, robust and modern, and we would like that of course to be taken into account when these standards are developed. Thanks.

MR. STANLEY: Okay. I'm Marcus Stanley, from Americans for Financial Reform, and as Doug said, AFR is a group of about 200 public and trust organizations that has come together in the wake of the financial crisis to work for stronger financial regulation, and my title here is meant to convey some modesty. I don't plan to dive into all the details of Capital regulation in the insurance industry, because we are still formulating our beliefs on that, and our perspective on those details. However, I think what I can do is give a sense of the perspective that informs us as we go about determining how we feel about these details.

And I thought I would start out with the very first thing you get told when you get into this area, especially when you're -- you have some experience in banking regulation, is it's impossible for there to be a run on an insurance company. So I thought I would start out with a picture of a run on an insurance company. This is AIS, Singapore's subsidiary. People are lined up to cash out their investment products with that subsidiary, based on what happened to another subsidiary of the company half a world away.

So, what does this tell us? Well, the reason why people claim that there can't be a run on an insurance company, is of course, because -- I'm sure there is plenty of discussion of this in the first panel -- the conventional insurance model does rely on generally diversified risk pooling. The polling of independent risky events that are uncorrelated with the broader financial sector, where clients cannot easily cash our or take back their premiums on demand, based on the condition of the insurance company, the classic example being property and casualty. I heard that example come up in the case of auto insurance I none of the questions previously. You know, we don't expect everyone in the United States to have a car crash at the same time.

But financial guarantee and investment products offered by insurance companies are quite different. These are products that really sort of concentrate financial risk to the insurer, draw that risk to the insurer. They're not really a diversified pool of independent events. They're really -- they're systemic risk insurance to one degree or another, depending on how the product is written. And there are these products at the institutional and fund level, and I'm sticking with products that are still common in the market.

I'll work my way to AIG in a minute, but these products are all still very common and routine in the market -- guaranteed investment contract -- RAFs, bond insurance is kind of recovering after some tough years in the financial crisis, and then individual products. Variable annuities, contingent differed annuities. Lots of annuities can be cashed out early on demand, and in fact, based on -- they probably should have that feature based on how they are sold to investors.

And this is just a quick example. There's been a lot of research coming out about the market penetration of these unconventional products, but this is just a quick example of the growth and the share of annuity, versus conventional life premiums between 1980 and 2012, you could see the percentage of total premiums coming from annuities more than doubles, and not all annuities have this feature of being able to be cashed out early, but a lot do.

So that's the kind of thing that drives that line that we saw in the -- that we saw at AIGs Singapore subsidiary. And then we have-- so not only do we have these financial guarantee products that tie the liability side of the insurance business to financial systemic risk. We have an insurer's role as asset holders. Insurers collectively own about a third of investment grade bonds. This implies some potentially significant impact on bond prices if they are forced to liquidate lots of assets in a disorderly manner. Insurers hold a lot of illiquid assets. That's perfectly appropriate and it's probably a good thing if it's properly aligned with their liabilities -- if they liabilities are truly diversified, truly long-dated. Not so good a thing if these liabilities are cash out liabilities in the event of systemic risk.

And then just the sheer size of the asset inventory held by insurance companies gives them the potential to become intermediaries through a securities lending business. And we saw this with AIG, they did securities lending, they reinvested the proceeds from that in risky assets, and then they couldn't get back those proceeds, and they were sort of intermediating between their own policy holders and outside entities that were borrowing in the markets.

So some lessons of the crisis that I think have guided us in the reform community in thinking about this is, AIG might be unique in the sense that, I don't think we're going to see another major global insurer offering to pick up tail risk on subsidiary-prime securities by selling credit default swaps. At least, I hope not. Is the SEC ever finished their rules on credit default swaps at least. But the lesson of AIG is really the ease with which a large insurer was able to support a financial guarantee subsidiary that had very large impacts across the financial systems, through the guarantees that are growing.

That's a broader lesson, and I think that lesson still holds. And you could see some of the same lessons, I think, in mono-line insurers and mortgage insurance that you had undercapitalized entities that look very big, because in good times, they were able to collect a lot of premium revenue and they didn't have to pay out. They were making direct financial guarantees that allowed arbitrage, and they couldn't pay out on them. So what we need on this is, we need some appropriate group level oversight to make sure this kind of thing isn't happening in a subsidiary of the company. We need to prevent cases where insurer -- financial guarantees by insurers are used to create inappropriate arbitrage of risk, to move risk to places in the system where it's undercapitalized, and I think we need to re-examine protection of policy holders, because of the dependence of a lot of insurance companies on federal support during the -- not a lot, but a number of insurance companies on central bank support during the crisis.

So when we look at the actual response we've got, we've got this alphabet soup of initiative, which is what I said I'm not going to completely dive into during this presentation. And you know, I'm sure people here are familiar with them. I'm not going to run through all of them, but we have changed the NAIC. We have the federal insurance office, we have Federal Reserve supervision of a wide range of entities. Globally, we have new supervision of internationally active insurance groups, systemically important insurers, two different things.

So some commonalities when you look across these efforts -- everybody involved, the Federal Reserve, the International Regulators and so on, claim to recognize this distinction I talked about between traditional and non-traditional insurance activities. Governor Tarullo has said publicly and he's said privately to us that he doesn't believe in imposing bank style capital regulation on traditional insurance, but then there is this recognition, which I think is proper and appropriate, that you have these non-traditional guarantee activities that could enable financial arbitrage, that are often directly competitive with banks who are offering similar kinds of investment -- of guarantee products and investment products, and those have to be capitalized on some kind of even playing field or plain with banks.

And the regulators to claim that they'll tailor regulation to these differences, and I think there is some agreement that you need somebody up there at the group level that is at least cognitive to the group issue and prepare to respond to them, whatever that appropriate response is.

Now, I do think a risk that we face with this alphabet soup here, is that we could, in the worst case, be looking at a Basel two for the insurance industry -- a kind of regulatory black hole that take a decade with endless fine tuning of risk adjustments that distract regulatory resources. And I think it's dangerous to have a mechanistic reliance on risk based capital. Particularly, when you're giving all the details of those risk adjustments to your regulated entities, you know. You exhaust yourself coming up with these risk adjustments. People figure out where the weak spot is, and they mechanically comply with it, but risk and arbitrage is taking place because they've spotted the weak points in your system

That is exactly what happened with Basel two, and it was a big problem. At the same time, if we properly conduct this process, we should -- it should lead us to pay attention to the full range of activities and their systemic inactions.

Now, I have only about a minute to go, so I'm going to speed through this quickly. I think that it's important to imbed this capital effort within a broader framework of looking at product regulation, firewalling, recovering resolution and capital and reserves, and not allowing capital to kind of swallow up these different parts. And I think on post regulation, it's really important because it forces regulators to go out and look at whether the liability side of the business really makes sense.

Are insurance companies making promises that they can really keep? Because when an insurance company makes a financial guarantee that is poorly designed, it's going to induce risk taking, it's going to permit inappropriate arbitrage. It's going to make a promise that can't be kept, systemically. And it's often easier to directly police product design than to try to chase the (inaudible) through capital regulations. And protecting consumer and investors has a strong connection to systemic risk, because systemic risk is what happens when these promises can't be kept.

I'm going to make this my last slide because I'm running out of time. But I think I'm firewalling. We heard about this from Commissioner Consedine, that we have this entity based system in the U.S. If you make real firewalls, you make firewalls really work, they can fundamentally shift the need and demand for capital and reserves, but the AIG case shows us that there was something very, very weird about investor belief and legal firewalls.

If investors had really believed those firewalls were there, would they have trusted AIG with all these undercapitalized guarantee commitments? I don't think so. So, effective firewalling requires a proactive informing of investors about the risk they are taking, and very clear priorities and resolution. And in capital, the recovering resolution, there's a clear connection there, and I think with capital and reserves, there are clearly connections to all four elements in this framework.

But we're going to be assessing capital regulation in light of how well and how clearly it addressed the lesson of the crisis that I laid out before. So thank you.

MR. ELLIOTT: Okay. Thank you all very much. I thought you all had quite interesting remarks, and you've given me a whole set of questions, so I will try to keep my time limited so all of you have a chance too. Let me start with -- I'll go through in this order. Commissioner, I thought you set up a little bit of a straw man in the sense -- and then Marcus had a star man too, so I'm not just picking on you. Both are straw men in the sense that you seem to imply that some of the international, or global regulators view capital as the answer to everything. Are you actually seeing them say that or show it in some concrete way? Because I've never heard one of them convey that to me.

MR. CONSEDINE: I think it's just really a function of where we see the focus of the debate. The time and the resources. So much of the discussion, when you go to the IAIS these days, is around capital. The BCR, the ICS, the HLA, developing all of these other elements of capital, and there are multiple work streams dedicated to one aspect of (inaudible). And I think our point is, again, we understand that is part of the comframe discussion. We need to develop capital, but what about all of the other significant lessons learned from the financial crisis that we also need to be continued to work towards?

Effective group supervision, in my opinion, coming out of the financial crisis -- one of the most important ones. Good corporate governments being another. Enterprise risk management, more so -- and again, when you look at what's going on in the work streams at the IAIS, much of the discussion is really focused on that capital, and I guess that's where we get the -- then fine, but let's also talk about these other things that are part of the whole package of global reform that we agree need to be talked about.

MR. ELLIOTT: Thank you, that's a good answer. Second questions I Had -- you kept things on a relatively high level, understandably. Can you give some examples of things you're worried about as to what might be included in the capital standards that you think might be inappropriate for the U.S.?

MR. CONSEDINE: Well, we'll go right into the heart of the matter in terms of evaluation of long-term liabilities, and a push and over-emphasis on market-consistent evaluation, being the direction that you see, generally the IAIS wanting to push us towards, which was alluded to in the prior panel, just really doesn't work here in the U.S., where we have a system based on Stat and GAP and products that really are based on our accounting system that we use here, based on an accounting system that you see being developed in Europe and elsewhere.

So I think our point there is, you know, again, let's focus on the outcomes, but let's not necessarily tie us to one jurisdictional preferred accounting standard, when we don't have a global accounting standard in place. So let's have some flexibility around that go back around to where the discussion started which was, we're going to talk about capital. Let's talk about it from an outcomes perspective, and let each jurisdiction develop an approach that works best for it.

MR. ELLIOTT: Okay. Sven -- question I have. I've had a sense that maybe of the European insurers are worried about the way that Solvency Two would affect their American operations. And if I understand the issue correctly, it's that Solvency Two in Europe is applied at the group level, including group operations which are in the U.S., and that Solvency 2 Capital Standards for at least some of these insurers would force them to hold more capital in their U.S. operations than U.S. rules, and presumably rating agency pressure would be required. Is that a fair statement, and do you think there's a good way of resolving this issue?

MR. GENTNER: Under Solvency 2, we basically have three different types of equivalents -- what we call equivalent that would work, that we could give to the industry, and it goes in several directions. One way is, of course, industry from outside the European Union, wanting to be active inside the EU, but the other direction is European industry being active in a market like the U.S. And we can take separate decisions on these things.

And in this process, one of the things of course we'll look at is in how far our EU companies active in the U.S. subject to a similar framework, and in how far can we then allow them to rely on the rules here, and not do everything according to Solvency 2, depending on how similar the two frameworks are, and the things that are involving. We'll have to look at that.

MR. ELLIOTT: Okay, and the Marcus, I think your straw man was that the industry says that there just isn't the possibility of runs. I have of course not heard anyone say that. They do argue that they're less prone to runs, and that they take a different -- they're -- they happen in different ways than in the banking industry, but I think anybody that's looked at this seriously, as I know you also have and you've alluded to, even in the U.S., we've had runs against major insurance companies, including I think Mutual Benefit with (inaudible) at the time, that it died.

So it can happen there. But (inaudible), coming from a public interest group, looking out for the benefit of consumers. You face an issue, it seems to me, different from what you do when you have your bank regulation capital on, which is, the products that most people use in banking are relatively straight forward on the hull. On the other hand, many times the insurance and investment products have a lot of bells and whistles that are included, often because their specifically things that the customer would like. How do you think through the right balance between making sure that there are appropriate capital levels, appropriate product design, et cetera, without stopping people from having features that they find to be useful?

MR. STANLEY: Well, you know, I have to say there are promises that are attractive to people without necessarily being a products that's going to be useful to someone. If you go out and tell someone hey, I'll guarantee you that you'll never lose your principle on this, you've never lose. I'm going to give you a floor guarantee on this. That can be a very attractive kind of promise to someone, but that could be a promise that either the insurance company can't execute on, or when you really analyze it, has, over a long period of time, a real loss to the person. I mean, people, especially when you're thinking over a long time horizon with an annuity that might have relatively lower term, so a fee that seems low could be very high proportion to that return. People often don't make that calculation perfectly well for themselves, and they often outsource that calculation to the broker, frankly, and the broker may have incentives that aren't their incentives. So you know, we fought for (inaudible) duty standards for -- in the Arissa context and for brokers when they are giving advice for precisely this reason. So, you know, I think it's a complex question, whether someone wants a complicated financial product.

And you know, there are also financial products where they're -- where, even if the person understands it, it can induce systemic risk on their part. Like some of these continued deferred annuities -- you have an enormous fee charged in exchange for that floor on loses. Well, what's the rational response to that? You go in there and you just load up like crazy on risk, because that's the way you can get your money's worth on that floor. It doesn't make sense to do a safe investment. So what you're then doing is concentrating that risk with the insurance company. It's not a good thing.

MR. ELLIOTT: Okay. Thank you. Now, Commissioner, you've touched on a very important issue that I wanted to bring up, and for much of the audience, this may not be something you focused on, (inaudible), but we do have a lot of insurance knowledgeable people here. But, when I give that very simple definition of capital before, it's the difference between the value of your assets and the value of what you owe, or your liabilities.

In insurance, unlike in banking, it's often very hard to know what the value is of those promises to pay. That, particularly, if you're providing life insurance or health insurance, or property casualty, of course. The amount of money, the assets you need to set aside to pay those future claims is uncertain. As you've pointed out, commissioner, the way that those reserving requirements are calculated in the U.S. are substantially different than much of the rest of the world. So I'm going to start with the other two and then come back to you, since you've already mentioned a little bit about it.

Given that this is so central to the capital calculation, because capital is assets minus these liabilities, do you think there's really going to be a way to find harmonized global approach to these calculations? We'll start with Sven and then Marcus.

MR. GENTNER: As I said before, I think we have to look at it at two levels. The one level is the globally systemically important insurers. And I think they will absolutely need to find something very soon, how we deal with them. Because there's been a lot of talk now about, do we really need these international -- this kind of coordination. Would it improve the situation, what have you?

Basel didn't prevent that last crisis. I suppose what we know for certain is the next crisis won't be the last crisis, and even though Basel didn't prevent the last crisis, I'm pretty that without Basel, it might have been a much worse crisis still. So I think there is a need for international coordination and there is a need, in particular, when it comes to these globally, systemically important insurance companies. And I think we're on a good track to find a way to deal with them.

I mean, from what has been agreed to up until now in the FSB and (inaudible), it's a very simple, slightly crude way of looking at things, but I think it will help to lay the foundation, to have a way to deal with (inaudible). When it comes to all internationally active insurers and the standards for them, I think we still have a ways to go. That is more complicated obviously, but I think as an objective, it's just as valid to try and find a system to have more regulatory coherence, and I think it's also something that will help make sure that we have a level playing field.

Because, of course, one issue is financial stability, and that's been the over-arching objective for several years, rightfully so, but I think we should also not forget that, given the global situation we have to make (inaudible), the difficulties of financing the (inaudible) economy and everything, we need a performant insurance sector, and we need an insurance sector that is subject to rules that work together and don't overlap and create friction, creating the potential for regulatory arbitrage and all that, and I think for that, we need more international coherence.

MR. ELLIOTT: Marcus, any?

MR. STANLEY: Well, we have divergence in accounting, even right here in (inaudible) in U.S. I mean, AFR was very involved in the negotiation on the recent insurance capital bill that just passed the senate and the debate between SAT versus GAP was very important in that, and of course the (inaudible) gap debate is very important for thinking about leverage ratios and bank. You know, I think what you have to do in all these things is surface the -- you're not going to be able to perfectly align these different standards. You're not going to be able to make them identical, but you have to surface the substantive issue that it is.

I mean, I think in SAT versus GAP, it has a lot to do with mark to market versus holder maturity, and also with the idea that entities are supposed to be firewalled. We have to ask, is that an appropriate assumption based on investor behavior and based on the kind of liabilities you're taking on? Certain kinds of liabilities are more appropriate mark to market, or hold to maturity, and you know, IFERS versus Gap, the derivatives netting issue, we've been very focused on. So that's all you can do really, I think. In the example in Basel, they have been working out a sort of harmonized leverage ratio, so that, you know, it's sort of in-between Gap and IFERs, so.

MR. ELLIOTT: Any additional comments on that topic?

MR. CONSEDINE: Well I think both Sven and Marcus have hit on some of the challenges that go to this sort of current theoretical debate around creating Global Capital Standards. I can't say that, again, from a U.S. delegation perspective, and that comprised of state insurance regulators, the Fed and treasury fire representatives. We're all committed towards working towards a solution that works for the U.S. But let me separate it, Doug, just briefly from that sort of theoretical exercise that's going on at the IAIS and compare it to the very real practical exercise that I, as a regulator have experienced the last few years, in the context of supervisory colleges, which is, and again, that's a forum where you have four large international active insurance groups in Pennsylvania.

We have a number of them that host or attend a college. Those involved, and I came from one as recently as last month, where we did a very deep dive on the company's group capital, its modeling, its analysis from an ORSA and ERM perspective on its capital needs, both at the legal entity level and at the group level, and we as regulators sat around that table and probed, pierced, challenged, analyzed that analysis, and ultimately as the end of the day came to a comfort level that yes, that company is more than adequately capitalized. And to me, we already met the goal in that particular case that comframe laid down for us, which is a comfort level collectively by the regulated legal entity regulator of large internationally active insurance groups on that group's capital.

So I think the point is, we're already making good steps forward and achievements in the context of supervisory colleges outside of this ongoing (inaudible) challenging debate and discussions we have to come up with a capital standard in the form of an ICS.

MR. ELLIOTT: Okay. And I'd like to give each of you a chance to comment on anything in the other two presentations that you thought you'd like to present a divergent view on. So I might as well go ahead and say was there anything that popped up while you were listening to the other two?

MR. CONSEDINE: You know, I think both presenters did a very good job. I would say, Sven, in the context of the U.S. EU discussion, and I have the privilege of representing state insurance regulators as part of that steering committee, and I think you made reference to a commitment of state insurance regulators to covered agreement as a process to resolve the re-insurance collateral. I think our position is a little bit more nuance than that, which is, we recognize that that is an ability that treasury has to pursue covered agreements, and certainly re-insurance collateral s one of those areas that has been identified very early on as being a natural subject of a covered agreement, but we -- and committed to that process in working through it, but at the same time, you know, we will continue to move forward with, I think, the very real progress we're making on the state side to modernizing our collateral requirements. And I think the more progress we make on that, I think it raises a question as to the need for covered agreement, which, in my opinion is a very significant step, really only to be used when you don't have that progress being made at the state level. But nonetheless, it has been identified as a mechanism and we are certainly a party to it, but I think we all need a lot more detail on what our friends at treasury and USDR have in mind when it comes to the details of covered agreement, and our first -- what we bring to the table is, will this be good for consumers, will this be good for our markets? And the jury is still out on that.

MR. ELLIOTT: Sven?

MR. GENTNER: Just to react to that, we fully understand that the landscape in the U.S. is, for once maybe even the EU, that doesn't happen very often. It's almost reassuring to us. No, seriously. We're glad that there is this interest and this commitment to say, let's take steps to maybe (inaudible) come to this kind of agreement, and we feel these are things that can help business and help the economy, but that can also help financial stability, that by working together in these areas, we can make sure that we don't make the mistakes that we did before.

And maybe just one more general word on this. One of the requests that the European Union has also made is to include financial regulation in tea tip, because we feel insurance is just one example, but there are many other examples as well, where enforcement by a U.S. corporation can help deal with these issues, and we're dealing with a very global industry, and they are very global questions, but even though they are global questions, lots of the business is still in the U.S., and I think together we have great chance to shape the regulatory framework for these industries in insurance and in other areas, and I think we should take this opportunity.

MR. CONSEDINE: Also, Sven knows now that I'm required to argue against the inclusion of these things in tea tip and AFR and many other public U.S. and European civil society groups do oppose the inclusion of financial regulation in tea tip, and I think a fundamental, just looking at it from the U.S. perspective for a second. There's a fundamental thing that – tea tip is kind of under the control of the USTR.

Treasury obviously has tremendous input into it, but those negotiations are kind of controlled by the USTR and not the line financial regulators, and in this case, we have the line financial regulators, the federal insurance office, the federal reserve, all kinds of regulators who have been -- the prevention regulators and so on who have been very, very engaged and involved on the financial stability board in a cooperative process, and we think it would be harmful, and actually the treasury department agrees with us, to remove this into the tea tip context.

One last thing I wanted to say -- I don't know if Professor Acharya is still here, but one difference I was picking up between his presentation and mine is that he was more focused on the asset side, where I Was more focused on the liability side, like let's make sure there aren't crazy promises on the liability side being made by insurers, which is something we are very concerned about and something I do think is very significant. I think his perspective was, you know, if you get a drop in the value of assets, even if insurers are being reasonable about their liability side, they're all of a sudden just not going to be able to play their intermediary role, in a sense, and that's going to create systemic risk, and I think that's an important perspective too. You have to think about the size of what that affect would be. It's kind of the fire sale effect. But it's also an important perspective that was a little different than the one that I took.

MR. ELLIOTT: Okay. I'd like to turn to the audience now. Please, do identify yourself, wait for the microphone, identify yourself, and if you can, please make it an actual question. So why don't we start from the back there?

MR. SNYDER: Dave Snyder, PCI. I will make it actually two questions, and I'll be very brief, and I want to get to the bottom lines on two fundamental issues we've discussed today. First of all, as Sven Gentner noted, that the ICS should take account of solvency 2. That's a reasonable perspective. I would ask the panelists, is it reasonable for the ICS to take account of, build on and recognize as compliant, the European system emerging under Solvency 2, as well as the U.S. system perhaps is modified. Secondly, the IIS is working on new meeting procedures that will eliminate pay to play, nobody disagrees with that, but will close meetings to both consumers and companies, and restrict the ability to affect and have input. My question to each of the panelists is, what's your position on those proposals?

MR. ELLIOTT: Why don't we start from your end, Marcus?

MR. STANLEY: I'm honestly going to back off a little bit. I just haven't been following the details of these things enough to be able to comment.

MR. ELLIOTT: Sven?

MR. GENTNER: Well, on the international capital standards, I think it's obvious -- of course it has to take into account the various frameworks that exist, but it also has to take into account what makes sense and what are good, robust working rules. Where exactly are we going to end up on this? I think that's unclear at this point in time. Of course there are different interests involved, but I think we all have to look at it not just from the perspective of what is there, what is being implemented, but from the perspective what makes sense, and what helps the international insurance industry, both in the sense of stability and efficiency. On the exact proceedings about what -- which meetings stay closed and open and all that type, I really cannot comment on that. In general, we are obviously in favor of transparent processes. Just to come back to tea tip (inaudible), I'm not going to abuse it any further. We just published our negotiating mandate on tea tip in the European Union, so we are taking these commitments very seriously.

MR. ELLIOTT: Commissioner?

MR. CONSEDINE: I think on the first question, Dave, it's kind of a no-brainer, recognizing that we, from the Us side need to come to the table, where I think a though out approach to Global Capital Standards and as I alluded to, I think we're well on our way to doing that and assuming we do that, and again, it reflects the principals of comframe, it's a no-brainer when you have the fist and two of the largest and most sophisticated markets in the world, generally at the same place, I think that should certainly be recognized and we just move on from there.

When it comes to transparency of the process used to produce what could be, you know, Global Capital Standards, we have, and I think my colleagues, who are regular attendees at the IAIS meetings, Commissioners McArdely and Ardy, Coblowski, McPeeken and others, and some key staff have been extremely vocal about our concern with the direction that the IAIS is going in reducing transparency and inclusiveness and participation and sort of the elements of fuel process that, again, I think was mentioned in the first process are inherent to any process we would utilize here in the U.S. to move forward with standards that we would present to our legislative bodies.

I know we probably have some folks who are on the legislative side, and we make those comments and criticisms to the IAIS, really as just a practical matter, which is, if you really want us to take these standards that come out of this process back to our home state legislatures or to Congress, in the case of the fed, let's make sure you have a process that's honest and that everybody, you know, bought into, and have the ability to participate. Otherwise, it's a non-starter when we talk to the members of Congress and members of our state legislature. So a little work on the front end in terms of the IAIS process, and you including transparency and openness, inclusiveness will go a long way on the back end to ultimately having the standards that we come up with implemented, which is the goal.

MR. ELLIOTT: Okay. Next? There's a woman up here.

MS. LUBRIS: Thank you. Elise Lubris from the NAIC. My question is for Mr. Stanley. Is there anything that you would suggest that the regulators, or even the rating agencies should be doing to reinforce the firewalls, and particularly in a way that would resonate with investors?

MR. STANLEY: You mean reinforce the firewalls between different insurance entities and non-insurance entities. Well, you know, Eric Denalo said that the rating agencies -- that AIG happened because of fictitious ratings. IN other words, that the rating agencies transferred the rating of the overall company to AIG financial products when they shouldn't have, because of these firewalls.

I guess all you can say is that the ratings weren't really that fictitious, since the people did get bailed out by a (inaudible) financial products, so they made a correct prediction. But rating agency practices definitely could become part of this change, where if a firewall is real, you need to be rating each tub, sort of on its own bottom. I think this gets into the area of resolution processes for insurance companies too. I think that people really need to see -- investors really need to see and be proactively informed. I will take this loss. Here's the people who are going to take this loss if this happens. I'm a general creditor to a non-insurance entity. I'm going to take a loss and the policy holders won't if this and this happens. And that probably involves thinking about the resolution process, even possibly the Dodd Frank title 2 resolution process. So I think it's a tricky thing. I don't have all the answers, but rating agencies would be a good place to start.

MR. ELLIOTT: Okay. Over there?

MR. CARRIS: Monty Carris again from Monty Carries Consulting. I have three questions for each of you.

MR. ELLIOTT: Why don't you start with two and we'll maybe get back to you.

MR. CARRIS: Well, Commissioner Consedine talked about the cost of policy holders (inaudible). Shouldn't there have been a cost-benefit analysis before the process started? We've already spent tens of millions of dollars doing this, and we still don't know the benefit to policy holders. To Sven, I would ask, in all other areas of commercial enterprise, the emphasis is on installing collateral requirements. Why should re-insurance counter to that? And to Marcus, you know, is CDS now, are they now insurance? Has anything changed? Has any lesson been learned? And moreover, was there a run on AIG on the life side in the U.S.? And did anybody in Singapore not get paid?

MR. ELLIOTT: Commissioner?

MR. CONSEDINE: On the cost of policy holders, Marty, again, that's a concern that we have expressed, I think, for a very long time now. And part of the frustration, you know, we have, is that we seem to be short circuiting the process that was originally laid out for us in terms of field testing a lot of these elements at a company level, before reaching actual decisions on the issues like capital standards and group supervision forms. And I think part of our expectation was that, you know, as part of a comprehensive field testing process, you would do a deeper dive, at least in terms of what's the impact on companies, which you could probably translate to its impact on consumers. We jumped ahead on a lot of those processes, and had conclusions pretty much reached for us already, and in doing so, I think it's really heightened our concern about the impact to consumers, which, as I said, is a part of the discussion that is not often brought to the table.

We actually took steps at the NAIC to fund consumer representatives to attend the IAIS meeting, who unfortunately probably won't with the steps that they're taking to close down the meetings. But again, that was a perspective that we thought was really important to have there, to provide. So we have those experts (inaudible). So again, it's an issue that we'll continue to raise, and hopefully, I think you here, you're starting to see Congress on both sides (inaudible) pick up on it, and it's a fair questions and I think one that's been raised in the U.S. in terms of the Fed, and (inaudible) will continue to push it internationally with the IAIS and FSP, so.

MR. ELLIOTT: Okay, so before we get to the other two, that touches on something I was meaning to ask earlier, which is -- I've heard it argues (inaudible), that what seems like an excessive haste on the part of the IAIS is because there has been an explicit mandate from the G20 heads of government. As high as you can get in this world, to hit a very aggressive time frame. Is that a fair assessment? And if they are trying to meet that, is there another way to do it?

MR. CONSEDINE: I think as I said in my remarks, our position is, this is a process that should be dictated by the regulators in the room that are dealing with the real world aspects of the various aspects of comframe and not necessarily because the DFSB told us to do so. And I think there's a balance, and Marcus made reference to the decade long process for Basel. We're saying -- we're on the other end of this extreme in that we're trying to develop capital measures in an incredibly short, and as one of my colleagues said, an almost reckless pace here, and it's really being driven for reasons that we're not quite sure we get. Let's take -- a simple point is, if we're going to do this, let's take the time we need to do it right. You know, because.

MR. ELLIOTT: But, I guess framing the question another way. If this really is coming down from the leaders of the 20 biggest countries in the world, do you have a choice about the process?

MR. CONSEDINE: Apparently now. And again , our issue with that is, it's also a process where the FSBU don't have state insurance regulators sitting at that table, reflecting some of the concerns that we have, both with the pace and with the direction. Doing it just for the sake of getting it done, to me, isn't a good reason.

MR. ELLIOTT: Sven?

MR. GENTNER: Maybe just on his also, I agree that there' always a question about how fast you do things. At the same time, sometimes it does also help to focus (inaudible) when you have a deadline, and without a deadline, this tends to drag on for a long time. On the collector requirements, I agree. If there are no adequate safeguards in place, of course you need these kinds of requirements, but we feel that with Solvency 2 now in the European Union, we have put the safeguards in place because there are specific provisions in Solvency 2 of how to deal with re-insurance collateral, and what kind of protections do re-insurers have to put there. And to have the collateral requirements here in the U.S. on top of that, we just see as an unnecessary burden, because the safeguards are already there. And we would like to look at the U.S. system in the same way and see what kind of protections are there, and what we can do in the EU. So I think it has to depend on a case by case comparison. It's not across industries, not across everyone. Equivalents, as we call them, have to do with a regulatory outcome. So do we achieve a similar regulatory outcome in the U.S. as we do in the EU? And if yes, can we do away with certain provisions? If we don't, nothing (inaudible) should keep them. We've never argued for across the board, doing away with safeguards if they are (inaudible).

MR. ELLIOTT: Marcus?

MR. STANLEY: When I used that slide, I knew somebody was going to ask about AIGs loss. I think it's very difficult to come up with a counter factual of what would have happened at AIG if the various federal reserve facilities and loans and interventions had not occurred, so U.S. policy holders did not take a loss at AIG but it's very difficult to tell what would have happened if there hasn't been that assistance. And in Singapore, they didn't take a loss, and the run was stopped, in part, because the government, the regulator in Singapore stepped in and said, there will be a firewall here. We are taking the resources within this subsidiary, and they are not going to flow out. I would be curious as to whether Commissioner Consedine could have, not being a sovereign country, could have done that in Pennsylvania.

I'm not a lawyer, so that's an open legal question. But that's kind of what it took, that they went in there, and, you know, there wasn't a run in the U.S., but there were giant declines in stock prices across the industry, as Professor Acharya pointed out, but I think we might have more faith in the U.S., in the federal reserves, than maybe in another country. I wasn't quite sure what you were getting at with the CDS question. I mean, CDSs are swaps, but financial guarantees -- CDSs in particular, swaps in general and CS as particular, do share a lot of characteristics with insurance. They are contingent, event based payments. Financial guarantees have bank and insurance kinds of characteristics. Some of us might favor swaps being regulated, CDSs being regulated more like insurance. That was not the course that was taken in Dodd Frank, though they are going to be backed up more by capital, I think.

MR. ELLIOTT: I think that's enough. Sir? Yes, it's coming.

MR. SIMMONS: Wayne Simmons, with State Farm. It seems like the debate boils down to legal, you know, firewall capital and legal entities versus fundable group capital in a group setting. And my question to you, to all of you, is this: what is the point of setting a group capital standard, unless your intent is to ultimately have fundable group capital? And then the second part of that is, has anyone done any analysis as to what fungible capital might mean for rat setting regulation in the United States? For legal liability regime? For the very integrity of legal entities themselves, and lastly, how much of this is enforceable. As Marcus may have pointed out, some countries don't want money moving out of their countries.

MR. STANLEY: I think you put your finger on it, actually, that if we're going to demand fungible group capital, are we changing the firewalling and potentially (inaudible)? AFR has supported separation in sort of a glass (inaudible) or (inaudible) type context separation between activities, either outside the entity or in swaps push out, you know, firewalling within the banks, so we are very friendly to the notion of firewalling, but you come to the -- I think our question, and this is one of the things that I was sort of wrestling with, and I said I didn't have the answer is, are we in a world where there is, you know, de facto, some kind of group -- investors are de facto, looking to the group and people are making commitments based on the groups, and if that's the case, you have to have some kind of backup for it, and I think, certainly you need some kind of group level supervision to see whether that's happening. Even if the supervisor doesn't impose the capital, they've got to know what's going on. So, you know, I think that was an open set of questions. And it has a lot to do with resolution too, because I think to make the firewall stick, you have to have a very clear resolution procedure -- has to be very clear in people's minds.

MR. ELLIOTT: Sven, how does it work in Europe?

MR. GENTNER: Well, I mean, within Solvency 2, the clear definitions of the group solvency ratio of minimum capital ratio and all that. So, my feeling is that we're pretty far advanced in this whole debate, in terms of the different entities, how they work together.

MR. ELLIOTT: I guess I was aware that you look at it on a consolidated basis. Do you look at it on an individual subsidiary basis as well, under solvency 2?

Commissioner, any comments?

MR. CONSEDINE: Well, I agree with Mark. That is the question and we've raised it any number of times in any number of ways at the IAIS. And really I think this is where you cross into the relationship between capital and the powers of the supervisor. What we really - what we're talking about here, when it comes to capital standards, are we really talking about the power of a group supervisor to direct the movement of capital at a legal entity level? That's a very different discussion than the one we're currently having, and if that's really what we're going for, then we should be having that discussion.

And again, we would offer some very strong views that no, when it comes to group supervision, that does not include the power of a group supervisor, doesn't invest it with superman like regulatory authority to say, move the capital from this legal entity to this legal entity. And again, we as the legal entity regulators, who -- our real function is to protect our consumers, especially in a time of crisis by ring fencing that capital, that's how our system works, and it's served us well.

We know what the AIG example -- and to answer your question Marcus, with the AIG in Pennsylvania, we could lock down capital and we did lock down capital, but at the same time, when we did that, diagnosis an assessment of what was needed for our policy holders, and determined that there was still a lot of excess capital available to push the group level, if need be, to help out there. We had that discussion, but it was a discussion. It was not a directive from one legal entity supervisor or one group supervisor to another.

MR. STANLEY: Can I just say one -- despite the naive perspective -- I'm not as experienced in these things as you, but obviously the stock holders are looking to group capital, and if the top management of the company is mostly paying attention to the stock holders, you know, that's an issue too. So, I'm not quite sure how that.

MR. ELLIOTT: If I could, and I think I probably have focus on insurance more than you have over the years, so if I could just expand on your point. I mean, when I think you've done a very good job of giving one side of the argument, and I don't personally have a strong view here, but to flesh out the other side, part of it, as Marcus said, is a concern that, in fact, the group may behave as a group, while -- I'm sorry.

Actually you were talking about a different -- that's the second point I was going to bring up. If it behaves as a group, which is really expanding on yours -- there are certainly instances in the past, in which a weak parent, or a parent with a weak subsidiary has found ways over time to move money over, despite all the protections that are there. For instance, cost-sharing agreements among all the subsidiaries within the group can always be changed around anyway.

So that would be one legitimate reason to think about the group capital, and the other would be as Marcus already noted. If the customers in fact have not been making the distinction between which entities they are buying from, that would be a second reason to care about it. And taken together, this might be why jurisdictions are trying to look at both levels. But you certainly raise important points, but what are the implications of doing that. Last question? Sir?

MR. SONICS: Ethan Sonics in NAIC. There's been a lot of discussion on the panel and among the audience about the legal entity in the group, and looking at that, and one of the things that concerns me, I'd be interested in the views on the panelists is, if we do think it's important to have those bulkheads, those firewalls around the insurance legal entities, you know, post Dodd Frank, the federal reserve, in implementing their source of strength doctrine, has the potential , at least for those (inaudible) holding companies, to be able to use insurance company subsidiaries, as a source of strength for the holding company or the bank. That, you know, I know from the point of view of insurance regulators scares us that you can have AIG insurance subsidiaries paying off credit defaults for counter-parties. Is this a concern that any of you all share, and what should we be doing about it to make sure that those firewalls, if we agree that they should stay there, are in place for those thrift holding companies. Thanks.

MR. CONSEDINE: Well, I think Ethan just sort of expressed the state regulator concern, and it is a concern, because again, that capital sits there for the protection of our policy holders at the legal entity level, and the same is probably true in most other countries. So having that potentially exposed in a source of strength approach is an issue. But I think right now is what we're doing is very engaged with, I think, a fed, that is similarly engaged with us in working through this, so we can get to a place where we have a better understanding of how it works in the insurance world versus how it works in the baking world.

And again, from our past experience, when you get into a situation like that, it can be a very cooperative, coordinated exercise. And the fed is now sitting with us at the table for the companies that they regulate as part of this exercise. So I think we can achieve a lot of what they may be looking to achieve through sort of a source of strength regulation through the supervisory college process and resolution planning that may come out of it.

MR. ELLIOTT: one quick thing. For those of you who are less familiar with the banking side, basically in banking regulation for some years now, it's been established that the holding company is supposed to serve as a source of strength for its banking subsidiaries. So it's actually a legal right to force funds to be put down, and that's why this becomes an issue, because there's never been the equivalent concept on the insurance side.

MR. STANLEY: Sorry. That's another great question, and just, real quickly, picking up on what Doug had said before about the cost-sharing agreements. That's a great example of how if the internal management is motivated by say, group wide stock pace, they can find all kinds of ways to go around the back of regulators in various ways. Even maybe have the legal right to go right in front of them to transfer money within the entity. That's why 23A and 23B exist in bank holding companies. In terms of source of strength, this is a very complicated legal doctrine and we are worried about precisely this issue.

You know, AFR believes in accountability and you know, ending moral hazard to the degree possible in the financial sector. We believe that wall-street counter parties who did not do their due diligence on whether someone could pay them back, you know, should take those loss -- shouldn't be able to raid policy holders for those losses. That is something we believe, sort of the justification for source of strength is to protect the deposit insurance fund. If you have a lot of policy holders in the small bank, and the back maybe doesn't have that many deposits, has a lot of other activities, it could be very inappropriate to use it there. But this is a very complicated legal question and we're just getting into it.

MR. ELLIOTT: Now, in theory, I'm supposed to subject you to about five minutes of concluding remarks, but I'm just going to skip that. So let's just thank the panelists.

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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Expires: November 30, 2016