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# SYSTEMIC RISK AND INSURANCE

## HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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# SYSTEMIC RISK AND INSURANCE

**Tuesday, June 16, 2009**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Sherman, Capuano, Hinojosa, McCarthy of New York, Baca, Lynch, Miller, Scott, Bean, Moore, Klein, Perlmutter, Donnelly, Carson, Speier, Foster, Adler, Kosmas, Grayson, Himes; Garrett, Price, Manzullo, Royce, Biggert, Capito, Hensarling, Neugebauer, McCarthy of California, Posey, and Jenkins.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Pursuant to an agreement with the ranking member, opening statements today will be limited to 10 minutes for each side. Without objection, all members' opening statements will be made a part of the record.

We meet to continue our discussion of insurance regulation, which the Capital Markets Subcommittee has debated in great depth for several years. On the eve of the Administration's unveiling of its plan to strengthen the oversight of our financial markets, it also appears likely that we will soon consider reforms aimed at mitigating systemic risk. As such, it makes sense for us to drive a bit deeper today into the issue of systemic risk and the insurance industry.

While we have yet to learn much about the specifics of the Administration's plan for insurance reform, we have spent enough time debating these issues to come to some conclusions. For example, I believe that only ostriches can now deny the need for establishing a Federal insurance resource center and a basic Federal insurance regulatory structure.

Insurance is a complex and important part of the U.S. financial industry, with more than $6.3 trillion in assets under management and $1.23 trillion in annual premiums. We need to recognize this reality by modernizing the overall regulatory treatment of insurance. We also need to protect against the risks certain sectors of

the industry may pose and address the greater sensitivity that some industry segments have to external events.

During this crisis, we saw a company that started out as an insurer spread far and wide in its activities and its international presence. American International Group, however, lacked a Federal regulator with real expertise about its vast insurance operations. Rather, the holding company purchased a small thrift and chose the Office of Thrift Supervision as its supervisor.

Currently, several other insurance holding companies have a Federal banking regulator as their primary supervisor, and more than 6 dozen similar entities avoid any form of Federal oversight, with selected States instead monitoring them on a consolidated basis. Because a number of these businesses could pose systemic risk, I believe that the Federal Government should directly examine all complex financial holding companies, including those whose primary activities involve underwriting insurance and those who play with credit default swaps.

In addition, our financial services markets are global and complex. Insurance is no exception. In order for effective communication and dialogue to take place on the international stage, we must have a single point of contact for the United States on these matters. Moreover, insurers must have a Federal regulatory voice on par with the banking and securities sectors in our financial markets so that the industry can communicate with its peer regulators at home.

In short, we can no longer sweep insurance regulation under the rug and cross our fingers that nothing will go wrong. We tried it before and learned that such an action may hide the mess for the short term, but pose greater problems in the long term. As such, when the Administration reveals its white paper tomorrow, I very strongly hope that it will recognize today's market realities and call for the establishment of better oversight for insurance holding companies and certain insurance activities, especially those most likely to pose systemic risk.

Moreover, I am confident that this Administration will recognize the wisdom of creating a Federal insurance office to advise a systemic risk overseer of the risks in the insurance sector, provide expertise to the Administration and Congress on insurance policy matters, and communicate with foreign governments. I have long advocated for such an office by introducing and advancing the Insurance Information Act. As part of the congressional restructuring of financial services regulation, I ask my colleagues to join me in the effort to enact this legislation.

With any luck, the Administration with its white paper will also hopefully advance the debate about Federal insurance regulation in other ways. Personally, I now believe that the Federal Government should actively regulate some specific insurance lines, especially those that pose systemic risk or which have a national significance. Using these tests, federally regulated lines would include bond insurers, mortgage insurers, and re-insurers. I also believe that we should examine how we can promote greater uniformity in the industry, with or without the establishment of a Federal charter. The Administration might reach similar conclusions.

In sum, before the Administration proposes its white paper tomorrow, we have many important issues to discuss related to regulatory restructuring as it affects the insurance sector today. I therefore look forward to the testimony of our witnesses and to a vibrant debate in the weeks and months ahead.

I would like to recognize our ranking member, Mr. Garrett, for 4 minutes, for his opening statement.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you all to our witnesses, as well, especially Mr. Skinner, who I understand came all the way across the ocean to be with us today. We have a fairly large panel, and wide perspective of different opinions on the insurance industry. So I look forward to all of your testimony.

Tomorrow, as you indicate, we expect to hear from the Obama Administration on its plan for financial regulatory reform. And, from what I can tell, it seems unclear to what extent a proposal will address insurance legislation. Different ideas have been floated, of course. But within the Administration and beyond, it seems that a clear consensus as to what to do in insurance has not totally been yet crystalized.

See, part of the difficulty, I think, in reaching a consensus on what to do is related to the difficulty in reaching a consensus on what is a systemic risk. And, furthermore, how do you identify it, if that's even possible in the future? And how should it be addressed if it is identified, and how it should be cleaned up, once it has been identified, if it's not too late.

Now, I would add another issue that policymakers should be thinking about: How can the policy be put in place so that incidences of systemic risk aren't actually encouraged in the first place, or exacerbated, or even institutionalized, due to government actions or unintended consequences?

I worry that some of the policies being considered by the Administration, and likely to be part of its plan, will unfortunately do more harm than good if they are actually implemented. You know, a systemic risk regulator, in conjunction with a resolution or a bailout regime will set up a situation where certain companies are either implicitly or explicitly perceived to fall under this yet another new layer of supervision, be seen as too-big-to-fail, gain an unfair advantage in the market place, and threaten further taxpayer pain.

Further complicating the resolution authority proposal is a question of how to pay for it. If only large firms potentially subject to the authority are asked to pay for it, then they will fairly explicitly be seen as beneficiaries of that regime. But asking a broader swath of the industry to pay for it would be not equitable, since smaller firms that have no chance of ever benefitting from it would be asked to contribute to a system design up there, and prop up their larger competitors.

Additionally, I don't believe that individual taxpayers should be asked to contribute to a fund that is set up to bail out a failed large firm and its creditors. And, furthermore, such a fund created for the resolution authority would need to be very large, and that's very costly for the firms that have to contribute to it.

But, at the same time, it would likely not be large enough to deal with an event deemed by regulators as truly significant.

As I said, I would argue that, at the first and foremost, we should concentrate on policies that don't encourage future bail-outs by promising firms that the government will always come to the rescue.

The Republican plan that was put forward last week addresses various policies that put the taxpayer at risk, but has no bail-out in the future. And its central unifying goal is no more bail-outs.

Now, returning to the theme of today's hearing, my primary questions are, are insurance firms, by their nature, systemically insignificant? I am looking forward to hearing from different participants on the panel on this question, in particular.

And, certainly, it would be a mistake to view the entire industry broadly as a single entity. At today's hearing, the breadth of the industry will be on display, as we will be hearing from the mortgage insurance industry, the bond insurers, life insurers, the re-insurers, as well as from the PNC sector, as well.

And we will also be hearing from the NAIC, which is actually in charge of insurance regulation in this country, as we speak. I am hopeful that its perspectives on systemic risk, how we might address it, and what further actions could be done, will be enlightening to everyone here today.

And finally, Mr. Chairman, as you know, you have introduced the Office of Insurance Information bill, the OII bill. And I know this legislation will be addressed by several members of the panel today. So I am interested to hear from our panel as to how this legislation may address deficiencies in our current framework. And I am particularly interested in its potential impact in regard to markets for the United States companies abroad, and related international agreements, as well.

So, once again, I welcome all the witnesses, and I look forward to their testimony. And thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. We will now hear from the gentleman from California, Mr. Sherman, for one minute.

Mr. SHERMAN. In this hearing is the question, what is insurance? Derivatives are, at best, insurance. At worst, they are a casino bet. AIG sold fire and life insurance through its regulated subsidiaries, and those subsidiaries are pretty much okay. It sold portfolio insurance through unregulated subsidiaries, convincing the world that it wasn't insurance, and they took down the company, if not the world economy.

The fire insurance policy on my house protects my lender in case my house burns down. But if my lender wants protection from the much greater risk that the value of my house goes down, or the value of my mortgage goes down, they also buy insurance. They call it a derivative, and it's completely unregulated.

We need to make sure that credit default swaps and similar derivatives are classified as insurance, and are subject to reserves. I yield back.

Chairman KANJORSKI. Thank you, Mr. Sherman. And now we will hear from another gentleman from California, Mr. Royce, for 2 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. And I would like to briefly thank Mr. Skinner for making this trip here to testify, and also

congratulate him on his recent election. He has been a leader in the European Union and in Parliament. He has been a leader and champion of the Solvency II directive, which provides an important yet relevant example of an effort underway to create a more efficient regulatory structure.

And yesterday's op ed in the Washington Post by Larry Summers and Tim Geithner noted the importance of international coordination among regulators, and reiterated the Administration's commitment to leading the effort to improve supervision around the world. Unfortunately, with our fragmented regulatory regime over insurance, we are lagging at this point; we are not leading the rest of the world.

As Solvency II works to unite the insurance markets in 27 member countries in the EU, we continue, on the other hand, to struggle with a patchwork system of 50-plus State regulators. With the implementation of this directive nearing, it is becoming more apparent that the framework potentially will be at odds with the U.S. regulatory structure. It is unlikely that the EU would find the current U.S. State-based regulatory structure equivalent.

This means the ability of our regulatory system to detect offshore risks will be weakened, and it also means that many of our U.S.-based institutions will be forced to shift significant operations overseas if they hope to continue to do business in the EU.

Certainly, an office of insurance information would be a logical first step to address this, and to address other problems we face in the international insurance market. However, an OII would rely heavily on the various State insurance commissioners to implement the regulatory policies. Without strong pre-emptive authority over the States, the ability of an OII to enact policies nationwide—and, consequently, the ability of an OII to adequately represent the entire U.S. insurance market—would be greatly weakened.

I remain concerned, however, that an OII will not go far enough. Maintaining solvency regulation at the State level will limit the effectiveness of a potential systemic risk regulator, as well as coordination efforts with foreign regulators.

Certainly, noting the failure of AIG, once the Nation's largest insurer, is relevant, given the focus of today's hearing. Dating back to 2006, the Paulson Treasury Department noted systemic gaps in the State-based system, which AIG exploited. The blame for the collapse of the company should start with AIG.

From a regulatory standpoint, there were failures at both the State and Federal level. Using capital from their insurance subsidiaries, with the approval of various State regulators, the securities lending division, in tandem with the financial products unit, put at risk the entire company and the broader financial system. Half of this came from the securities lending division, the other half from the financial products unit, in terms of the overleveraging.

With more than 250 subsidiaries operating in 14 States and more than 100 countries, AIG is the poster child for both the need to open up lines of communication among regulators worldwide, and the need to establish a domestic insurance regulator with the ability to oversee these large and complex institutions.

And again, Mr. Chairman, thank you for holding this hearing.

Chairman KANJORSKI. Thank you, Mr. Royce. And now we will hear from the gentleman from Georgia, Mr. Scott, for one minute.

Mr. SCOTT. Thank you very much, Mr. Chairman. I think this, of course, is a very important and timely hearing. The issue is, of course, I think, what is systemic risk as it relates to our insurance industry? And where and how is it best regulated, at the State or Federal level?

But I think that the major model that we are using, AIG, is flawed, at its best. Because, as we look back at it, what caused the problem at AIG was their Financial Products Division, based in London, which again was regulated at the Federal level.

So the question becomes, if we use a Federal charter, or regulate insurance at the Federal level, would that have prevented the situation at AIG? I think, going forward, we have to be very careful to make sure that the points we take into consideration are these: that we have the sound consumer protections in place; that we also do not deter competition; that we do not bring on excessive operating costs; and, in fact, in our efforts to do some good, that we do something that could very well be dangerous down the road.

So, the question becomes, do we do it at the Federal level or the State level? And, of course, as I say, we have to look with a very jaundiced eye, to make sure that we are looking right when it comes to the cause of this at AIG. Because if we did have Federal intervention there, as we had, and it didn't prevent it, what's to say that the Federal charter and Federal regulation is the way to go?

I think there is a lot to be said with making sure that we have regulations at the State level that work. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Scott. And now we have the gentlelady from Illinois, Mrs. Biggert, for 2 minutes.

Mrs. BIGGERT. Thank you, Chairman Kanjorski. I am pleased that we are having a second hearing to examine insurance regulation.

As I mentioned at the previous hearing, this is an important part of the conversation, as it relates to systemic risk. Fortunately, the insurance industry is in good shape, due to sound State regulation. I think State insurance regulators are doing a good job.

And with that, I would also like to thank and welcome to today's hearing Illinois Department of Insurance Director Mike McRaith, representing NAIC. I am really happy to have something really good to say about Illinois. That doesn't happen so much these days.

But it is important that we roll on to the debate on systemic risk the role of the Federal regulators when it comes to duly regulated entities like AIG. I think OTS dropped the ball, and that's why a part of our Republican regulatory reform proposal preserves the option for a thrift charter, but rolls OTS into the OCC.

And, in addition, our proposal addresses risky behavior that AIG-like entities may engage in, such as with derivatives. I think we establish a market stability and capital adequacy board, comprised of all Federal regulators and possibly others to look at what should be done with regard to the derivatives regulation. We recently had a hearing in this committee to discuss how over-the-counter derivatives could be put into the three buckets of regulation.

I also think that we need to improve the dialogue among regulators and insurance needs to be part of that dialogue. That's why I joined Chairman Kanjorski, with his Office of Insurance Information bill.

And, with that, I look forward to hearing from today's witnesses, who represent the very diverse insurance industry. I also look forward to working with them and my colleagues to strike the right balance on this matter. With that, I yield back.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert. And now we will hear from the other lady from Illinois, Ms. Bean, for 3 minutes.

Ms. BEAN. Thank you, Mr. Chairman. Being from Illinois, I would also like to give a shout out to Mike McRaith, but to all of our witnesses, as well, for joining us today, and sharing your expertise.

Until this year, the role of Federal involvement in the insurance industry has centered on whether to establish a Federal insurance regulator. I have worked with Congressman Royce on legislation to establish a Federal regulator for the insurance industry.

Last Congress, our bill was focused on consumer choice and protections, advantages for agents, and industry efficiencies. But much has changed in our financial system since the last Congress. The collapse of AIG, the world's largest insurer, has proven to be one of the most costly and dangerous corporate disasters in our Nation's financial history. With nearly $180 billion of Federal tax dollars committed to AIG, plus $22 billion to other insurers, the Federal Government has made an unprecedented investment in an industry over which it has no regulatory authority.

The need for Federal regulatory oversight has never been greater. And having a Federal insurance commissioner who can work with the expected systemic risk regulator or council is vital to ensure proper oversight of an important pillar of the U.S. financial system.

In April, Congressman Royce and I introduced H.R. 1880, the National Insurance Consumer Protection Act. Unlike previous legislation, our bill deals with systemic risk. Recognizing that Congress will create a systemic risk regulator, it subjects all insurance companies, national or State-chartered, to a systemic risk review.

The systemic risk regulator would have the ability to gather financial data from insurers and other financial services affiliates within a holding company structure to monitor for systemic risk. Based on that financial data, the systemic risk regulator can make recommendations to appropriate regulators for corrective regulatory action, including the national insurance commissioner.

The activities of an insurance company or companies, an affiliate of an insurance company, like an AIG financial products unit, or any product or service of an insurance company, would have serious adverse affects on economic conditions or financial stability. In this instance, the systemic risk regulator can recommend to the Federal or State insurance regulator that an activity, practice, product, or service must be restricted or prohibited.

In instances where a functional regulator refuses to take action, the systemic risk regulator would seek approval to override the functional regulator from a coordinating council of financial regu-

lators established in the bill that consists of the current members of the President's Working Group on Capital Markets, plus the Federal banking regulators, the Federal insurance commissioner, and three State financial regulators from the three sectors: insurance; banking; and securities.

Finally, if the systemic risk regulator determines an insurance company is systemically significant, it is required to consult with the national insurance commissioner to determine whether the company should be nationally regulated. I believe all financial activity, including that of insurance companies, should be subject to review by a systemic risk regulator.

Some suggest the insurance industry does not pose a systemic risk to the financial system. But we know from our experience at AIG that it did pose a systemic risk, and not just through the Financial Products Division, but through the securities lending program, which was regulated by the State insurance commissioners, and has led to over $40 billion in taxpayer money being invested.

As we move forward in the next few months to establish a systemic risk regulator or council, we need to provide this regulatory body with all the tools to properly review and evaluate the activities of insurance companies. That should include a Federal regulator for insurance that can work with a system risk regulator in a similar manner as the OCC and SEC do for their respective regulated industries.

Thank you, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Ms. Bean. And now, our final presenter, Mr. Hensarling of Texas, for 2 minutes.

Mr. HENSARLING. I thank you, Mr. Chairman. Thank you for calling this hearing. Obviously, these are very important issues for us to consider. There is no doubt each of us knows what a critical role the insurance industry plays in our economy today.

However, I am not sold on the belief that any one insurance company is necessarily an agent of systemic risk to the entire economy. And if I did believe that, I can think of no greater self-fulfilling prophecy than to designate a firm as systemically risky. Then it becomes systemically risky, and we know what happens after that—$173 billion of taxpayer money later, AIG has essentially become a conduit for the transferring of taxpayer wealth to counterparties, some of which include foreign entities.

Congress has to be very, very careful about introducing moral hazard into the equation, even more than already exists. We simply cannot enshrine a too-big-to-fail bail-out policy. There is a huge difference between the government walking in and bailing out an individual institution, and having emergency provisions for liquidity and stability aimed at the market as a whole.

We also have to remember that Federal regulation is not a panacea. Witness Fannie and Freddie, Wachovia, Citi, Bank of America, and the list goes on.

Finally, with respect to AIG, we had their chief regulator here on March 18, 2009. And the regulator said, "You know what? We had the resources, we had the expertise, we had the authority. We just simply missed it." Sometimes regulators get it wrong.

The ultimate goal here should be not to designate certain firms as systemically risky, so that we have more ticking time bombs,

like Fannie and Freddie throughout the economy that will ultimately blow up on the American taxpayer. We don't necessarily need more regulation; we need smarter regulation, which will help the consumer.

And with that, Mr. Chairman, I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Hensarling.

And now, we will have the panel. The panel is made up of eight members. That is why we contracted some of our presentations by the Members. Each of the panelists will be allotted 5 minutes. And, without objection, their written statements will be made a part of the record.

First on the panel, we have the Honorable Peter Skinner, a member of the European Parliament from the United Kingdom, and most recently re-elected—congratulations, Mr. Skinner, we look forward to your tenure. Mr. Skinner?

**STATEMENT OF THE HONORABLE PETER SKINNER, MEMBER, EUROPEAN PARLIAMENT**

Mr. SKINNER. Thank you very much, Chairman Kanjorski, Congressman Garrett, and honorable members of the subcommittee, for inviting me here today. I know this is a special occasion for me, if nothing else, for the fact that I have just been re-elected, but also to come here, to know that I am usually sitting on your side of this table, rather than here. But it is a great honor to be here, and I appreciate that.

I am Peter Skinner. I have been a member of the European Parliament since 1994. And this month, yes, I was elected for my fourth term. I am a member of the economic and monetary affairs committee and directly involved in the—what's known as the transatlantic regulatory dialogue, a discussion between Congressman—Shelley Berkley, I believe, chairs this subcommittee with the European Parliament. So we talk regularly about issues like this.

I was previously sponsor for the bill in the reinsurance directive in 2005, and Solvency II, which is now being passed as a law recently in the European Union, and will actually pass into the statute books of individual member countries by 2012. But each country is already moving towards that introduction.

Let me say I fully understand and respect, from the start, the need for each trading block to establish its own sovereign rules and practices, and therefore, wish this committee every success in its deliberations.

We have to take into account what I think we have already heard, however, that taking divergent approaches during a global recession, matched by the kinds of things that we know about across the Atlantic and around the globe, will actually lead to the wrong conclusions. We need to agree on common approaches, common regulatory structures. But this doesn't mean we have to say exactly the same thing.

In terms of systemic risk and the insurance industry, it is the management of that risk that is important for the European Union. It is the chain of events which leads to systemic risks. And this begins with the failure of management and the supervision of such risks. The EU's focus has been to try to eliminate any failure by

predicting behavior, using reasonable models, and testing against them. In fact, we have been having impact assessments which involve American companies inside the European Union giving evidence as to that effect.

In Europe, a committee led by Jacques de Larosiere—you may have heard of him—a former managing director of the International Monetary Fund—has proposed sweeping changes to the way the European financial services are regulated. These changes would result in the creation of a European systemic risk council, an independent body responsible for safeguarding financial stability and conducting macro-prudential supervision at the European level.

Europe gets its information on the insurance business from the 27 regulators it has representing all of the individual member states of the European Union, and these meet under one body: CEIOPS, it's called, the Committee of European Supervisors. It sits in Frankfurt, and agrees common standards which are applied, through the Solvency II law, across the European Union.

In terms of that cross-border oversight, we have developed a system which is coming, again, from the de Larosiere report, which highlights the need for greater integrated supervision. The proposal is to bring together the work of the three committees in the capital markets and insurance and in banking through the supervision through one financial sector type of regulatory body.

In terms of developments from abroad which may affect the U.S. market—and, again, I come from a European perspective; I can only talk really about how our markets are interconnected, and we have seen that the near-financial meltdown and has meant that, actually, when you get a cough or a cold in California, we feel the sneeze effect in London, in Frankfurt, and in Rome.

Solvency II was set outside of this financial crisis, and was trying to look and predict what might go wrong already. It is a radical overhaul of the prudential regime for insurers in the European Union. The objectives of Solvency II are to deepen integration in the EU insurance market, enhance policyholder protection, and improve the international competitiveness of EU insurers and re-insurers.

International communications amongst regulators can be difficult. And you know, in order to be able to get this move-in, we have to try and do something about this. It is difficult if we don't have a single regulatory person to speak to.

In fact, the United States, I understand, is the only country around the world not represented by a single national insurance regulator at the International Association of Insurance Supervisors. And that's where it begins on third country equivalents in the context of Solvency II. We will be faced with the same question we always face: Who are we going to talk to? Who speaks for the United States, as a whole, on insurance? And I believe, for us, this is a question about how we move on. That is up to you.

But our maintaining the standards and enforcing the rules at the European level, I can tell you that, along with the regulators, we have the European Commission, which ensures, at the administrative level, that the European directives are sensibly applied in each country. And as those laws are applied with American countries

doing business in Europe and European countries doing business across the whole of the European Union, it allows for each country to do business, State by State, by member country by member country.

On systemic risk and insurance, just a short comment, if I might. During the current crisis, the insurance companies that were most likely to be affected—and I have heard it already today—were those involved in significant quasi-banking activities. That's a fact.

There are second order effects, as well. We are aware of that, and I think that we have to appreciate that. But they were not the directly involved facts which may lead to greater systemic risk. It is the failure to use appropriate controls and manage risk that we believe leads to the problem of systemic risk.

On Europe's attitude to guaranty funds, burden sharing and compensation schemes are not necessarily practiced in every member state across the European Union, but we are now considering how to change that to introduce it.

So, in conclusion, Mr. Chairman, if I can say that if there is anyone who has been close to this committee's work and what you are going to do, it is I. And I look forward in any way to help, to offer to help, to be a resource in any way from the European Union, and through our committee in the European Parliament, to offer fraternal greetings and respect to what you do here to come up with common approaches and common deliberations to face a global crisis. Thank you.

[The prepared statement of Mr. Skinner can be found on page 131 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Skinner. Next, we will hear from the Honorable Michael T. McRaith, director of the Illinois Department of Insurance, testifying on behalf of the National Association of Insurance Commissioners. Mr. McRaith?

**STATEMENT OF THE HONORABLE MICHAEL T. McRAITH, DIRECTOR, ILLINOIS DEPARTMENT OF INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)**

Mr. MCRAITH. Chairman Kanjorski, Ranking Member Garrett, and members of the committee, thank you for inviting me to testify. I am Michael McRaith, director of insurance for the State of Illinois. And, as mentioned, I speak today on behalf of the National Association of Insurance Commissioners.

The insurance industry, even in these difficult times, has withstood the collapses that echo through other financial sectors. We likely agree that insurance regulation must not only serve industry needs, but also prioritize U.S. consumers. Consumer protection has been, is, and will remain priority one for State regulators.

It bears repeating that we supervise 36 percent of the world's insurance market. Our States, individual States, include 4 of the top 10 and 28 of the top 50 world markets. And alone, we surpass two, three, and four, combined.

To be sure, as with any dynamic industry, insurance regulation must modernize, and it does. We worked with your great staff, Mr. Chairman, to fashion the office of insurance information, which, if

passed, would provide a Federal focal point for international trade matters and Federal data analysis.

The NAIC maintains the world's largest insurance database. While the States do and will provide data to Federal regulatory counterparts, we agree that insurance sector data should be available within the four walls of the Federal Government.

Consolidated oversight of holding companies will be enhanced by a council of regulators that build on the existing data and expertise of functional regulators. State insurance regulation is, of course, inherently compatible with a systemic stability council. Any financial stability regulator should develop best practices for risk management, required for U.S. insurers, but glaringly lacking in other sectors. Information sharing and confidentiality protocols can be established, and coordination among regulators formalized.

Under no circumstance, though, should a viable insurance subsidiary be sacrificed for the benefit of another entity within a corporate family. Internationally, the development of accounting standards through the international accounting standards boards leads the United States and others within the next several years to adopt accounting standards based on international financial reporting standards.

We have undertaken a solvency modernization initiative that will evaluate lessons learned nationally and internationally, and examine areas appropriate for refinement.

We work internationally with the G20, the joint forum, CEIOPS, the Financial Stability Forum, the International Association of Insurance Supervisors, the OECD, and others. We work collaboratively with our international counterparts to develop and improve international standards. We brought our foreign counterparts to the United States, and developed a standardized MOU to allow for international information sharing. With the world's most competitive, mature marketplace, we, your States, are the gold standard for regulation in developing countries.

Through the Holding Company Act, we monitor release of capital from an insurer and support our system of multi-jurisdictional regulation. Our expertise can be applied to international cross-border transactions, but all insurers operating in our country must be independently viable.

Our financial analysis working group coordinates leading financial regulators from multiple States for the purpose of monitoring and analyzing and coordinating action involving major insurers. Internationally, with supervisors from other countries, we participate in colleges, monitoring Berkshire, AIG, Zurich, Swiss, and ING, among others.

Indeed, insurance is not a source of systemic risk, and not one insurer imposes systemic risk. Insurers may be challenged by failure in other sectors, as with AIG. But the most vibrant markets in the world mean the demise of any one insurer will not alter our country's financial stability.

Also, contrary to misleading alarms, our State guaranty fund system has the wherewithal and the creative force to resolve insurer failures, even multiple concurrent failures, while protecting consumers.

We support systemic regulation, pledge our good faith interaction, and renew our commitment to engage constructively with this committee. Thank you for your attention. I look forward to your questions, and replying to comments made by Mr. Skinner and others.

[The prepared statement of Mr. McRaith can be found on page 104 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. McRaith. And next we will hear from Ms. Teresa Bryce, president of Radian Guaranty Incorporated, on behalf of the Mortgage Insurance Companies of America. Ms. Bryce?

**STATEMENT OF TERESA BRYCE, PRESIDENT, RADIAN GUARANTY INC., ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA (MICA)**

Ms. BRYCE. Thank you, Mr. Chairman, Ranking Member Garrett, and members of the subcommittee. I appreciate the opportunity today to testify on behalf of the Mortgage Insurance Companies of America, the trade group representing the private mortgage insurance industry.

Mortgage insurance enables borrowers to responsibly buy homes with less than a 20 percent downpayment. Many of these are first-time and lower-income borrowers. Since 1957, mortgage insurance has helped over 25 million families purchase homes. Today, about 10 percent of all outstanding mortgage loans have private mortgage insurance.

This morning, I would like to make three points. First, we do not cause or contribute to systemic risk. To the contrary, we absorb risk. If a borrower defaults, mortgage insurance pays the lender or investor 20 to 25 percent of the loan amount, plus expenses. The insurance payment plus the proceeds from the sale of the house makes up much of the lender's or investor's loss.

In the current crisis, since 2007, we have paid over $15 billion in losses, just like we are supposed to do. I would also note that, because mortgage insurance companies have their own capital at risk, we have very clear incentives to mitigate our losses, by taking action to avoid foreclosures, if at all possible. Last year, mortgage insurers were able to save almost 100,000 people from losing their homes.

My second point is that the industry has adequate capital to continue paying claims on existing loans into the future, because our State regulators require us to have sufficient capital reserves. The backbone of the industry's financial strength is the State-imposed reserve requirements, and specifically the contingency reserve. Half of each premium dollar earned goes into the contingency reserve, and generally cannot be touched by the mortgage insurer for 10 years. This ensures that significant reserves are accumulated during good times, so that they are able to be there to handle claims in bad times.

The history of the mortgage insurance industry illustrates the value of this reserve structure. Mortgage insurers paid out millions in claims, as a result of regional recessions in the 1980's and the 1990's. After each recession, we built-up capital and were able to meet the next stress period.

Mortgage insurers and the banks that make the loans face similar mortgage default risks. But only mortgage insurers raise capital in this countercyclical manner. In fact, only now are Federal banking regulators working to construct a similar system for banks.

My third and final point is that, with additional capital, we can significantly help the housing recovery by responsibly expanding the number of new home buyers. As the subcommittee knows, the members of MICA have requested capital assistance from Treasury. As I have explained, we do not need help to meet our obligations to pay projected claims on our existing loans. Instead, we are asking for assistance in order to increase the number of loans we are able to insure, while maintaining strong capital reserves.

Every billion dollars of capital mortgage insurers hold translates into approximately $100 billion of new funding for home purchases, more than 650,000 new mortgage loans. A $10 billion program would increase market capacity by enabling 6.5 million loans to be insured. Such a government investment would dramatically benefit the housing market, and enable more borrowers to realize the dream of homeownership on terms they can afford and sustain.

So the bottom line is that, with additional capital, the mortgage insurance companies can insure more loans. We hope it is forthcoming.

In conclusion, I want to thank you for the opportunity to testify today. The private mortgage insurance industry continues to absorb risk, just like it is designed to do. MICA strongly supports the State regulatory system, and believes the structure assures that we can continue to meet our obligations during these very challenging times.

We also would like to contribute still more to the housing recovery. We could do so the day after we receive additional capital. This is a housing recovery program that is ready to go. Thank you.

[The prepared statement of Ms. Bryce can be found on page 73 of the appendix.]

Chairman KANJORSKI. Thank you very much, Ms. Bryce. And next we will hear from Mr. Sean McCarthy, chief operating officer of Financial Security Assurance, Incorporated. Mr. McCarthy?

**STATEMENT OF SEAN W. McCARTHY, PRESIDENT AND CHIEF OPERATING OFFICER, FINANCIAL SECURITY ASSURANCE HOLDINGS LTD.**

Mr. MCCARTHY. Thank you. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, my name is Sean McCarthy, and today I am testifying in my role as president of Financial Security Assurance Holdings, or FSA, and Assured Guaranty Corporation, which is expected to complete the acquisition of FSA on July 1st.

We appreciate the opportunity to testify at this hearing to improve oversight of the insurance industry and a restructuring of the Federal Government's role with regard to insurance products.

As monoline insurance companies, we provide, in the case of FSA, bond insurance for the U.S. municipal and global infrastructure markets. And in the case of Assured, bond insurance for U.S. municipal, global infrastructure, and structured financings. Insurance utilized only in the financial markets is a very different prod-

uct from that of property casualty, life, and health insurance companies.

Article 69 was enacted by New York State to segregate financial guaranty insurance from multiline products and the risks those entail. While it was a good step, it is not strong enough. We believe we require mandatory Federal regulation that is closer to that of the banks, and that, being centralized and encompassing all aspects of regulation, including required capital.

The current decentralized regulatory regime for monolines is aimed at preserving their solvency, rather than their financial stability. There are no uniform, consistent credit, capital, and financial strength standards. Recognizing this, the New York insurance commissioner, Eric Dinallo—who has recently announced that he is leaving—had noted the potential need for Federal regulation with the bond insurers in the monoline industry.

Importantly, due to the lack of a single regulator, the rating agencies have become the de facto regulators of our industry. While we continue to strive to achieve the highest possible ratings, we believe the rating agency views currently play too singular a role in the evaluation of our financial strength. Ratings are based on criteria that vary, and include many subjective characteristics. And rating agency methodologies are not readily transparent.

Additionally, all three rating agencies have different sets of guidelines, which present conflicting goals, and make it possible to manage a stable company.

Though investors cannot easily evaluate rating agency conclusions, due to the impact of their ratings on trading value of securities that monolines have insured, investors are forced to accept the impact that ratings have, with respect to financial guarantors.

The end result of this de facto regulation by rating has been to destabilize markets and reduce municipal issuers' cost effective access to the capital markets. This has been most difficult for small municipal issuers and municipal issuers of complex bonds, where bond insurance homogenizes the credits, providing market liquidity and market access. The penetration of the bond insurance industry for the first 5 months of 2009 has been 13 credit. The letter of credit has now declined to about 6 percent.

Certainly, there is no question that some financial guarantors took large, concentrated risks in mortgage-backed securities that severely underperformed, which, in turn, caused downgrades, or failures, of five of the seven primary guarantors. Notably, many of these now problematic transactions were rated AAA by the rating agencies at the time of issuance.

The financial guaranty industry is now in a rebuilding phase, and a number of potential new entrants are poised to participate in the market. Assured and FSA have come through this unprecedented period of turmoil in strong capital positions. And, despite the understandable concerns that the market has expressed about the financial guarantee model, we are confident that investors will continue to see value in guarantors that combine capital strength with diligent experienced credit selection skills.

In conclusion, we would like to see mandatory Federal oversight of our industry that would provide regulation by design, not by default. We believe that licensing requirements should be stringent,

and require high but predictable capital levels. Guarantors should provide detailed disclosure of risks to all constituencies, and should be subject to an annual stress test that would be applied equally to all companies. This would increase investor confidence, and provide much needed transparency and stability to the capital markets.

Thank you. I look forward to your questions.

[The prepared statement of Mr. McCarthy can be found on page 98 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. McCarthy. Next, we have Mr. Kenneth Spence, executive vice president and general counsel at the Travelers. Mr. Spence?

**STATEMENT OF KENNETH F. SPENCE, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, THE TRAVELERS COMPANIES, INC.**

Mr. SPENCE. Chairman Kanjorski, Ranking Member Garrett, and subcommittee members, thank you for the opportunity to testify today on systemic risk and insurance. My name is Ken Spence, and I am executive vice president and general counsel of Travelers. Travelers offers a wide variety of property casualty insurance products, and surety and risk management services to numerous businesses, organizations, and individuals in the United States and abroad. Our products are distributed primarily in the United States through independent insurance agents and brokers. And the company is a member of the American Insurance Association.

There appears to be an emerging consensus that there should be systemic risk regulation at the Federal level. I will share some of Travelers's specific systemic risk regulation recommendations in a moment.

However, for any systemic level oversight to be meaningful across financial service sectors, there must be an insurance regulatory presence at the Federal level, to ensure that appropriate information is provided and analyzed, and to ensure that any systemic-level directives are effectively implemented.

To that end, the creation of an office of insurance information, as the chairman has proposed in his legislation, would bolster the Federal Government's presence in, and understanding of, the insurance sector. The OII would bring needed information about the insurance market place to Washington and to any national systemic regulator, and would give the United States a single voice with which to speak on international insurance policy and trade matters.

We believe a comprehensive approach to Federal financial services modernization will not be complete unless it also includes a broader Federal insurance presence that encompasses Federal chartering for insurers. This will ensure robust and consistent regulatory oversight, strong consumer protections, and a healthy competitive insurance industry.

We have been carefully considering the notion of systemic risk regulation. As an initial matter, we are mindful that the determination as to whether a company is systemically important does not necessarily depend upon its size or industry, but rather to the extent to which its financial condition is potentially so inter-related

with other institutions that its failure could cause widespread and substantial economic harm, extending beyond those stakeholders who would assume the risk.

For example, any unregulated holding company with a strong credit rating from its underlying operations could have underwritten credit default swaps which played an important role in the current financial crisis.

In addition, we think it is also relevant to consider the systemic risk that may be presented on an aggregate industry-wide basis. For example, even if a particular community bank or insurance company would not present systemic risk, the widespread failure of community banks or insurance companies could. A natural or man-made catastrophic event or series of events, for example, could cause more than an isolated failure of property casualty insurance companies, which in turn, could be systemically significant.

There are two elements in particular that we recommend for your consideration in a reform proposal: mandated internal enterprise risk oversight through board-level risk committees; and substantially enhanced disclosure requirements related to risk. I must emphasize at the outset that our two recommendations are not intended to be a comprehensive solution. But we believe that any such solution should include these two essential elements.

First, corporate governance reform should require systemically important companies to assign responsibility for risk oversight to a committee of their board of directors with a management risk officer that reports directly to the board committee on a regular basis. Travelers has, for many years, had a board risk committee and a CRO, and the relationship is akin to a board audit committee relationship with the company's chief internal auditor, who often reports directly to that committee.

A board's risk committee would be responsible for overseeing the company's risk-related controls and procedures, and the chief risk officer would be responsible for implementing and managing those controls and procedures. This protocol recognizes the importance of risk management, and provides clear responsibility and accountability for the management of risk.

Second, systemically or potentially systemically important financial institutions should be subject to a robust disclosure regime in order to provide regulators, rating agencies, and the public with the information necessary to provide a comprehensive understanding of an institution's overall risk profile, and to be able to identify those institutions that pose—or that could pose—a systemic risk to the economy. Market forces would, in turn, help to limit a company's incentive to take risks that could potentially undermine its own long-term success, and, as a result, the larger economy.

A more robust disclosure regime should be principles-based and flexible, but include additional quantitative disclosure of transactions and risks and other factors, including mandated stress testing that could cause a systemically important company to fail.

Thank you for affording me the opportunity to testify today, and I will be happy to respond to any questions you may have.

[The prepared statement of Mr. Spence can be found on page 137 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Spence. Next we have Mr. Franklin Nutter, president of the Reinsurance Association of America. Mr. Nutter?

**STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA (RAA)**

Mr. NUTTER. Mr. Chairman, members of the committee, thank you very much. I am Frank Nutter, president of the Reinsurance Association of America, representing reinsurance companies doing business in the United States.

Reinsurance is a risk management tool for insurance companies to improve their capacity and financial performance, enhance financial security, and reduce financial volatility. Reinsurance is the most efficient capital management tool available to insurers.

Reinsurance is a global business, and encouraging the participation of reinsurers worldwide in the U.S. market is essential, because reinsurance provides that much needed capacity in the United States for property casualty and life risks. Including their U.S. subsidiaries, foreign-owned reinsurance companies accounted for nearly 84 percent of property casualty premiums ceded on U.S. risk by U.S. insurers.

Because the reinsurance transaction is between sophisticated business parties, the regulation of reinsurance focuses almost exclusively on prudential regulation, insuring the reinsurer's financial solvency, with no consumer component. Because reinsurance is a business, a business transaction involving knowledgeable commercial parties, there are no reinsurance guaranty funds at the State level, and there is no need to create one at the Federal level.

As this committee is well aware, there is no Federal entity with statutory authority or designated responsibility for oversight of insurance. Consequently, when an insurance issue arises, there is no source of information at the Federal level to appropriately advise policymakers.

At a minimum, there is a need for a Federal entity that can utilize information and data from State regulators, but which is empowered to conduct its own analysis and provide advice on a broader perspective than individual State interests. We believe the chairman's office of insurance information legislation is good and timely, and goes a long way toward addressing this problem.

Reinsurance is an important part of the risk transfer mechanism of modern financial and insurance markets. Yet there are clear distinctions between risk, finance, and management products that are relatively new financial tools, developed in unregulated markets, and risk transfer products like reinsurance, whose issuers are regulated by U.S. regulators, or by their non-U.S. regulatory domicile, and whose business model has existed for centuries.

In the case of reinsurance, regulatory reform is necessary to improve regulatory and market efficiency, and maximize capacity in the United States. And that reform should focus on licensing, prudential regulation, and international coordination and cooperation.

It has been suggested that the authority of a systemic risk regulator should encompass traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, and authority to take regulatory ac-

tion, if necessary. We are concerned that the systemic risk regulator envisioned by someone without clear, delineated lines of Federal authority and strong preemptive powers would be redundant with the existing State-based regulatory system.

We also note that without reinsurance regulatory reform and a prudential Federal reinsurance regulator, a Federal systemic regulator would be an additional layer of regulation with limited added value, create due process issues for applicable firms, and be in regular conflict with the existing multi-State system of regulation.

Foreign government officials, not unlike Mr. Skinner today, have continued to raise issues associated with having at least 50 different U.S. regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies. The time has already arrived when this lack of a single voice is adversely impacting U.S. reinsurers. The interaction between the United States and its foreign counterparts on issues like European Union Solvency II will likely impact not only the ability of U.S. companies to conduct business abroad, but also the flow of capital to the United States.

The possibility that the entire 50-State system in the United States will be deemed equivalent appears questionable, at best. Thus, without a Federal involvement by a knowledgeable entity tasked with responsibility for international policy issues, the U.S. reinsurance industry will continue to be disadvantaged in these equivalence discussions.

The current multi-State U.S. regulatory system is an anomaly in the global insurance regulatory world. The United States is disadvantaged by a lack of a Federal entity with constitutional authority to make decisions for the country, and to negotiate international insurance agreements.

The RAA was encouraged by the inclusion of a system of supervisory recognition among countries in the National Insurance Act of 2008, S. 40, introduced in the last Congress. Supervisory recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries, and allows reinsurers to conduct business, based upon the regulatory requirements of their home jurisdictions.

A single national regulator with Federal statutory authority could negotiate an agreement with regulatory systems of foreign jurisdictions that achieve a level of regulatory standards, enforcement, trust, and confidence with their counterparts in the United States.

Financial markets are global and interconnected, and no sector is more global than reinsurance. Even the NAIC has acknowledged that, "The time is ripe to consider whether a different type of regulatory framework for reinsurance in the U.S. is warranted."

As Congress proceeds with financial services modernization, we emphasize that only the Federal Government currently has the requisite constitutional authority, functional agencies, and experience in matters of foreign trade to easily modernize reinsurance regulation. Multi-State regulatory agencies on matters of international trade are, at best, inefficient, pose barriers to global reinsurance transactions, and do not result in greater transparency.

The RAA recommends that reinsurance regulatory modernization be included in any meaningful and comprehensive financial services reform, through the creation of a Federal regulator, who would have exclusive regulatory authority over reinsurers that obtain a Federal charter, and make clear there is no redundancy with State regulation.

We further recommend that any financial reform incorporate authority for a system of regulatory recognition to facilitate cooperation and enforcement with foreign insurance regulators.

Thank you very much.

[The prepared statement of Mr. Nutter can be found on page 120 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Nutter. Now we will hear from Mr. Patrick S. Baird, chief executive officer of AEGON USA, on behalf of the American Council of Life Insurers. Mr. Baird?

**STATEMENT OF PATRICK S. BAIRD, CHIEF EXECUTIVE OFFICER, AEGON USA, LLC, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS (ACLI)**

Mr. BAIRD. Chairman Kanjorski, Ranking Member Garrett, and other members of the subcommittee, I would like to thank you for the opportunity to appear today to present the views of the life insurance business on systemic risk and its implications for financial regulatory reform. I am Pat Baird, CEO of AEGON USA. I live and work in Cedar Rapids, Iowa.

I would like to lead off with the premise that the life insurance industry is, by any reasonable measure, systemically important. And, from that, it follows that whatever regulatory reform package you advance must include the life insurance industry in order to assure that the resulting new regulatory structure operates as effectively as possible, and minimizes the likelihood of a similar crisis occurring again.

Here are some highlights on the importance of the life insurance business. Life insurance products provide financial protection for some 70 percent of U.S. households, or over 75 million families. There is over $20 trillion in life insurance in force, and our companies hold $2.6 trillion in annuity reserves. Annually, we pay out almost $60 billion in life insurance benefits, over $70 billion in annuity benefits, and more than $7 billion in long-term care benefits.

We are the backbone of the employee benefit system. More than 60 percent of all workers in the private sector have employer-sponsored life insurance, and our companies hold over 22 percent of all private employer-provided retirement assets.

Life insurers are the single largest source of corporate bond financial, and hold approximately 18 percent of total U.S. corporate bonds.

I would also note that without the financial protection provided by the life insurance companies, American families may very well need to rely on the Federal Government for assistance.

That said, we don't believe any individual life insurance company poses systemic risk. So the question becomes, how do you deal with an industry that, as a whole, is systemically important, but which doesn't have any individual companies that pose systemic risk?

First, we assume life insurers will be covered in whatever broad systemic risk oversight is made applicable to the banking and securities industries. Beyond that, we believe it is imperative that Congress create a Federal functional insurance regulator, and make it available to all life companies within the industry on an optional basis. There was ample justification for the creation of such a regulator prior to the crisis, and the case today is even stronger, after the crisis.

Absent a Federal functional insurance regulator, there is a very real question regarding how national regulatory policy will be implemented, vis a vis insurance. Whatever legislation this Congress ultimately enacts will reflect your decisions on a comprehensive approach to financial regulation. Your policies need to govern all systemically significant sectors of the financial services industry, and need to apply to all sectors on a uniform basis, and without any gaps that could lead to systemic problems.

It's also worth noting that critical decisions are being made in Washington affecting our business today, but they are being made without any significant input or involvement on the part of our regulators.

Some specific examples include: the handling of Washington Mutual, which resulted in life insurers experiencing substantial portfolio losses; and the suspension of dividends on the preferred stock of Fannie and Freddie, which again significantly damaged our portfolios, and directly contributed to the failure of two life insurance companies.

The mistaken belief by some that mark-to-market accounting has no adverse implications for life insurance companies, and more recently, provisions in the proposed bankruptcy legislation that could have resulted in unwarranted downgrades to life insurers' AAA-related residential mortgage-backed investments.

The industry also supports a level playing field at an international level, as regards financial reporting and solvency. Competition should be about serving customers, operating efficiencies, and basically slugging it out every day and proving your business model. Competition should not be about capital accounting or tax arbitrage. But yet, today, we have no regulator there with authority that can engage with Mr. Skinner and other international regulators.

I would also like to make the point that concerns over regulatory arbitrage in the context of an optional Federal insurance charter are without merit. The life insurance business is not seeking, nor did this Congress ever consider enacting a Federal insurance regulatory system that is weak, in terms of consumer protections or solvency oversight. Indeed, the ACLI has consistently advocated for a Federal alternative that is as strong as, if not stronger than, the best State regulatory systems.

If anything, a properly constructed optional Federal charter would result in the States being challenged to raise their standards to meet those of the Federal regime.

Mr. Chairman, there are a number of ideas being considered on how to address insurance in the context of overall regulatory reform. We applaud you for reintroducing legislation that would create an office of insurance information within the Treasury Depart-

ment. While our ultimate goal remains an optional Federal charter, an OII would certainly be a step in the right direction.

We are also appreciative of Representatives Bean and Royce for introducing the National Insurance Consumer Protection Act, which sets forth the framework for an optional Federal insurance charter.

We do, however, caution against a so-called Federal tools approach to insurance regulatory reform. As detailed in my written statement, the constitutional and practical limitations of this concept make it ill-suited to deliver the type of reform that would be in the best interests of the insurance industry and its customers.

We again thank you, Mr. Chairman, for holding this hearing, and pledge to work with you and the members of the subcommittee to see that insurance regulatory reform becomes a reality. And we would be happy to answer any questions. Thank you.

[The prepared statement of Mr. Baird can be found on page 63 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Baird. And now, we will have Mr. John T. Hill, president and chief operating officer of Magna Carta Companies, on behalf of the National Association of Mutual Insurance Companies. Mr. Hill?

**STATEMENT OF JOHN T. HILL, PRESIDENT AND CHIEF OPERATING OFFICER, MAGNA CARTA COMPANIES, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES (NAMIC)**

Mr. HILL. Thank you, Mr. Chairman. Good morning, Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee. It is an honor to testify before you today on these important issues. My name is John Hill, and I am president and chief operating officer of Magna Carta Companies.

Magna Carta was founded in New York in 1925 as a mutual insurance carrier for the taxi cab industry. Although we no longer insure taxis, we employ 240 individuals and write in 22 States. We very much remain a small, Main Street mutual insurer with $170 million in direct-written premium.

I am here today on behalf of the National Association of Mutual Insurance Companies, to present our views on systemic risk. NAMIC represents more than 1,400 property and casualty insurance companies, ranging from small farm mutual companies to State and regional insurance carriers to large, national writers. NAMIC members serve the insurance needs of millions of consumers and businesses in every town and city across America. I serve as chairman of NAMIC's financial services task force, which was created specifically to develop NAMIC's policy response to the financial services crisis.

Our Nation faces uncertain economic times, and we commend the subcommittee for holding this hearing to explore the role of systemic risk regulation in the insurance industry.

The property casualty insurance industry, like millions of Americans and businesses, did not contribute to the current financial crisis. However, we too have felt the negative impact of this crisis. Just like most American citizens and businesses, the property casualty insurance industry has played by the rules. We are solvent,

and continue to serve our policyholders the same today as before the economic crisis. If you exclude a very few companies that are linked to financial markets, our analysis concludes that our industry poses no systemic risk.

We disagree with the suggestion that we need to completely rethink the regulation of our industry. The property and casualty market place is well-regulated, highly diverse, very competitive, and is open to anyone that is willing to play by the rules.

It is important to understand the distinction between the property and casualty insurance industry and others in the financial services sector. The fundamental characteristics of our industry, including conservative and liquid investment portfolios, low leverage ratios, strong solvency regulation, and a highly competitive and diverse market place, make it stand out as unique, and work to insulate the property casualty insurance industry from posing systemic risk.

Today, as other financial services companies are failing and seeking government assistance, property and casualty insurers continue to be well capitalized and neither seek nor require Federal funding. Our industry remains one of the well-functioning bedrocks of our financial structure. The record shows that property and casualty insurers played no role in causing the current financial crisis.

Moreover, it is exceedingly unlikely that property casualty insurers, either individually or collectively, could cause a financial crisis in the future. For one, the capital structures of property and casualty insurers and the nature of their products make them inherently less vulnerable than the highly leveraged institutions when financial markets collapse.

Additionally, the nationwide State-based guaranty funds system also reduces the systemic impact of any failing property casualty insurer.

NAMIC believes that any new oversight of systemic risk should focus on products, activities, and market-oriented events and developments, rather than broad corporate categories or industries. It should be carefully designed to address the kind of market-oriented problems that have the ability to cause systemwide access.

Only institutions that offer products, or engage in transactions deemed to create systemic risk, including insurers, should be subject to systemic risk oversight. The current crisis demands that Congress act. But Congress must act prudently and responsibly, focusing limited resources on the most critical issues, and avoid the inclination to rush to wholesale reform.

NAMIC does believe that Congress can strengthen the regulatory process, improve regulatory coordination, and monitor systemic risk by establishing an office of insurance information to inform Federal decisionmaking on insurance issues, and facilitate international agreements.

We would also recommend expanding the President's Financial Working Group to include insurance regulators. We believe such reforms are measured, appropriate, and timely responses to the present crisis.

As the process moves forward, we stand ready to work with the committee to address the current problems and regulatory gaps. We urge Congress to keep in mind the dramatic differences be-

tween Main Street businesses that have never stopped meeting the needs of local consumers, and those institutions that caused this crisis.

Again, thank you for the opportunity to speak here today, and I look forward to answering your questions.

[The prepared statement of Mr. Hill can be found on page 81 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Hill, and thanks to the entire panel. This is interesting testimony. I look forward to my own questions, and those of the subcommittee.

Mr. McRaith, I am going to put you on the spot for the first question. In 2001, an insurance holding company called Reliance—I imagine you are familiar with it—was owned by Mr. Saul Steinberg, who took the underlying insurance proceeds, and then that allowed him to play the role of a multi-millionaire speculator, benefactor of the Wharton School, and art patron. Is that correct? Do you recall that transaction, or those transactions?

Mr. MCRAITH. I am certainly familiar with the company. I wasn't familiar with the Wharton School.

Chairman KANJORSKI. Subsequently, that holding company defaulted on bonds and bank debt.

How would you rate the effect of what happened there with that particular company? Is that a failing of the State regulation, State-to-State? Would that have occurred if we had a Federal regulator in place? Or do you see any difference?

Mr. MCRAITH. The unfortunate reality in any capitalist economy is that companies will fail. Companies, insurance companies, led by individuals with ethical—or a lack of ethics are companies that are more likely to encounter cash flow problems, and ultimately suffer the demise—or a demise similar to Reliance.

A Federal regulator would not have assisted or prevented that solution. I am not familiar with the holding company challenges at Reliance. The individual insurance company, those challenges occur—and they have occurred for decades in the insurance industry.

As soon as we learn of them, we place the company into receivership. The policyholders are protected. Because the capital requirements we impose on companies are so significant, the shortfall at the end of the day for the guaranty system is relatively nominal. And we—and that guaranty system is also intended to protect the consumers.

Chairman KANJORSKI. I thank you very much, Mr. McRaith. My good friend, Mr. Skinner, do you believe that the United States companies will have adequate access to the European markets after Solvency II is in effect?

And do you believe European companies have adequate access to the U.S. markets?

Mr. SKINNER. It's an interesting question, Mr. Chairman. The law comes into being in 2012. What it is dependent upon is something called equivalence. And I think, as I said when I started, that equivalence from a European perspective is looking for something that can match the deeds and the purpose of the legislation, the final outcomes of that legislation, certainly not the letter on the dot and the T and the cross, but something which does the same thing.

For that, we need to find a single voice to talk at the U.S. level from an EU level, because we are actually only permitted to get agreements, country by country, at an EU level. There is no sense in beating around the bush on this.

So, for U.S. companies to do business inside the European Union—and there are a few of them who do this very well—they will have to make sure that their regulators in the United States are people who can talk to the European Union about matching up these credentials.

The thing is, of course, if they don't get matched up, it will be down to each individual member State, therefore, as has been said, where there is memoranda of understanding or whatever, to impose their own requirements upon those companies.

And we don't really want to be there, because I don't think there should be any discrimination about this. If we get the match to work—and we can talk to each other about this dialogue and how it works—then I think there should be no discrimination for U.S. companies. In fact, U.S. companies, I believe, as a result, will be competitively enhanced by getting access to the market as a passport across all 27 countries.

Chairman KANJORSKI. So it is your conclusion that anyone who opposes a Federal regulator here in the United States would be in some way impeding their progress in competition in areas like the European Union?

Mr. SKINNER. From a commercial point of view, I think that most companies would want to make sure that they had the fewest number of regulators to have to work with. I think that's almost a common sense statement.

I think, from a U.S. perspective, I think this is something you're grappling with, like we have grappled with. We still have multi-jurisdictional, multi-legal personalities, in terms of the countries we have at European level. They have their own laws, their own regulations, their own standards. We have just introduced Solvency II, and it has actually just changed the whole thing. It has harmonized it, it has brought the standards up in countries where it wasn't competent and you didn't have the capacity.

As a result, we want to make sure that they are maintained for companies coming into the European Union. And I think that you would want the same inside the United States, as well.

Chairman KANJORSKI. I see my time has expired. We will now hear from Mr. Garrett from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman. And I begin there, with Mr. Skinner. Thanks for coming on over. You heard a number of people on the panel testify here from the PNC side, and others as well, that the problem that we had in this country was not caused by—they would argue—problems in the insurance industry. We have heard that from other panels, as well.

I note in your testimony you said that the legislation you're talking about was going to go into effect in 2012, right? If we were having a panel like this back overseas, would that be the same testimony that we would hear over there, as well, that the problems in the marketplace and everything that's going on in Europe was due in no large part from the insurance industry, as well?

Mr. SKINNER. Yes, I think in many ways we would hear the same discussion. You would be pleased to hear that we are almost twinned. There is an economic and financial services committee that I am involved in and represent today. We would be talking about the same issues, and classically, we would be talking about derivatives, you know, and we would be talking about the effects that they have had.

But I think, as one of your honorable colleagues said already, the securitization issue—

Mr. GARRETT. Right.

Mr. SKINNER. —is actually a kind of a reinsurance in itself, isn't it? It's the spread of risk.

Mr. GARRETT. Right.

Mr. SKINNER. So, the insurance industry, as a whole, is not immune from systemic risks, as such. We believe it's about the management of that risk, and having—

Mr. GARRETT. Well, coming up to this point in time, would you agree with some others who have said here that you can't point to this company or that company as being the systemic problem, which is what some of the members of the panel would be arguing for, as far as this country is concerned?

Mr. SKINNER. Yes, I think that it's true to say that you can—you probably have to put to one side the individual certain companies—

Mr. GARRETT. Sure, sure.

Mr. SKINNER. —and you have to start talking about the industry, as a whole.

Mr. GARRETT. Thank you. And I will run down the row as much as I can.

Mr. McRaith, you were making your case along the way with regard to the OII, and some of the benefits, and the upside that would bring about, as far as the sharing of information. But then, as you get near the end of your testimony, you seem to be—if I heard you right—talking about some of the great things you all have been doing, as an organization in these areas already—if I heard you right.

Mr. MCRAITH. That's correct.

Mr. GARRETT. So, I almost heard it like, "Well, gee, we're already doing that," on the one hand.

Mr. MCRAITH. Right.

Mr. GARRETT. So why do you then take the other side at the beginning your testimony, saying that we still need this help out there?

Mr. MCRAITH. Well, listening to at least one of the panelists today would imply that the State regulators are not engaged in international discussions. We are engaged in developing standards, working with our international counterparts on every continent, in multiple forums.

My testimony, Congressman, regarding the office of insurance information, reflected the reality we know, which is not a question of standards or supervision or regulation; it's a question of international trade agreements. And we are aware of the limitations of Article 1, Section 10 of the United States Constitution, which says that a State cannot independently enter into a treaty with a foreign government.

So we supported Chairman Kanjorski, in that initiative without the preemptive impact. But we do engage—and always consistently engaged—internationally with our foreign counterparts. And at some point in time, I would be happy to talk about solvency, too, but I will hold off on that.

Mr. GARRETT. All right. Let me just jump down to Mr. Baird. You know, in your testimony, you stated that the life insurance industry is either systemically significant or systemically important—one of those terms, at the beginning of your testimony. Mr. McRaith said in his comments that the industry is—or, rather, that the too-big-to-fail concept does not apply to insurance, per se.

Mr. MCRAITH. I'm sorry, not to any one company. The sector, of course, is significant.

Mr. GARRETT. Okay. So maybe that answers the question.

Mr. MCRAITH. Same thing—

Mr. GARRETT. I was going to go to you, Mr. Baird, to address that concern, but maybe he addressed it already. Do you want to speak on that, Mr. Baird?

Mr. BAIRD. Other than I would say this is one of those instances where Director McRaith and I agree.

Mr. GARRETT. Okay.

Mr. BAIRD. We think the entire industry is of systemic importance, but no one company is.

Mr. GARRETT. All right. Okay. For anyone on the panel, one of the proposals coming out of the White House seems to be that we're going to need a systemic risk regulator, and it very well could go into the Federal Reserve, which a lot of us disagree with.

But assume that happens, and you put it into the Federal Reserve. And assume, for the sake of argument, that it also has an insurance component. Does anyone on the panel have a concern that you may have a bank regulator who has no past experience, or what have you, dealing with the insurance industry to be basically your supervisor or regulator in this area? Mr. Hill?

Mr. HILL. That would be one of our concerns, Congressman Garrett, that you would have someone regulating insurance who really has no real insurance background.

And, again, I would reiterate that I think our position is that the best way to look at systemic risk is to look at market-oriented products, and any firm that's engaging those products should fall under the purview of the systemic risk regulator. But to just isolate a particular industry group, and just say that the systemic risk regulator is just going to oversee that, that could potentially miss something that's occurring elsewhere in our global economy.

So, our recommendation is to be more product and market oriented.

Mr. MCCARTHY. As financial guarantors, we actually think that the Fed might be a logical place to oversee our industry, primarily because the service that they provide to the banking industry would parallel the kinds of financial activity that we have in the capital markets. So we would think that perhaps—

Mr. GARRETT. You're a little bit different, then, from some of the other—

Mr. MCCARTHY. That's right, because again, financial guaranty, we only do—we have, you know, one nail, and we're trying to hit it.

Mr. GARRETT. Yes.

Mr. MCCARTHY. The multi-lines have a lot of different kinds of risks that they're taking. And, really, not just our solvency, but really our financial stability, as an industry, is what is critical.

Mr. GARRETT. Thanks a lot.

Mr. BAIRD. Oh—

Mr. GARRETT. It's up to him.

Chairman KANJORSKI. Go ahead.

Mr. GARRETT. Go ahead, Mr. Baird.

Mr. BAIRD. No, I just wanted to add, to directly address your question, I think that is a concern to the life insurance industry, However, it is resolved if the Congress creates a Federal functional regulator, which then—presumably, the two Federal agencies would cooperate with one another.

We think the creation of a Federal functional regulator would give a Federal agency, then, the expertise to properly regulate the life insurance industry, and cooperate and give information to the systemic regulator.

Mr. GARRETT. But absent that?

Mr. BAIRD. Absent that, then that is a concern.

Mr. GARRETT. Okay.

Mr. BAIRD. And we think it's incomplete.

Mr. GARRETT. All right.

Mr. MCRAITH. And, Congressman, if I could also just—Mr. Chairman, if I might add just very briefly?

That is, of course, a very serious concern for State insurance regulators. The regulation of the insurance industry is significantly different from the bank industry. So we do—as the regulators now have expertise that can be integrated with systemic risk regulation, but should not be displaced.

So, one of the priorities for any systemic regulator is to recognize and value the expertise of the functional regulator, facilitate communication among those regulators, and prevent the systemic disruption that we have experienced.

Mr. GARRETT. Thank you, panel, I appreciate it.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. Now, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman. Thank you for being here.

It's interesting. I heard pretty much everybody say that the insurance industry doesn't threaten the system. I am just curious. Are any of you familiar with the acronym TRIA? TRIA is the one that the U.S. Government had to pass after 9/11, when the insurance companies were all going bankrupt, and everybody was afraid that they were going to take down the economy at that time.

Did anybody here who now thinks that the insurance industry somehow doesn't provide risk, did you come up and tell us that we should not do TRIA because everything was fine? I don't think you did.

Ms. BRYCE. Actually, the mortgage insurance companies did. But our business is such a different business than, you know, most—

Mr. CAPUANO. So you don't think we should have passed TRIA?

Ms. BRYCE. That was our position at the time.

Mr. CAPUANO. Good for you.

Ms. BRYCE. I'm sorry—we got ourselves exempted. I apologize.

Mr. CAPUANO. I know you got yourself exempted. I know that. But the question is, do you think we should have passed the TRIA Act? Does anybody think we should not have, I guess is the better question?

[no response]

Mr. CAPUANO. So we should have. And I agree.

Mr. MCRAITH. Congressman? Excuse me. The issue with terrorism is the absolute impossibility of predicting the risk. What TRIA does is facilitate the property and casualty market. It would not exist—Manhattan, Chicago, major urban areas would not have access to coverage for terrorism events in the—

Mr. CAPUANO. I understand.

Mr. MCRAITH. —as companies can exclude—

Mr. CAPUANO. The inability to ascertain the risk, similar to the inability to ascertain the risk on CDOs and CDSs. The inability to ascertain risk is the same.

Mr. MCRAITH. That's—

Mr. CAPUANO. The items are different.

Mr. MCRAITH. That's—

Mr. CAPUANO. So we should have passed TRIA. But everybody here thinks that there is one company that somehow provides systemic risk. That's what I heard. I don't think I heard anybody say anything different.

Has anybody here heard of the company AIG? I know it hasn't been in the news lately.

Mr. MCRAITH. But, Congressman, to be clear, AIG is kind of colloquially referred to as the world's largest insurance company. But it is 71—

Mr. CAPUANO. Well, excuse me, Mr.—

Mr. MCRAITH. It is 71 insurance—

Mr. CAPUANO. Excuse me. The idea is it is an insurance company—

Mr. MCRAITH. —met all claims—

Mr. CAPUANO. —that does different lines.

Mr. MCRAITH. Their policy—

Mr. CAPUANO. And the problem that I have with it is that it is one company that was into so many things that the State regulators chose not to regulate. The Federal Government didn't have anybody to regulate, and the States collectively said, "We don't need to look at what AIG is doing. We will only look at this slice, this slice, and this slice."

Mr. MCRAITH. That—

Mr. CAPUANO. That's all. And those slices worked fine.

Mr. MCRAITH. Actually, Congressman, the insurance regulators looked at the insurance subsidiaries. The problem was—and this is why we support systemic regulation—

Mr. CAPUANO. Bingo.

Mr. MCRAITH. —there was a complete lack of regulation at the holding company level. What should happen is—

Mr. CAPUANO. Well, the problem is—

Mr. MCRAITH. —regulators of all those—

Mr. CAPUANO. —you are looking at the relationship between the—

Mr. MCRAITH. —work together—

Mr. CAPUANO. —between the policyholders and the company. No one was looking at what was happening with the money coming in, how they were investing it. The States didn't do it, and that's where the systemic regulator comes in. So one company, depending on what they do, depending on who looks at them, I guess can shake the system up just a little bit.

So, therefore, I don't quite—I mean, though I appreciate this hearing—I'm not quite sure what we are talking about, except a unanimous opinion that there is some need for some generic national oversight of what's happening in the insurance industry, understanding fully well that the Federal Government should not and need not be doing things that some of the States are doing very well, particularly that aspect between the company and the customer. I agree totally. The Federal Government doesn't need to do that; States are doing that great. That's the consumer side. But on the investment side, no one is looking at it.

One company has and could again tomorrow—did I miss something? Has anybody on any level today, up until this point, said that there could not be another AIG tomorrow? The Travelers, if they chose to, couldn't choose to invest all of their receipts into credit default swaps, if they chose? I don't mean to pick on Travelers, you just happen to be here today. Or any other company?

The answer is no, I think, but go ahead and correct me if I am wrong.

Mr. SPENCE. The answer is no.

Mr. CAPUANO. That's why we are here, is to try to say, okay, we all screwed up by not looking at a huge segment of the business, the side where people invest, where the companies invest. We need to correct that. States cannot do it on an individual level.

We need a systemic regulator—I don't like the word "regulator," because I think that implies overactivity—at least a systemic monitor, maybe a regulator, to review what's going on. If I—does anybody disagree with that?

[no response]

Mr. CAPUANO. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. I know you do not get very emotional about these things.

Mr. CAPUANO. It's my mood.

Chairman KANJORSKI. The gentleman from Georgia, Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman. I want to—and I appreciate the opportunity for this hearing. I think this has been an excellent panel, and the information that you have provided has been very, very helpful.

I think it is important to appreciate that Federal regulation of insurance is different than instituting a systemic risk regulator for insurance, and I think it's important that we keep that in mind. And we are kind of sometimes combining apples and oranges here.

I want to shift gears a little bit and talk about and get some response regarding the financial products consumer safety commission that has been bandied about by the Administration. And it ap-

pears to many of us to be a kind of a command and control apparatus for different industries, including the insurance industry.

And I wonder—and I know oftentimes Congress and the Administration can go too far; in fact, that seems to be the order of the day, is going too far—I wonder if, starting with Mr. Spence and kind of heading on down the table, do you have any thoughts about what would be too far for the insurance industry, or what the effect of this would be on the insurance industry for a products consumer safety commission?

Mr. SPENCE. Thank you, Congressman. We believe the creation of a Federal financial services product safety commission that includes insurance raises two concerns. Insurance products are already regulated, so this would add another costly layer of regulation, and regulatory delays without gaining any consumer benefit.

And we're concerned about possibly separating product regulation from solvency regulation, which could lead to poor regulatory decisionmaking, because the product regulation would lack the information necessary to fully understand the industry. And there could be competing—

Mr. PRICE. So there is a line beyond which we go—if we go beyond—that results in limiting the ability of you to serve customers and help Americans insure themselves in various ways?

Mr. SPENCE. We believe so.

Mr. PRICE. Mr. Nutter?

Mr. NUTTER. Mr. Price, in the reinsurance area, it's strictly a business-to-business transaction. There is no direct legal obligation to the consumer. And, therefore, reinsurance regulation tends to focus on solvency, prudential regulation. It would appear not to apply to reinsurance contracts, the consumer aspect.

Mr. PRICE. Thank you. Mr. Baird?

Mr. BAIRD. When we design a product, we feel we are making promises to our customers to deliver benefits 20, 30, 40 years into the future. At the point in time when we're designing that product, we have to bring in solvency, capital markets people, solvency people, marketing people, to make sure we're designing something that somebody values.

To separate that, and have an agency only focused on the consumer side, we believe, is not complete. If we didn't have all of our pieces, if we didn't have all of our disciplines at the point in time we designed a product, that product would fail.

Mr. PRICE. Well, what could we do, or what would we do, what might we do that would limit your ability to allow Americans to have a greater opportunity to insure themselves against challenges?

Mr. BAIRD. Yes, I believe that, you know, obviously, the life insurance industry is about strong consumer safety standards.

I believe if it is looked at in a vacuum, and not part of a Federal functional regulatory and solvency and capital markets risks, that regulation would not be complete, and would therefore slow down the process, and you would have regulators—if regulation was bifurcated, you would have regulators with different standards and different agendas, and that would keep us from designing a product that the customer needs most.

Mr. PRICE. Mr. Hill?

Mr. HILL. Congressman Price, we represent the property casualty. Our membership is mainly property casualty. And we see this as more geared towards financial products, of which we really don't—

Mr. PRICE. So if we got into your business, that would be bad. Is that accurate?

Mr. HILL. Yes.

Mr. PRICE. Thank you. I want to switch gears to Mr. McRaith. You mentioned that you wanted to comment on the Solvency II framework, and I wondered if you have had an opportunity to look at the consequences that will have, or may have, for States.

Mr. MCRAITH. Yes. Thank you, Congressman. First of all, I do want to commend Mr. Skinner and his colleagues in the European Union for developing Solvency II. It remains in its ancient stages, as we heard—it's not even to be adopted by legislation until 2012—of course at the States, you know, we have 64,000 company years of regulating solvency, so we look forward to working with the EU, as they further develop their approach.

One report mentioned earlier by Mr. Skinner was what's called the de Larosiere report. And what was interesting about that report is that he commented on the need to reflect upon and improve the BASIL II capital standards. You might recall several years ago there was a clamor in Washington to give our own banks the capital freedom that BASIL II allowed for European institutions. And for that reason, Solvency II, I think, warrants some serious scrutiny.

But I think it's fair to say, if Solvency II had been in place during the current crisis, the economic impact would have been significantly worse for companies and consumers in the United States.

Mr. PRICE. Thank you. Thank you, Mr. Chairman.

Mr. NUTTER. Mr. Price, may I—if I may also comment on the Solvency II matter? If I could actually take a sentence out of Mr. Skinner's testimony, it seems to me this is the concern the reinsurance market has about Solvency II.

This statement from Mr. Skinner's testimony is, "Since equivalence decisions will have to be made at the country level, this fact alone will make it almost impossible to find the USA equivalent under Solvency II, unless changes are made to the current insurance regulatory framework in the U.S."

The global market is dependent upon regulatory interaction. We would strongly encourage a Federal regulator to facilitate that kind of international trade agreement.

Mr. SKINNER. If I may, can I come in just—I'm sure the question was directed as much to everybody who had something to do with Solvency II.

Correct the impression, which is that this is not a piece of legislation already. I rather think that, like your House, that when you have had a vote on it, you effectively think of it as law. Where it, therefore, has to go then afterwards is to each Member's State, to have them ratify it in the statute book.

Substitute, therefore, "once it has been adopted in the European Parliament," which it was on the 22nd of April of this year. It was law. It now has 2 years to be implemented by the regulators on the

ground. I think we should be absolutely clear about this, so there is no false impression left as to whether or not this is legislation.

Secondly, it deals with the three principles that we wanted to base our legislation on. So I'm not so sure where we go by comparing what is happening with the United States with what was happening in the EU. We went for a risk-based approach, a principle-based approach, and an economics-based approach.

And this has been 10 years in development with practically every industry that there was to be known in insurance in Europe and from elsewhere, getting involved in consultations about getting the piecemeal issues involved and out of the way beforehand.

Now we have implementing processes, where the regulators would be allowed to introduce this on the ground, where we will be guaranteeing and looking after policyholders' interests far more than we ever could have done in the past, not in a piecemeal way, but in an absolute harmonized way. And I think we are looking at the best and the highest of standards.

I think I am afraid, you know, I must correct the impression that it has left with you that the Solvency II standards are anything that we expect you necessarily to apply in the United States. That's not what we're saying, either. What we're saying is we have gone all this way in the European Union, and it matches the development that is happening elsewhere in the world.

It's happening—what's happening in the IAIS, with 11 countries choosing to go ahead, the United States not so. The danger is, and the risk is, for policyholders and for companies, if they can't be competitive in that global situation, that we will not be finding like for like.

You have a market which has 85 percent penetration already with foreign companies. So that means you have 15 percent left U.S. companies. In terms of your global reach, you have companies that can do it. I would say you have to consider whether not changing the rules, not moving along with an international global standard is going to endanger many of those other companies that you have with international ambitions.

Chairman KANJORSKI. Thank you, Mr. Skinner. Mr. Hinojosa?

Mr. HINOJOSA. Thank you very much, Mr. Chairman. I thank you and Ranking Member Garrett for holding this hearing today to discuss systemic risk.

The Treasury will release its regulatory reform proposal tomorrow, June 17th, which makes this hearing all the more important. I have always supported State regulation of insurance, and I will continue to rally behind that regulatory construct.

If the National Association of Insurance Commissioners is correct, that even the failure of a major insurance entity based and operating in the United States will generally not impose systemic risk, we need to pursue this claim further, and not rush to judgement on the capability of State insurance commissioners to properly and effectively regulate the insurers.

Furthermore, I cannot support a system in which an insurance company headquartered in one State is given permission to operate in the remaining 49 States, based on their home State's insurance regulations. Whereas this might be accepted and feasible in the European Union, I am not certain that comparing sovereign nations

to States in the United States is appropriate. We might be comparing apples and oranges.

So I ask my question and direct it to Michael McRaith, from the Illinois Department of Insurance and, if possible, to give me a second opinion from Kenneth Spence, with Travelers Insurance.

What do you like, or what would you like to see in the Administration's regulatory reform proposal?

Mr. MCRAITH. Thank you, Congressman. First of all, I think it's important to appreciate the strengths of our current system, as you clearly understand. We are a nationally-coordinated system of States. We have multiple sets of eyes, multiple sets of experts looking at one company, so that it's not a single regulator, it is multiple regulators working together in a coordinated fashion with a national system of solvency regulation, a national system for people like Mr. Nutter and others in his constituency and internationally. There is that national system that can be recognized.

In terms of systemic risk, as I mentioned earlier, there needs to be—there must be—a primary role for the functional regulators. In our case, of course, it's the expertise that we have, the information we have, and the experience that we have in relation to State insurance regulation. Systemic regulation can integrate. It is inherently—State regulation is inherently compatible with systemic regulation. We need to formalize regulatory cooperation, reduce barriers, enhance communication.

The systemic risk management—as I alluded to earlier, as regulators of the insurance industry, we require extensive exhaustive risk management for any insurance enterprise. We need that at the holding company level, and of course at systemically significant institutions, that is even more true.

And then limit the circumstances in which the functional regulator can be preempted—must be extremely narrow and extremely limited. Only if there is an actual possibility of not just risk, but disruption to the system. And those circumstances are very narrow, indeed. The primary function and purpose and service that a systemic regulator will provide is to enhance the communication.

And using AIG as the poster child, there was not sufficient interaction and communication among the functional regulators. We support systemic regulation, Congressman.

Mr. HINOJOSA. Let me ask Mr. Spence, with Travelers Insurance, how do you all see it, as an insurance company? What would you like to see in this reform proposal?

Mr. SPENCE. Thank you, Congressman. As I indicated, we would support the concept of a systemic risk regulator.

For a number of years, Travelers was part of a financial holding company that was regulated by the Fed. The insurance operations were not regulated by the Fed, but they did soundness and safety reviews of the company, including the insurance operations.

And that process demonstrated the lack of Federal knowledge or knowledge at the Federal level of insurance operations, which is why we think the chairman's OII is a sound proposal. And we think that, depending on what a systemic risk oversight regulator would do it would likely require the need for a functional regulator to implement whatever directives the systemic risk regulator might choose to implement.

And then, as I indicated, whatever the regime is, we think the two key components are mandated risk committees and enhanced disclosure.

Mr. HINOJOSA. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Hinojosa. Mr. Royce of California for 5 minutes.

Mr. ROYCE. Yes. Thank you, Mr. Chairman. I will pick up on Mr. Spence's point.

Insurance operations were not regulated by the Fed. The New York Insurance Department reviewed and monitored AIG's securities lending program. AIG's securities lending program heavily invested in long-term mortgage-backed securities, as a matter of fact, took that money from the insurance subsidiaries. AIG Life insurers suffered $20 billion in losses related to their securities lending operations last year. And of course, the bottom line, the Federal Reserve has provided billions now to recapitalize AIG Life Insurance companies.

So, you know, we have a patchwork quilt here of regulation. We had—as I said in my opening statement, we had problems with the Financial Products unit, we had problems with the Securities Lending unit and the Securities Lending program. So we have a difficulty here.

Now, at this—as we have discussed at this subcommittee, there was an implicit belief in the market that, should Fannie Mae and Freddie Mac get into trouble, the Federal Government would step in to save them. In part, it was that perceived Federal lifeline that enabled these firms to borrow cheaply and take on so much risk.

As we discuss reforming our regulatory structure to address firms that are too-big-to-fail, I am concerned that we run the risk of bifurcating our financial system between those that we designate as systemically significant and everybody else that is in competition.

As our experience with the housing Government-Sponsored Enterprises demonstrates, this would be a big mistake. And it would provide competitive advantages to companies that have the implicit backing of the taxpayers, and they would be incentivized to engage in higher-risk behavior. That's what economists who look at this model tell us when they fret about what we're doing here.

So, in the context of systemic risk regulation, do we run the risk of distorting the market by labeling those institutions that are too-big-to-fail as such? And would it be more effective for a systemic risk regulator to focus on potentially high-risk activities in the market, instead, rather than a set of large financial firms? Mr. Spence?

Mr. SPENCE. Is that directed to me?

Mr. ROYCE. Yes, sir.

Mr. SPENCE. Thank you. We agree with you. We think that the systemic risk regulator, it's not a question of labeling companies that are too-big-to-fail, but it is determining in advance, and preventing companies to become too-big-to-fail.

Mr. ROYCE. Thank you. And then, my last question goes to Mr. Skinner, because, Mr. Skinner, you have spoken at length on the need to establish a Federal presence on insurance in the United

States, as well as the problems EU regulators have run into when trying to negotiate with the various State insurance commissioners.

There appears to be a consensus that something should be done in this regard. But to what degree remains, obviously, a question. When is an office of insurance information just an office to collect data? If this office is created without strong preemptive authority over the States, weakening the ability of an office of insurance information to enact agreements nationwide, how effective would it be, in the long run?

Mr. SKINNER. Thank you very much, Mr. Royce. I suspect that you know the answer partly, yourself, that in many ways, at any international level, it's countries and groups of countries that have to work together in order to get the global rules which will prevent future systemic risks.

And those systemic risks, as we have discussed today, are at the root level: the company management processes; the risks it takes; the premiums it doesn't charge, etc., etc. So we need something that is standardized, harmonized, that we can agree with.

I think the office of insurance information is a great idea. Don't get me wrong. I think that is what perhaps, you know, you will end up with. But I think we still have a fundamental which underlies the exact way in which we will approach each other over specific laws, and the ways we will apply laws. And where there is an absence of that particular bridge, you know, there is always going to be a gap. So we have to find a way through that.

Now, I suspect that this committee will come up with ideas and talk to us about that, and we should be an open door for you. You know, we're not going to say how you should do it. But we are a compliant group ourselves, inside the European Union. The European Parliament wrestles with the same issues that you wrestle with. We just want to work with you, to make sure that you can figure out what's best for policyholders, as well as the international competitiveness of companies. And, as I say, those demand future modernization and new approaches to regulation.

Mr. ROYCE. Thank you. Thank you, Mr. Skinner. Thank you, Mr. Chairman.

Chairman KANJORSKI. The gentlelady from New York, Ms. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. I appreciate it. I think many of my colleagues have said that this has actually been a very interesting journey that many of us have taken on this committee over the last several months.

But, Mr. Baird, I wanted to ask you, as an alternative to Federal regulations, some have recommended moving to Federal minimum standards that would enforce by the current State insurance regulatory structure. Would that solve the regulatory burden in areas such as licensing, market conduct, and speed to market? If not, please explain why.

Mr. BAIRD. Thank you for the question. We believe it does not. We believe Federal minimum standards—many of us run national businesses. We, unlike the property and casualty industry, we price a product one time for all 50 States. Our producers are often national. Our producers often have their customers move from one State to another.

So, when someone suggests that Federal minimum standards is the answer, what that means is those minimum standards will be met, but there will still be 51 different sets of rules and regulations that we must file product approvals for, design products around, and producers must license for. So we think that solves very little, if anything.

Mrs. MCCARTHY OF NEW YORK. Mr. Skinner, listening to your remarks, when we think about it—and you're talking about, you know, working with all the different countries that you're working with—we have to work with all the States. And I would tend to think working with the States on the same level is like working with a country. And I think that's going to be our—what we're going to have to solve. Because, obviously, a lot of the insurance companies do want to do global marketing, they are going to be into all the different countries for the—I keep saying UK—EU.

So, as we follow through, if you could, follow through with what you were saying before. Just go a little bit further on how you could possibly see all of us—because this is going to be difficult, each State, we all represent our—you know, we represent our districts, but we actually represent our State. So what goes on in the State is going to come to us, and then they will put the issues in front of us, as we fight for the regulations that are going to come down.

I mean, they are going to come down. Anyone who thinks that they're not is not awake in the real world. We cannot allow or afford what has gone on in the last year-and-a-half, 2 years, to happen again. If you could, follow through with that.

Mr. SKINNER. Thank you very much. I actually think that we're all dealing with multi-jurisdictional districts, regions, countries, States. And you're right, it is how do we harmonize, how do we get the rules that will give the best safety for consumers? How will we help companies expand capacity to areas where they haven't been offering insurance before, and at lower rates? How do we get efficiencies into the industry without running against risk?

All these things have to be based upon what is prudentially sound, what is economically beneficial and sound, and what is, hopefully, subject to risk management. Now, those things are the clues that we went through, in terms of over 10 years, in trying to sew together 27 countries with 500 million people in.

And not everyone had the same level of competence. I mean, this is a serious issue. And thank you for recognizing me coming from the UK. It's true. I mean, London likes to think that it is ahead of the world in many ways, along with New York, in financial regulation. But the truth is actually, you know, we can all catch a cold on what happens. So we all have to be alert. And what comes across our borders are some things that we don't expect, and can be beyond our control.

So, when we talk about systemic risk, we're talking about control over groups, groups that can cross borders, have branches and subsidiaries. So I want the same rules and the same powers and the same tools to every regulator at a maximum level, so that they can be enhanced in the job that they do, and we know that consumers in Lithuania, Latvia, Malta, and London can have the same kinds

of expectations about their policies being in good order when they finally come to have them paid out.

And, most of all, perhaps just as well, that they can afford them. And as I know, in terms of an economic crisis as we're facing at the moment, many people are turning their back on insurance and thinking, "Well, do I have to pay the insurance bill for my house?" The consequences of that could be enormous, in terms of the social impact, as well. So I don't want to price people out of the market.

So it's capacity and competence which has driven us to make sure that we have one market in insurance.

Mrs. MCCARTHY OF NEW YORK. I appreciate your thoughts on that, because I actually do believe that people, when they are coming back—and the same thing is happening here in this country—they are looking where they can cut back, just to survive, by paying their mortgage or whatever. And if they can get away with—whether it's car insurance, letting it lapse and hoping they don't get caught, health care insurance—obviously, we're dealing with that, so—oh, I'm sorry, my time is up. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Ms. McCarthy. And now we will hear from the gentlelady from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. Mr. Baird, in response to Dr. Price's question, you basically said that the functional regulator in charge of regulating the safety and soundness of a financial institution should also be the regulator in charge of regulations related to consumer products and practices.

Why is that? And why should it be the same regulator who looks at safety and soundness, as well as consumer-related products?

Mr. BAIRD. Yes, thank you for the question. I certainly didn't want to get into the shoes of Congress and determine who reports to whom. The remarks I made—and I want to make this very clear—we think that they have to be together in a collaborative or cooperative—or perhaps one does report to another; you will decide that, not us.

But you cannot separate and bifurcate consumer standards, consumer safety standards, from solvency regulation.

Mrs. BIGGERT. Thank you, thank you. Then, Director McRaith, what sort of coordination took place among the regulators following the AIG debacle?

Mr. MCRAITH. Thank you, Congresswoman. At the national level, there was coordination within the days and weeks—of course there is coordination constantly. But we were—as we learned about the holding company problems, the AIG Financial Products Division in London, we learned that the holding company challenges could have implications for the insurance subsidiaries, and immediately nationally, the regulators worked collectively daily, multiple calls, meetings, visits, regulators from around the country—because, of course, policyholders are based in every State of the country with AIG.

In addition to that, led by the New York department, the State regulators led national—or, I'm sorry, international—conference calls, giving our colleagues from the EU and all continents the opportunity to participate in a discussion to understand, really, the root cause of this problem isn't the financial products division

based in London, it is not a U.S. insurance company problem. And those conversations still continue to this day.

Mrs. BIGGERT. Okay. Well, it appears that the insurance sector has fared better than the banking and the securities counterparts in the current economic crisis. What are the reasons for that, and what are some of the elements of the State insurance regulatory system that could be instructive to Federal policymakers in setting up a systemic risk regulatory system?

Mr. MCRAITH. First, I understand the EU is working to bring together 27 different countries, and they intend to implement Solvency II within a few years. And, again, I commend that effort, it's a significant achievement.

As for the States, we have been working together collaboratively for over 100 years. We have, as I mentioned earlier, 64,000 years combined of company regulation. We understand the importance of working together, so that the consumers in Illinois understand the impact of an AIG challenge, for example, that the regulators in Illinois collaborate with AIG in New York, and Pennsylvania, all the other States.

So, the primary and essential systemic—let me back up. One other key component of insurance regulation that was raised by Congressman Capuano, we restrict not only what types of investments insurance companies can have, but how much any one company can invest in any one type of investment. That type of conservative capital and accounting requirement prevents the crisis in the insurance industry that we have seen in the banking and other sectors. So—

Mrs. BIGGERT. Okay, if I could just get in one more question—

Mr. MCRAITH. Sure, I'm sorry.

Mrs. BIGGERT. —when my time—if we were to have the Federal market stability and capital adequacy board—that was what I mentioned before, it's where—comprised of all of the Federal regulators and maybe some outside experts and others, to look at what could be done with regard to the derivative regulations, should an insurance representative or representatives be at the table? And who should be at the table?

Should it be a rotating State regulator, or should it—we set up the office of insurance information—if we set that up, it would be the head of that entity, to be involved in that?

Mr. MCRAITH. Unequivocally, Congresswoman, a State regulator should be in that conversation with the council, absolutely.

Mrs. BIGGERT. And should it be rotating, or could we use the office of insurance information?

Mr. MCRAITH. That's right. It should—I expect it would be rotating. I think there is value in having that diversity of opinion, although a consistent standard message, but diversity of perspective. Absolutely.

Mrs. BIGGERT. Thank you very much. I yield back.

Chairman KANJORSKI. Thank you very much, Mrs. Biggert. Now we will hear from Mr. Scott, from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. Let me ask—we are here, debating this largely because of actions that stemmed from the problems at AIG, with excessive trading and credit default swaps out of their Financial Products unit in London that was not regu-

lated by State commissioners, but by the Federal Government, the Office of Thrift Supervision.

However, some are using the collapse of AIG to argue for the creation of an optional Federal charter for the insurance industry. And, as I said in my opening statement, this is somewhat problematic, because here we have an entity that had the Federal oversight.

So, the question has to be asked, would an optional Federal charter, had it been in place, would it have prevented the collapse of AIG, which, again, is already federally regulated? May I get your point?

Mr. MCCARTHY. I think it's a good question. And, again, we look at it from our sort of narrow perspective in the industry.

The first word you used "optional," is where the trouble is, I think, in that an optional charter would leave itself open to arbitrage, meaning that people would—companies would have the ability to gravitate towards wherever they think the most liberal or the most friendly for their particular pursuits would be. A mandatory Federal, that would encompass all companies, whether it's just the monolines or whether it's a broader class of companies, would address that.

The second issue is that if there was Federal regulation, whether it was—and it was focused on products, one of the ways to look at perhaps the AIG issue, is their participation in credit default swaps. But inside those credit default swaps there are requirements for them to post collateral, which really was the reason why they ended up collapsing. It's the product itself, and the nature of the terms that are inside that product. So, I would say that, you know, Federal mandatory sort of applies to everybody, no possibility for arbitrage is important.

But second, had it been in place, and had they focused on what were the terms in the product, that would be the case. And that's why we think, in a financially driven company such as ourselves, that really looks more like something that the Fed would do for banks, in terms of permissible kinds of business that they're in.

Mr. SCOTT. All right. Thank you very much. Another part of my question is that—and let's move to the State regulation, because, in the final analysis in this whole reform issue, I want to do what's best for the Nation, but certainly I want to do what's best for Georgia.

We are comprised of 50 States, 50 different States. And I believe that State regulation over the insurance industry is a legitimate regulatory entity, because States are able to make their own rules to comply with what that State deems important for their own population. We are one Nation, but we are 50 different States with 50 different kinds of constituencies, industries, geography, climate, all of the things that make the great diversity of the nation.

And so, I believe we have to have room for States to deem what is most important for their own populations, that they would have the independence to grow in their own way and their own time, and most importantly, ensure consumer protections for that kind of constituency, and ensure competition within the industry. Am I not right about this? Is this not—should this not be the case, Ms. Bryce?

Ms. BRYCE. Well, I would agree with that. I believe that what we have found is that the State insurance structure has been a real asset, we believe, to our industry.

If you can imagine, we are obviously participating in a mortgage market, where we are subject not only to some of the issues of, you know, loans that were originated, but also to a lot of macroeconomic issues that we can't control, like unemployment, etc. And yet, we are in a position to be able to continue paying our claims, because of the structure of the reserve system that we have with the States.

And what we have found is that has been a structure that has helped us really survive through this challenging time. At the same time, it has been very clear that the regulators themselves have been talking to each other and coordinating, as well as, in our case, sharing information with the FHFA.

And so, you know, we believe that that structure is working and will continue to work.

Mr. SCOTT. Thank you.

Mr. NUTTER. Mr. Scott, may I just add a comment to that?

Mr. SCOTT. Yes, sir, please.

Mr. NUTTER. I represent the reinsurance industry. Going back to the chairman's opening statement, there are certain—aspects of insurance, some lines of insurance—in our case, reinsurance—where a Federal prudential regulator would, in fact, enhance the kind of relationship at that consumer level that you want. The lack of a Federal prudential regulator indeed cries out for, the problems associated with international agreements focused on international insurers and reinsurers doing business in this country.

So, I would suggest that even accepting your premise about the consumer concerns, there are still aspects of regulation where a prudential Federal regulator would enhance that.

Mr. SCOTT. Okay.

Mr. MCRAITH. However—

Mr. SCOTT. Yes, sir?

Mr. MCRAITH. May I add to that? The ultimate consumer protection, Congressman, is when your constituent pays a premium and doesn't have a claim for several years, that the company is not only around to answer the telephone, but is able financially to pay the claim. Reinsurance is an essential part of solvency, and solvency is the core mission, core purpose, of consumer protection in each State. And for that reason, it is appropriately a subject for State-based regulation.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Scott. And now the gentleman from Florida, Mr. Posey.

Mr. POSEY. Thank you very much, Mr. Chairman. We have really heard about two issues today: one is international harmony; and the other is about regulation. I won't go into the harmony, because there is just not time. And besides the EU, we know what happens when Asia gets in and South America gets in. I mean, it's really too large even to discuss too far here today.

But as you have heard most of our colleagues discuss today, many of us believe clearly that the regulation of insurance is a

State's right. That's purely and simply a State's right. It's reserved under the States.

And the biggest violation of consumers that I have seen, quite frankly, has been by companies that write health insurance, for example, under ERISA. They will do business in 49 States, every State except the State in which they reside, collect premiums, and don't pay claims, because the Federal Government does nothing about it. And it wasn't until a consortium of States got together just several years ago and crossed State lines for the first time in history to prosecute health insurance fraud. If we left it to the Federal Government, they would still be plundering people in 49 States, unfortunately.

It is clear that if your testimony today was true, very few of you need any more useless bureaucratic regulation. And who would have ever thought that, after the S&L crisis, so relatively shortly after the S&L crisis, with all the additional regulation that was put in place following the crisis, that we would again find ourselves in this hole of a financial crisis.

I mean, if regulation would have solved the problem, we wouldn't be here today, because brighter minds, creative lawmakers threw a bunch of regulation into the S&L crisis, and obviously it didn't do anything. And why we would think that we could be successful in trying to advance, out-think a creative risk-taker, kind of defies logic.

I think the answer is to hold people who harm people accountable. You know, we pretty much, I think, agree that the cause of the crisis that we're in now has been caused by greed. We have greedy executives—and it apparently is not illegal—who put the long-term best interests of the financial—fiduciary relationship that they have with their customers, their clients, their stockholders, behind their personal ambition for short-term gains and grossly exorbitant bonuses. And that's why we're in the problem that we're in now. I think everybody pretty much agrees with that.

And I don't think that you are going to be able to ever craft a law that is going to outwit these creative—I hate to use the term—geniuses. Some of the schemes that they come up with seem pretty good for the short term, to improve their own lot. I think the only answer is going to be if you hold the people responsible who violate these fiduciary relationships, like they do in some industries.

And for that, I realize there is not enough time for all of you to respond. I don't expect all of you to agree with that. But I would appreciate it if you would respond with your thoughts in writing to the chairman—and he can see that the rest of us would get a copy of it—what your thoughts would be, where you would draw the bar, what kind of boundaries you would recommend to legislate better accountability for these people who have plundered this Nation. They have plundered the world, so to speak.

And, I mean, if regulation would take care of it, the SEC's 1,100 attorneys would have prosecuted Bernard Madoff 10 years ago when his scheme was exposed to them, and they refused to take any action.

So, I think it's going to have to be a matter of criminal and civil accountability on a personal level if we are going to change the course of the future in this regard. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Posey. If the panel wishes to send that response in, we will make sure that the members of the subcommittee receive it. The gentlelady from Illinois, Ms. Bean.

Ms. BEAN. Thank you, Mr. Chairman. I would first like to ask unanimous consent to enter the written statement of the Honorable Steve Bartlett, president and CEO of the Financial Services Roundtable, into the record.

Chairman KANJORSKI. Without objection, it is so ordered.

Ms. BEAN. Thank you. And I would also like to acknowledge some of the testimony in response to some of my colleague's questions that no one that is advocating for a national insurance charter in any way is suggesting that we lower consumer protections.

And, in fact, we are starting at the baseline of the NAIC models, and only improving by adding a systemic risk regulator, by adding a national insurance commissioner who would have oversight of holding company information, both for insurance and non-insurance subsidiaries, like AIG Financial, who could prohibit activities by non-insurance companies that put those companies or their policyholders at risk. And also the testimony that you mentioned of a Federal prudential regulator only again enhances consumer protections.

My question is for Mr. McRaith: If the Federal Government had not stepped in to provide AIG bail-out money, how prepared were the State regulators and the reserve funds to deal with the fall-out? How would the States have come up with the $44 billion of Federal tax dollars that had gone to shore up AIG Life Insurance subsidiaries who took risky bets through their securities lending programs that, notably, were approved by the State commissioners?

And a follow-up question to that, what resources have been put in place subsequently by you and other State commissioners to oversee an insurance subsidiary's securities lending program?

Mr. MCRAITH. Right. Thank you for that question, because securities lending has come up in other comments, as well. It is important to understand that the problem—first of all, that the New York Department of Insurance was working to reduce the level of securities lending in the AIG subsidiaries before the crisis. The crisis, remember, was a result of the—essentially, a collateral call on the AIG holding company, resulting from the credit default swaps. This would not have been a problem, but for the CDS failure.

And it is also important to remember that the securities which were involved were AAA-rated securities at the time. So it points to the need for better regulation of the credit default swap market. The—

Ms. BEAN. So where would the $44 billion have come from?

Mr. MCRAITH. Well, let me answer that. I am going to get to that, but I want to—you also asked about reforms that have been undertaken.

We have increased capital requirements if companies are engaged in securities lending, enhanced reporting, and we are looking at how to revise our accounting standards, and that last improvement is ongoing. In terms of $44 billion, it is important to understand that each insurer, of course, has significant capital require-

ments, to begin with. Their assets cannot be used to satisfy the debts of the holding company.

Even if these subsidiaries—I think it's an open question, also Congresswoman, whether if the—without the $44 billion, whether these companies would have actually become insolvent. Many financial regulators will argue that they would not have been insolvent without the $44 billion, that they would have been okay. However, if there had been a question of solvency, then the companies would have been placed into receivership.

And insurance is not like the FDIC, for example, where you need liquidity and cash immediately. Insurance, in the guaranty fund system, essentially replaces the contract. They don't have to—and the coverage. They don't have to generate cash immediately, because, of course, not everyone dies—God forbid, everyone dies—on the same day, or everyone has a car accident on the same day.

And, for this reason, $44 billion would not have been needed immediately if, hypothetically, it would have been needed at all. It would have been managed over a period of many years, if not decades. And this is what happens—and does happen—through the course of State-based receiverships of insurance companies. The State-based system would have been able to handle it, and it would have been, again, a—protected the consumers, the policyholders, first.

Ms. BEAN. I appreciate your testimony on what has been done by the NAIC since that time to address the gaps that exist in the current system to protect policyholders. And again, it is those who oppose legislation to move towards a national charter who suggest that there be any weakening of consumer protections, who refuse to acknowledge the $13 billion of savings to the industry that could get passed on to consumers from the redundancies of a 50-State system. Thank you, and I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Bean. And now, the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you. I found it interesting that some of you there think that you can ask the Federal Government for so much, but in your own wisdom stop it, and then you will be in a position later on, when you're complaining, that the Federal Government went too far.

And I think Mr. Royce, in his own questions, went beyond his own bill on setting up an office of information, insurance information. And then his question was—and this is Ms. Bean's bill, also—is what good does it do to have the information if you have no authority to act upon it?

I come from Illinois, and one of the things that we do right in that State is regulate insurance. We have the cheapest insurance rates, probably, in the country.

Mr. McRaith, my understanding—and correct me if I'm wrong—is that AIG was in five pieces, five separate entities, call it what you want, and that the life insurance aspect was cordoned off by some firewalls from the investment side that went sour. Is that correct?

Mr. MCRAITH. That is correct, Congressman. Every State has adopted what we call the Holding Company Act. The Holding Company Act, along with our other financial regulations, requires each

insurer to be financially independently viable. And we have very strict capital and accounting and investment requirements.

One function of the Holding Company Act is that insurers—the life insurers, for example—cannot release capital to the holding company to support the holding company without regulator approval.

Mr. MANZULLO. So the investments that were made by the AIG Life Insurance section were separate from the investment arm that went sour, is that correct?

Mr. MCRAITH. That is correct. AIG Financial—AIG, in our conservative estimate, had 247 different companies; 71 of those were U.S.-based insurance companies. Each one of those was independently financially viable.

The financial products in the jet leasing company, those were regulated in other ways by other agencies in which the insurance companies—and the insurance companies were not threatened by those operations.

Mr. MANZULLO. So the life insurance side of AIG has always been sound, in terms of—you would have to have all the insureds, life insureds, die in one day or in a week in order to threaten the solvency of the insurance end.

Mr. MCRAITH. It is—some very smart, experienced financial regulators in this country would say exactly that.

Mr. MANZULLO. Well then, why would anybody want to regulate the life insurance company on a Federal level? How could it be done any differently, any better, than what has been done at the State level?

Mr. MCRAITH. Well, our position, of course, Congressman, is that it cannot be. And I think that your colleagues have pointed out numerous examples of why that would not be the case.

I think Chairman Kanjorski asked me earlier about Reliance Company, and would a Federal regulator have discovered the misconduct of its principal. Well, if—the SEC didn't discover the misconduct of Mr. Madoff, either, at the—

Mr. MANZULLO. And if I could stop you right there, that is my point. The man who is the whistleblower—I can't think of his name right now—oh, Mr. Makopoulous—testified that he had been screaming at the SEC for 5, 6, 7 years, and no one would listen. So the authority and the regulators were in place, they just failed with Madoff. And the same thing with the Federal Reserve.

Now, you said, Mr. McRaith that, "We restrict the nature and extent of the investments of insurance companies." And the Federal Reserve has jurisdiction to restrict the nature and extent of mortgage instruments and underwriting standards. And they sat on their butts and did nothing. In fact, Chairman Bernanke testified here in October of 2008 that it wasn't until December of 2007 that the Fed ever got involved in the whole subprime housing market. And I find that astonishing.

And Mr. Capuano is giving you hell that—he said where were the States when this went down the tube, but it was the Federal agency with direct jurisdiction that did absolutely nothing.

And now we're talking about using that standard, the SEC standard that blew it with Madoff, the Federal Reserve standard that blew it with doing nothing on governing these instruments to

stop the 2/28s and 3/27s, and making sure that people who took loans could afford to buy them, and now we're expected to sit here and have a Federal insurance regulator. Why?

I mean, I'm looking at your testimony here. You plead the Tenth Amendment on some certain areas, and I could understand what you're trying to do. The problem is, how do you think you can stop the Fed from going only as far as you want them to go, and then not going beyond the area where you don't want them to go?

That's a tough question, Patrick, but if you want to handle it, go ahead.

Mr. BAIRD. Well, I would like to try.

Mr. MANZULLO. I will leave it to you. If I could have some time, Mr. Kanjorski?

Mr. BAIRD. I will take anything I can get.

Mr. MANZULLO. Thank you.

Mr. BAIRD. I will try to keep this in the context of the purpose of the hearing, which is systemic risk. If the chairman will indulge me for 30 seconds, I have been coming up here for 7 or 8 years, long before AIG became the household name, and long before there was a financial crisis. And we were up here, advocating for an optional Federal charter, because we thought we could serve our customers—those of us who do business on a national basis, which is much of the life insurance business—better.

As Congresswoman Bean suggested—and you had a bigger number than I would have in my pocket, but there are billions of dollars of annual operating expenses that would be saved if we had a single regulator, rather than the 51 regulators that ultimately gets passed on to the customers.

Now, in the context of systemic risk, what we have been talking about today is, whether it's Federal or whether it's State in the past, there have been failures of regulators on both sides. And I think the purpose of this hearing is to try to make it better, it is to try to improve, and it's trying to bring all of the risks from the entire financial services industry together to keep this from happening again, which, given the amount of sleep that I have lost in the last 8 months, I am all about.

So, if we are indeed here to talk about a Federal systemic overseer or regulator, we don't think that you can regulate just systemic risk of the life insurance industry without having the expertise, collaboration, and cooperation of a Federal functional regulator. And that, to me, is how we bring all this together.

Mr. MANZULLO. That's a good answer. I appreciate that.

Mr. BAIRD. Thank you.

Mr. MANZULLO. Thank you. I do have another question, but I know I'm past my 5 minutes.

Chairman KANJORSKI. Let me start another round, and we will see if we can get another 5 minutes.

Mr. MANZULLO. Okay, that will be fine.

Chairman KANJORSKI. Okay. The gentleman from Florida, Mr. Grayson.

Mr. GRAYSON. Thank you, Mr. Chairman. I don't want to talk to you all or ask you any questions today about whether we should have a Federal regulator versus State regulators for insurance. I do want to talk to you and ask you questions about the subject of

systemic risk. You are a panel of members who are here to represent the insurance industry. And I would like to start with a very simple question.

Assume that systemic risk reflects the idea that the failure of one particular company would cause its creditors to also fail to go bankrupt, and reverberate throughout the financial system to the point where there is a dry-up of credit nationwide, or even worldwide.

The first question I want to ask you—we will start with Mr. McRaith—is which companies does that describe? In other words, which existing companies pose systemic risk if they fail?

Mr. MCRAITH. Not one insurance company based in the United States presents systemic risk, according to the definition you have provided.

Mr. GRAYSON. What about AIG?

Mr. MCRAITH. AIG's 71 U.S.-based insurance subsidiaries were financially strong, remain financially strong. Not one of those companies independently ever presented any systemic risk.

Mr. GRAYSON. As a group do they pose systemic risk?

Mr. MCRAITH. As a holding company, its Financial Products Division out of London, which was not appropriately regulated—but not a matter of State insurance regulation, by the way—that clearly presented systemic risk to the country.

Mr. GRAYSON. So what you're saying is that only the Financial Products Division of AIG posed any systemic risk, not any of the insurance operations, and the Financial Products Division was not an insurance operation, in your view. Is that correct?

Mr. MCRAITH. According to the definition you have provided of systemic risk, yes.

Mr. GRAYSON. Good. Let's go on to Mr. Spence. Which insurance entities today pose systemic risk to the system?

Mr. SPENCE. Thank you, Congressman. As we detailed in our testimony, I essentially agree with Mr. McRaith. However, I think that, on an aggregated basis, the insurance companies, as a whole in the United States, could, if there were a natural catastrophe of significance, or if—in the event of a terrorist attack pose a systemic risk.

Mr. GRAYSON. Well, that's an interesting point. So what you're saying is not the scenario we saw with AIG, that wouldn't pose the kind of systemic risk you're talking about. What you're talking about there is some sort of attack or natural disaster that would impose trillions—well, or at least hundreds of billions of dollars, potentially—I'm talking about, for instance, a nuclear blast—hundreds of billions or trillions of dollars of loss on the industry.

At that point, do you think that would be a systemic risk? And at that point would that be, in effect, the least of our worries?

Mr. SPENCE. As I indicated, we think that, on an aggregated basis, insurance companies in those events could be systemically at risk, correct.

Mr. GRAYSON. All right. Is there anything that a systemic risk regulator could possibly do about that?

Mr. SPENCE. That's a very good question. What the systemic risk regulator could do would be to try to ensure that examination of insurance companies' exposure was properly managed, whether the

aggregation of risks in urban areas were properly managed. There are things they could try to do to improve the situation.

But you are correct. Depending on the situation, there may not be much that could be done.

Mr. GRAYSON. Are there any particular entities that you would identify as being the ones to watch if we wanted to avoid a systemic risk in those extreme circumstances?

Mr. SPENCE. Again, we have looked at it more on an aggregated basis.

Mr. GRAYSON. All right. And I don't know if you will regard this question as fair or not, but if your company went broke, who else would go broke?

Mr. SPENCE. We don't have that many counterparties, like other insurance companies. So I'm not sure I can really answer that question.

Mr. GRAYSON. As far as you know, would any other major entities go broke if your company went broke?

Mr. SPENCE. No, sir. No, sir.

Mr. GRAYSON. All right. What about you, Mr. Baird?

Mr. BAIRD. You're asking me to use my imagination as to what a systemic risk regulator does, because I have thought about that a lot.

Mr. GRAYSON. Well, no. What I am asking you is, are there any current companies in existence, including your own, that you believe pose systemic risk, in the sense that if your company failed so many other companies would fail that it would result, in effect, in the mass destruction of credit in this country, or even the world. That's the question.

Mr. BAIRD. Okay. If all else were the same, if the reason for our failure did not impact any of the other companies, or—can I think of any other single company out there in the life insurance industry, okay, if the reason they were going to fail did not impact any other company, the answer is no.

Mr. GRAYSON. Okay. And going back to the previous answer, what you're saying is there are certain scenarios where we would have something resembling systemic risk, something like a terrorist attack, a mass disaster. Those are the kind of scenarios that we should be thinking about in the context of systemic risk. Is that correct?

Mr. BAIRD. In the property and casualty industry, yes. In the life insurance industry, it could be a broad devaluation of equity markets, credit defaults, and so forth.

Mr. GRAYSON. Okay.

Mr. BAIRD. It would impact all companies.

Mr. GRAYSON. All right. To me, this has been very helpful. If any of you want to supplement your comments with addressing these specific issues, I would certainly be grateful to you. My time is up. Thank you very much.

Chairman KANJORSKI. Thank you very much, Mr. Grayson. We are going to try another round quickly, and those members can take their full 5 minutes if they so desire, but they can certainly take less.

I will hold mine and pass over and go to my co-host here, Mr. Garrett of New Jersey, for 5 minutes.

Mr. GARRETT. And I will just run quickly through, because I don't want to hold the panel up, either. They may be anxious to—but I appreciate the panel being here.

Mr. McRaith—and I saw Mr. Skinner—well, I shouldn't make comments—maybe disagree with you—yes, and my wife always says that—with regard to the AIG situation. And you were running down the scenario with regard to who is looking at it, and of course Mr. Manzullo raised the issue and Mr. McRaith, you made the comment, portions of the units were overseas. And in London, specifically, right?

And I believe I have heard that before, that part of the issue here is that it was not the State regulator, necessarily, to some extent. Federal regulators, or lack thereof, as Mr. Manzullo is making—you're raising one, as well, as far as the European arm of it, or are looking at it, as maybe of missing it as well. Just want to chime in on that?

Mr. MCRAITH. I think the important point is that regulators need to have formalized structure for information sharing, for communication, not because of the risks, because frankly, there are large companies who will present risk. It's to avoid the disruption. So the structure of—

Mr. GARRETT. Okay.

Mr. MCRAITH. —the stability—

Mr. GARRETT. But I guess what I heard—and Mr. Skinner can comment on it—is was there a failure also not only on the Federal Reserve part, not only on the Federal regulators looking at the AIG situation, but was also a failure from the European regulators, as well, looking at this situation and not catching this going into it?

Mr. SKINNER. This is very interesting. As I am listening to this, I gather that you believe AIG functioned as it did in the United States. In fact, AIG functioned, country by country, inside the European Union.

And Solvency II challenged AIG, and said, "You've got to now behave as a group. You're overseas, and you're inside the European Union, in the market, in an internal market. You're now going to have to put your hands up and say you're a group." If they had been a group, we would be able to administer and supervise that group in its entirety, whatever it did, banking and insurance.

It just seems to me strange to keep picking on London. London was a conduit for trading. It was appropriately regulated at the time. Whether we now will have a crystal ball and we look back and we say, "Oh, securitization was bad," I do not think that's true. It's not rational, either.

But the reality is, actually, what went on was due to the derivatives market—and we know why, indeed, why it went bad in the derivatives market, so we don't need to go there. But if we are saying that AIG and the United States has to blame what went on on London for the failure of supervision, then I think that's taking it a step too far.

I think what we have to say is, where was it supervised inside the United States, who had oversight of it, why didn't, if State regulators had such a close relationship with this company, know about the kinds of investments it was making, and what propo-

sition did it make, in terms of trying to stop those investments with the Office of Thrift Supervision who, by the way, rejected—

Mr. GARRETT. I appreciate that. I guess a lot of what we do here is make the questions to other people. I said had we had different regulations in place, would we have prevented the situation, and it would seem as though, in certain cases, maybe not.

And Mr. Skinner, one other one quickly. You talked earlier in your testimony with regard to equivalency, and that's something we need to move to, right? You have the OII legislation that's out there. In the—I will call it the bare bones, the basic OII legislation, which does not have—sorry, as I understand it—all of the other regulatory aspects of it, it's basically just an OII office of insurance information, a collection of information.

Would that bring us to—just having that, does that bring us to equivalency alone?

Mr. SKINNER. I can only say at the moment, from what I know, just a collection of information in itself would not be enough, I hate to say.

Mr. GARRETT. Okay.

Mr. SKINNER. I think what we're looking for is for this to be the platform for whatever discussions and deliberations—

Mr. GARRETT. Right.

Mr. SKINNER. —and it's up to you where you go on this, of course. But what we want, really, is to examine what you're bringing, in terms of regulation, and it has to have some—

Mr. GARRETT. Yes, and I guess maybe the last question is we see the dichotomy here between the two approaches. And Mr. Capuano made the comment, I think, that he—and I don't want to put words in his mouth—sort of sees the need for the State regulations with regard to the consumer protection aspect. I think I heard that from him.

Mr. Baird, though, you could see the problems, however, along Mr. Price's line of thinking, of if you have—if you don't have the consumer protection aspect on the same level, or combined—and I know you don't want to get into who regulates what—combined with the prudential regulator, you could see a problem there indicated, right?

Mr. BAIRD. Yes.

Mr. GARRETT. So you would also see a problem, then, if Mr.—if I understand Mr. Capuano—if you continue the—those divided between the State and the Federal, with the consumer protection here on the State level, exclusively, as he seems to be supportive of, and the prudential regulator here on the Federal regulator, you would see a diversion of—or kind of conflicting of approaches or interests there, correct?

Mr. BAIRD. That is correct. When—

Mr. GARRETT. Besides the efficiency one.

Mr. BAIRD. Besides the inefficiencies, when we get it right, when we design a product that meets the customer's needs and allows us to be prudent and reasonable as regards solvency, so that we can deliver on promises 20 and 30 years out, we bring together our solvency people, our financial reporting people, our pricing people, and our—we have committees in our company that we call, "Would you

want your mother to own it committees." That would be our equivalent of making sure that the consumer is treated fairly.

When we get it right, all those different disciplines come together in the same place. To regulate us any differently, I think, would fail.

Mr. GARRETT. So if we do—if President Obama comes out and he does nothing, let's say, with regard to insurance, that's just not on the table, but he does give us a systemic risk regulator, perhaps in the Federal Reserve let's say, and he also—so that's over here—and over here he has a consumer protection division in some other area, that would be—either one of those permutations without—that would be the vision that would not work.

Mr. BAIRD. If that includes insurance. If that includes insurance products—

Mr. GARRETT. But it doesn't—

Mr. BAIRD. In my opinion, if you have regulators with different agendas, it does not allow us to bring it together to serve the customer the best way.

Mr. GARRETT. Nor will it work if you have, in your opinion of Mr. Capuano's approach, where you keep some level down here in the State and some up here on the Federal?

Mr. BAIRD. That is correct.

Mr. GARRETT. Okay. Thanks a lot. I appreciate it.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. Ms. Bean, for 5 minutes.

Ms. BEAN. Thank you, Mr. Chairman. Mr. McRaith, during your testimony, you highlighted that the NAIC works actively with international regulatory bodies. What authority does the NAIC have in actually compelling States to comply with any changes or recommendations that the international community would like to see?

Mr. MCRAITH. Well, the first value that the NAIC adds to that process is a coordinated interactive agency to work with our international colleagues. There are 27 countries in the EU. There are many countries around the world who have similar systems.

In terms of the preemptive authority of the NAIC, its role is not to preempt the States, it is to supplement and support the State regulation. So, in that sense, as it develops—as internationally there are developed standards, we support the development of those standards. And that is the measure by which we will determine equivalency, by the way, is the development and compliance with international standards.

Ms. BEAN. So you support the standards and you educate the States, but ultimately you don't have the authority to compel them to comply in the same way that the NAIC, for 140 years, has tired to drive uniformity across the States domestically, and has been unable to get all States to move forward towards agreement on standards, as well?

Mr. MCRAITH. Well, just quickly, I think that's a fair comment. There are differences among the States. I think, as your colleagues have mentioned—you know, for example, in Illinois, we have a rating system where—that works for our State. Companies don't need prior approval on property and casualty rates in our State. How-

ever, that system would not work—I think many legislators would argue—in the Gulf States, or on the Pacific Coast.

So, those differences, while they might present a system that some of the largest players in the industry would argue is difficult, provide essential consumer protections to the people who actually live in the districts and in the States themselves.

Ms. BEAN. All right, thank you. My question for Mr. Skinner is, from the European perspective, how successful is the NAIC in implementing agreements reached with European counterparts?

Mr. SKINNER. To be honest, on reinsurance in particular, where we have had some perennial problems on collateral charges, not very successful at all.

The European Commission holds out that this is entirely discriminatory against European companies operating inside the United States, where there is as much as $40 billion worth of collateral held in States across the United States. There has been a move to move towards a rating process.

That rating process, in itself, seems quite discriminatory, with the higher ratings being required—very high ratings required for foreign companies—and very much less, or so it seems, for domestic companies, which we—if you're operating in a global reinsurance market, business-to-business, it doesn't make much sense.

Obviously, I understand the necessity of covering risk, but we have just done away with collateral inside the EU. We think it's a blunt instrument. We wonder why, you know, that it is still a cause celebre here. Whenever the NAIC comes to the European Union and says, "This is what we're going to do," we're still shocked by it, we still think it's not a very modern approach, or a very modern technique, and we prefer to look at risk management which, after all, at the end of the day, tells you just what those companies are doing, how they're behaving, and how they're predicting their risks, which is far more essential than how much money they have in the bank.

Ms. BEAN. Thank you. One last question for Mr. McRaith. In 1999, the NAIC chose to become a Delaware corporation. And, at the time, the executive vice president of the NAIC, Kathy Weatherford, explained that Delaware laws were conducive to corporations.

Why does the NAIC believe they should be able to choose where to incorporate, based on what was in the best interest of the NAIC, but insurance companies with nationwide offerings shouldn't have the option of a Federal charter to streamline their operations and better serve their customers?

Mr. MCRAITH. Well, excellent question, Congresswoman. Let me first comment on the reinsurance collateral issue with this very brief anecdote, which is that my colleagues on the panel to my left almost uniformly would oppose the release of collateral on reinsurance transactions, so it's interesting to have this diversity of opinion on this one panel, although I appreciate the EU's perspective.

In terms of the Delaware incorporation by the NAIC, I don't think it's a mystery to anyone in the country that Delaware is a home place for corporations to incorporate.

The NAIC, as you alluded to earlier, is not, in and of itself, a regulator. And, in that sense, it is not delivering directly to consumers the products—it's also not a company, so it is not delivering prod-

ucts. It doesn't have solvency requirements. It's not selling complicated insurance policies to people in every State around the country. And, for that reason, companies should be domiciled within States and subject to the regulation of those States in which they sell products.

Ms. BEAN. I appreciate your response, and I yield back. Thank you.

Chairman KANJORSKI. Thank you very much, Ms. Bean. Do you have any further questions, Mr. Posey?

Mr. POSEY. Thank you, Mr. Chairman. I want to thank each and every one of you for your time and your testimony. And your forthrightness, especially, is appreciated.

Mr. Skinner, you are right. There has been a big disparity between the requirements for domestic and non-domestic reinsurers. And I think just in the last couple of years, though, we have been so plundered and abused by the reinsurers that have done business in some of our States—all of whom happen to have the exact same rates—that you will see some of those States are dropping those requirements.

More than protectionism, the purpose of that was so that if we caught them misbehaving, theoretically we could put them in jail and hold them accountable if they were domiciled in this country. If they were domiciled some other place in the world, that becomes a little bit more problematic. So that was done more as a matter of accountability than it was protectionism, hopefully.

When we talk about a systemic regulator, I wonder—and you have come the farthest, Mr. Skinner, and might have the best ideas on this—how in the world could we expect a systemic regulator to regulate derivatives, complex derivatives? I mean, from a practical application, I have not heard anyone yet explain how somebody could evaluate them and then regulate them.

I mean, in theory, we say, "Yes, we need somebody to regulate this stuff and make it right," but I haven't heard a practical example given yet of how they would regulate complex derivatives, for example.

Mr. SKINNER. I think that's a good question. I mean, one of the things, obviously, these products went ahead of some of the regulators who were meant to be regulating them. And some of even the boards of the companies who were actually in charge of these particular products—you also had the combination of Chinese walls between agencies who were meant to rate them, and then were also designing products, and banks doing the same. Everybody made money in this. It was the wrong incentive for any of these things.

So, in terms of having oversight, well, clearly, one of the things we have done at the European level, certainly amongst banks, is we have said, "If you start off with a derivative, we think that you should retain some of that derivative, so that we can spot if there is any problems, down the line, where it came from." And one of the things was that there was no originator principle in derivatives.

So, we have just introduced a law, the capital requirements directives in banks, to ensure that up to 5 percent of all such derivatives that are started have to be maintained with—inside those banks. That is something I know that is being discussed elsewhere,

and you probably have heard about it already. But clearly, from our perspective, it is only with that particular type of start that we can hope to look at this market.

But one thing is for sure. We quite clearly need a securitization industry if we are to build capacity. And insurance depends upon that, just as much as banking. But we just have to stop the unethical behavior that was clearly behind a lot of this, and certainly some of the greed which led to the most uncertain derivatives being unleashed on the markets.

Mr. MCRAITH. Congressman—

Mr. POSEY. Mr. McRaith?

Mr. MCRAITH. Yes. I think you are asking the multi-billion-dollar question. But I think the Chicago Mercantile Exchange—if I can be a little bit parochial—had an excellent proposal, and that is to have an electronic trading platform and a clearing function, so that there is pricing transparency and counterparty certainty. And those two things, in conjunction, would have prohibited or limited the impact of the crisis we have seen and are suffering through now.

Mr. NUTTER. Mr. Posey?

Mr. POSEY. Yes, please.

Mr. NUTTER. I actually wanted to come back to your reinsurance comment, but I will be glad to defer to someone, if they are responding to your comment about credit default swaps first.

Mr. MCCARTHY. I would just like to make one point. Credit—the critical part of a regulator—and, again, we think perhaps the Fed—is to analyze the instruments themselves. The difficulty with credit default swaps with AIG was leverage and the huge number of transactions that they did, and the leverage that was embedded in each one.

It is critical, and it would be interesting to see what the—Mr. McRaith would say about this. But the amount of staff that it takes to analyze these financial instruments, to regulate them and to try to make sure which things are permissible or not, we think is more akin to what the Fed does than what Eric Dinallo or one of the State regulators would be able to do with staff analysis, and be able to stay on top of that particular kind of financial instrument.

Mr. POSEY. So does anyone think that—the people who are putting these together are highly valued, making tremendous sums of money—does anyone have the slightest notion that we would be able to afford to hire those people, and that they would want to work for the government at evaluating the profitability of these derivatives throughout the world?

I don't believe in the Tooth Fairy or the Easter Bunny, and I don't believe we're going to create somebody like that, either. I mean, if I'm wrong, somebody tell me why you think that's really a practical idea, that we're going to get somebody who is going to be able to evaluate the derivatives, the complex derivatives that are throughout the financial markets, and they're going to work for the government, and they're going to be able to tell us which are smart and which are dumb and which are going to make money and which aren't, and which are risky and which aren't risky. I mean, I just think that's an absolute absurdity, just to think that could happen.

Mr. MCRAITH. Congressman, as the one public sector employee on this panel, I would like to offer this perspective, that there are many very smart, bright, committed regulators who sacrifice short-term compensation so that they can provide a contribution to the greater society.

Mr. POSEY. Well, we are going into new water here now. And I think with what we have already discussed, what we saw with the SEC, what we saw with all the agencies that failed to investigate, failed to prosecute—Enron is probably one of the only ones that we can see, and for every Enron, I can show you a State regulator that put somebody in jail, TRG for example, the best example I can think of—but to start from scratch this new bureaucracy that is going to solve all these problems, I think, is just an unrealistic expectation.

I am not saying that there are not good people who work for government. I am saying that the level of expertise that is required here—that the person could have his own independent evaluation for the rest of the world and maybe serve a greater good than trying to have the government do it.

And there is nothing wrong, certainly nothing wrong, with having a database. We have talked about that before. We have thought about that before, that, you know, if you have a derivative, you file a derivative, you list every component of the derivative, and you put that on an index that you can get online, that anybody can go see online, just for a transparency.

But then, of course, the word is, "Well, we are registered with this," and there is an implied value to that, that an unwary consumer who we're trying to look out for might not understand.

And thank you. I think you gave me some extra time, Mr. Chairman. I appreciate it.

Mr. NUTTER. Mr. Chairman, if I might comment on Mr. Posey's comment about reinsurance. One of the reasons that we support a prudential regulator at the Federal level is, in fact, that much of the reinsurance market is a non-U.S.-based market. And the lack of expertise and capability, as well as the lack of a legal framework between countries that are major trading partners with the United States, is the reason that we think it's appropriate to have a Federal regulator. Mr. McRaith commented earlier that the lack of Constitutional authority for States to enter into trade agreements with other countries is an impediment to dealing with that.

I would also disagree with your characterization of the reinsurance market. In fact, it has contributed an enormous amount of money to refinancing after 9/11, after Hurricanes Katrina and Wilma, after the hurricanes last year. It really has been a very responsible market in paying its claims.

Mr. POSEY. Mr. Chairman, just—I didn't say they weren't responsible, and I didn't say they didn't pay claims. I said they all had the same rate, in my State, which seems a little coincidental.

Chairman KANJORSKI. Thank you very much. The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses, and to place their responses in the record.

Before we adjourn, the following written statements will be made a part of the record of this hearing: The Center for Insurance Research; The Proper Casualty Insurance Association of America; and the CEA, a trade association of European insurers. Without objection, it is so ordered.

I want to thank this panel for their contribution today. We did it in 3 hours, which is pretty good. And maybe next time, we can keep you for 5 hours.

It would be another opportunity to visit with Mr. Skinner, if we call him over here. We would enjoy that. I think that we gained a lot from the international exposure of having Mr. Skinner as part of the panel, but all of the participants on the panel were extraordinarily contributive today.

And I think even the greatest doubters on the committee may tend to say that we moved the ball down the field a little further, with the result of this hearing.

I want to thank you again for being part of it. I look forward to some future hearings on this very subject. And now the panel is dismissed, and this hearing is—

Mr. GARRETT. Just to enter something into the record, from the AIA, a letter of June 5th.

Chairman KANJORSKI. Without objection, it is so ordered.

Mr. GARRETT. I didn't mean to hold you up an extra 30 seconds, but I did want to make sure that gets into the official record as well. Thank you.

Chairman KANJORSKI. Thank you.

[Whereupon, at 1:07 p.m., the hearing was adjourned.]

# A P P E N D I X

June 16, 2009

**OPENING STATEMENT OF CHAIRMAN PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON SYSTEMIC RISK AND INSURANCE**

**JUNE 16, 2009**

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We meet to continue our discussion of insurance regulation, which the Capital Markets Subcommittee has debated in great depth for several years. On the eve of the Administration's unveiling of its plan to strengthen the oversight of our financial markets, it also appears likely that we will soon consider reforms aimed at mitigating systemic risk. As such, it makes sense for us to dive a bit deeper today into the issue of systemic risk and the insurance industry.

While we have yet to learn much about the specifics of the Administration's plan for insurance reform, we have spent enough time debating these issues to come to some conclusions. For example, I believe that only ostriches can now deny the need for establishing a federal insurance resource center and a basic federal insurance regulatory structure.

Insurance is a complex and important part of the U.S. financial industry with more than $6.3 trillion in assets under management and $1.23 trillion in annual premiums. We need to recognize this reality by modernizing the overall regulatory treatment of insurance. We also need to protect against the risks certain sectors of the industry may pose and address the greater sensitivity that some industry segments have to external events.

During this crisis, we saw a company that started out as an insurer spread far and wide in its activities and its international presence. American International Group, however, lacked a federal regulator with real expertise about its vast insurance operations. Rather, the holding company purchased a small thrift and chose the Office of Thrift Supervision as its supervisor.

Currently, several other insurance holding companies have a federal banking regulator as their primary supervisor, and more than six dozen similar entities avoid any form of federal oversight, with selected states instead monitoring them on a consolidated basis. Because a number of these businesses could pose systemic risk, I believe that the federal government should directly examine all complex financial holding companies, including those whose primary activities involve underwriting insurance and those who play with credit default swaps.

In addition, our financial services markets are global and complex. Insurance is no exception. In order for effective communication and dialogue to take place on the international stage, we must have a single point of contact for the United States on these matters. Moreover, insurers must have a federal regulatory voice on par with the banking and securities sectors in our financial markets so that the industry can communicate with its peer regulators at home.

In short, we can no longer sweep insurance regulation under the rug and cross our fingers that nothing will go wrong. We tried it before and learned that such an action may hide the mess for the short term, but pose greater problems in the long term. As such, when the Administration reveals its white paper tomorrow, I very strongly hope that it will recognize today's market realities and call for the establishment of better oversight for insurance holding companies and certain insurance activities, especially those most likely to pose systemic risk.

Moreover, I am confident that this Administration will recognize the wisdom of creating of a federal insurance office to advise a systemic risk overseer on the risks in the insurance sector, provide expertise to the Administration and Congress on insurance policy matters, and communicate with foreign governments. I have long advocated for such an office by introducing and advancing the Insurance Information Act. As part of the congressional restructuring of financial services regulation, I ask my colleagues to join me in the effort to enact this legislation.

With any luck, the Administration with its white paper will also hopefully advance the debate about federal insurance regulation in other ways. Personally, I now believe that the federal government should actively regulate some specific insurance lines, especially those that pose systemic risk or which have a national significance. Using these tests, federally regulated lines would include bond insurers, mortgage insurers, and reinsurers. I also believe that we should examine how we can promote greater uniformity in the industry, with or without the establishment of a federal charter. The Administration might reach similar conclusions.

In sum, before the Administration proposes its white paper tomorrow, we have many important issues to discuss related to regulatory restructuring as it affects the insurance sector today. I therefore look forward to the testimony of our witnesses and to a vibrant debate in the weeks and months ahead.

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FOR MORE INFORMATION, call:202-225-4465 • www.house.gov/garrett

EMBARGOED UNTIL DELIVERY
Tuesday, June 16, 2009

Contact: Erica Elliott
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## Garrett Opening Statement for Financial Services Insurance Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services Subcommittee on Capital Markets hearing entitled "Systemic Risk and Insurance":**

"Thank you, Mr. Chairman. And welcome to all of our witnesses today – particularly to Mr. Skinner, who traveled all the way across an ocean to testify here today.

"We've got a large panel with a wide range of perspectives on different aspects of the insurance industry. I look forward to your testimony.

"Tomorrow we are expecting to hear from the Obama Administration in regards to its plans for financial services regulatory reform. From what I can tell, it is unclear to what extent its proposal will address insurance legislation. Different ideas have been floated, but within the Administration and beyond, it seems that a clear consensus on what to do in the area of insurance has not yet crystallized.

"Part of the difficulty in reaching a consensus on what to do I think is related to the difficulty in reaching a consensus on what, exactly, constitutes systemic risk, and furthermore, how do you identify it (if that's even possible much of the time), how should it be addressed if it can be identified, and how should it be cleaned up if it's not identified before it's too late?

"I would add another issue that policymakers should be thinking about. How can policies be put in place so that incidences of systemic risk aren't actually encouraged in the first place, or exacerbated, or even institutionalized due to government actions or unintended incentives?

"I worry that some of the policies being considered by the Administration, and likely to be part of its plan, will unfortunately do more harm than good if they are implemented.

"A systemic risk regulator, in conjunction with a resolution or "bailout" authority regime, will set up a situation where certain companies are either implicitly or explicitly perceived to fall under this new

layer of supervision, be seen as too big to fail, gain an unfair advantage in the marketplace, and threaten further taxpayer pain.

"Further complicating the resolution authority proposal is the question of how to pay for it. If only large firms potentially subject to the authority are asked to pay for it, then they will be fairly explicitly seen as the beneficiaries of such a resolution regime. Asking a broader swath of the financial industry to pay for it would not be equitable, since smaller firms that would have no chance of benefitting from the funds would be asked to contribute to a system designed to prop up their larger competitors.

"Additionally, I don't believe individual taxpayer should be asked to contribute to a fund that is set up to bail out a failed large firm and its creditors.

"Furthermore, such a fund created for the resolution authority would need to be very large (and thus very costly for firms that have to contribute to it) but at the same time likely wouldn't be large enough to deal with an event deemed by regulators as being truly significant.

"As I said, I would argue that first and foremost we should concentrate on policies that don't encourage future bailouts by promising firms that the government will always come to the rescue. The Republican plan that was put forward last week addresses various government policies that put the taxpayer at risk and has "no more bailouts" as its central and unifying goal.

"Returning to the theme of today's hearing, my primary question is, are insurance firms by their nature systemically significant? I'm looking forward to hearing from different participants on today's panel on this question, in particular. Certainly it would be a mistake to view the entire broad insurance industry as a single entity. At today's hearing the breadth of the industry will be on display as we'll be hearing from representatives of the mortgage insurance industry, the bond insurers, life insurers, the reinsurers, as well as voices representing different aspects of the property and casualty sector.

"We'll also be hearing from the NAIC, which is actually in charge of insurance regulation as we speak. I am hopeful that its perspectives on systemic risk, how it might be addressing it, and what further could be done, will be particularly enlightening for the purposes of today's hearing.

"Finally, Chairman Kanjorski has introduced his Office of Insurance Information, or OII, bill. I know this legislation will be addressed by several of our witnesses today. I am interested to hear from our panel as to how this legislation may address deficiencies in our current framework – I am particularly interested in its potential impact in regards to market access for U.S. companies abroad and related international agreements.

"Once again, welcome to our witnesses and I look forward to your testimony."

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7TH DISTRICT, INDIANA
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
SUBCOMMITTEE ON INTERNATIONAL MONETARY POLICY AND TRADE

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Statement of Congressman Carson
Subcommittee on Capital Markets, Insurance and GSEs
"Systemic Risk and Insurance"
June 16, 2009

Thank you, Chairman Kanjorski for your leadership on this Subcommittee and for your dedication to ensuring that insurance regulatory reform consideration in the House is inclusive and thorough.

In our third hearing in the 111th Congress pertaining to insurance reform, the issues we are debating are critical to broader concerns of systemic risk in the financial services regulatory restructuring discussion.

As the Representative from Indiana's Seventh Congressional District, where both the National Association of Mutual Insurance Companies, represented here today, and the National Conference of Insurance Guaranty Funds are headquartered, I appreciate the depth of the debates in this Subcommittee regarding insurance modernization.

Today, as we delve further into global competitiveness and systemic risk mitigation, I believe it is important to reconcile efforts to fix obvious regulatory gaps while maintaining effective oversight structures.

I understand and share in the anger over the bailout of AIG. We have learned the hard way that fragmented and lax oversight of insurance products, such as credit default swaps, can have disastrous results. However, I also understand that most insurance companies that are closely regulated by the states were not responsible for flooding the market with these high-risk and over-leveraged products.

And while there are undeniable strengths to our state regulatory structure including consumer protection and the ability to respond to local conditions, I remain concerned about the lack of insurance information and expertise on a federal level.

I believe the creation of a federal office with comprehensive and timely data regarding products and trends is a key component to insurance modernization.

With that, I look forward to discussing these concerns with the witnesses today and I yield back my time.



PRINTED ON RECYCLED PAPER

**STATEMENT OF**

**THE AMERICAN COUNCIL OF LIFE INSURERS**

**BEFORE THE**

**UNITED STATES HOUSE OF REPRESENTATIVES**
**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE & GOVERNMENT SPONSORED ENTERPRISES**

**ON**

**SYSTEMIC RISK AND INSURANCE**

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June 16, 2009

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Statement Made by
Patrick S. Baird
Chief Executive Officer
AEGON USA

Mr. Chairman and members of the Subcommittee, my name is Patrick Baird, and I am Chief Executive Officer of AEGON USA. I am appearing today on behalf of the American Council of Life Insurers. The ACLI is the principal trade association for U.S. life insurance companies, and its 340 member companies account for 93% of total life insurance company assets, 94% of the life insurance premiums, and 94% of annuity considerations in the United States.

Today's hearing could not be more timely. The Administration is poised to unveil its proposals on financial regulatory reform, and this Subcommittee must carefully consider in the weeks ahead the most appropriate course of action to reform and restructure our financial regulatory system in a way that assures that a similar crisis does not occur in the future. Your statement announcing this hearing correctly notes that insurance is a significant and integral part of the U.S. financial system. As a consequence, regulatory reform must encompass insurance if the new regulatory structure you put in place is to operate effectively and without problematic gaps.

Addressing systemic risk in the financial markets, both domestically and globally, has emerged as the driving force behind regulatory reform efforts. My comments today reflect that perspective and begin with the premise that the life insurance business as a whole is, by any measure, systemically significant.

**The Life Insurance Industry Is Systemically Significant**

Life insurance companies play a critically important role in the capital markets and in the provision of protection and retirement security for millions of Americans. Life insurers provide products and services differing significantly from other financial intermediaries. Our products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care and disability income insurance. The long-term nature of these products requires that we match our long term liabilities with assets of a longer duration than those of other types of financial companies.

Life insurers are the single largest U.S. source of corporate bond financing and hold approximately 18% of total U.S. corporate bonds. Over 42% of corporate bonds purchased by life insurers have maturities in excess of 20 years at the time of purchase. The average maturity at purchase for all corporate bonds held by life insurers is approximately 17 years. The role life insurers play as providers of institutional credit through our fixed income investments cannot be overemphasized. We are significant investors in bank bonds and consequently are an important factor in helping banks return to their more traditional levels of lending.

Life insurers are also the backbone of the employee benefit system. More than 50% of all workers in the private sector have life insurance made available by their employers. Life insurers hold approximately 22% of all private employer-provided retirement assets.

Our companies employ about 2.2 million people, and the annual revenue from insurance premiums alone was $600 billion in 2007, an amount equal to 4.4% of U.S. GDP. Some 75 million American families - nearly 70% of households – depend on our products to protect their financial and retirement security. There is over $20 trillion of life insurance coverage in force today, and life insurers hold $2.6 trillion in annuity reserves. In 2007 life insurers paid $58 billion to life insurance beneficiaries, $72 billion in annuity benefits and $7.2 billion in long-term-care benefits. Without the financial protection provided by life insurance, these families may need to rely on the federal government for assistance.

**Individual Life Insurance Companies and Systemic Risk**

While the life insurance industry as a whole is systemically important, we do not believe any individual life insurance company can accurately be characterized as posing systemic risk. There are certainly a number of large life insurers, and the failure of any one of these companies would unquestionably send shock waves through the industry and put pressure on the life insurance guaranty system (the industry's financial backstop that serves a function roughly analogous to that of the FDIC).

The typical indicia of systemic risk would not, however, appear to be present even in the case of the failure of a large life insurer. These indicia would include: the extent to which the failure of an institution could threaten the viability of its creditors and counterparties; the number and size of financial institutions that are seen by investors or counterparties as similarly situated to a failing institution; and whether the institution is sufficiently important to the overall financial and economic system that a disorderly failure would cause major disruptions to credit markets or the payment and settlement systems.

**Structural Considerations**

In developing an effective overall U.S. financial regulatory structure, the key question with respect to life insurance is this: how do you deal with an industry that as a whole is systemically important but which comprised individual companies no one of which poses systemic risk? We believe the appropriate answer is to include two essential structural elements in any regulatory reform package. The first is to cover life insurance in whatever broad systemic risk oversight is made applicable to the banking and securities industries. The second is to create a federal functional insurance regulator and make it available to all life insurance companies within the industry on a voluntary basis.

We do not offer any comments at this time regarding which agency or agencies should serve as the systemic risk regulator. As far as how the jurisdiction of a systemic risk regulator should be established, we would observe that moral hazard and the potential risk of competitive imbalance can be minimized by avoiding a public, bright-line definition of systemic risk and by keeping as confidential as possible the role a systemic risk regulator plays with respect to an individual institution.

In the same vein, we have no strong views on the need for a resolution authority to address troubled institutions posing systemic risk and currently viewed as "too-big-to-fail." Most if not all of those horses appear to have left the barn, and we assume a principal objective of a revamped and more effective financial regulatory structure is to avoid such circumstances ever arising in the future. However, we have commented on the concept of a resolution authority from the perspective of how it would interact with

various life insurance regulatory mechanisms, most notably the state insurance guaranty system. If such an authority is to be included as part of Congress' regulatory reform package, we believe careful consideration must be given to making certain that it does not conflict with other essential life insurance regulatory functions.

We do feel strongly that the creation of a federal functional regulator for the life insurance business is an essential element of sound regulatory reform. This belief is predicated on three structural considerations: effective implementation of federal regulatory policy; effective coordination with the new federal systemic regulator and authority to coordinate global regulatory responses to the financial crisis..

This Congress will reach a number of important national policy decisions regarding how to improve the regulation of the U.S. financial markets and minimize the chances of a similar crisis occurring in the future. Implementation of these policy decisions will be carried out by federal financial regulatory bodies. However, absent a federal insurance regulatory agency, there will be no federal agency with the necessary expertise on insurance to either advise Congress on relevant policy matters or to implement policy with respect to life insurance companies. Understanding and implementing critical federal policy solely through reliance on hoped for cooperation on the part of 51 state regulators rather than through enforceable federal statute is not a model Congress should embrace.

Similarly, effective systemic risk regulation relative to life insurers, whether conducted by a single federal agency or a group of federal agencies, will be difficult absent any in-depth regulatory knowledge or understanding of the business at the federal level. Treasury's experience with life insurers applying for Capital Purchase Program funds bears out this fact. Having the systemic risk regulator rely on the states in this regard is certainly an option, but it will never be as effective as being able to partner with a knowledgeable federal regulatory counterpart.

We also believe that making a federal functional regulator available to life insurers on a voluntary (optional) basis is both realistic and appropriate. Two issues need to be addressed in this regard, the first being regulatory arbitrage and the second being the propriety of federal functional regulator – optional or otherwise - for an industry that is systemically important but which does not have any individual companies that pose systemic risk.

Concerns over regulatory arbitrage, which have been raised principally by state insurance regulators opposing an optional federal charter, are without merit. The life insurance business is not seeking, nor would this Congress ever consider enacting, a federal insurance regulatory system that is weak in terms of consumer protections and solvency oversight. Indeed, the ACLI has consistently advocated for a federal alternative that is as strong as, if not stronger than, the best state regulatory systems. If anything, a properly constructed optional federal charter would result in the states being challenged to raise their standards to meet those of the federal regime. And it should be kept in mind that insurers currently have the right to change their state of domicile (i.e., they can pick the state that will have primary solvency responsibility), and regulation from state-to-state is anything but uniform in terms of substantive requirements, staffing, expertise and enforcement. The creation of an additional but strong federal option can only encourage a flight to quality.

The propriety of having a federal functional insurance regulator needs to be considered from both a pre-crisis and a post-crisis perspective. Prior to the financial meltdown, life insurers had made a persuasive case to Congress that the inefficiencies of the state regulatory system, plus the fact that the states have no constitutional authority to bind the U.S. with respect to trade negotiations or global regulatory matters, justified the establishment of a federal functional insurance regulator with the ability to charter companies on an optional basis. Not a single aspect of this pre-crisis rationale in support of an optional federal charter has diminished. Post-crisis, the rational for a federal functional regulator is augmented by the points noted above – the need to effectively and

uniformly implement whatever federal regulatory policy Congress establishes and to coordinate most effectively with a new systemic risk regulator.

If a federal insurance charter were made available to life insurers on an optional basis, and assuming it provided for a strong and effective regulatory alternative for those companies doing business in multiple jurisdictions as well as globally, there is no question that life insurers representing a significant portion of the industry would elect the federal option. That, in turn, would mean that the federal functional regulator would have direct jurisdiction over a critical mass of a systemically significant industry – whether measured by assets or otherwise – and would be able to implement national regulatory policy in a meaningful manner with respect to that industry, partner more effectively with the new federal systemic risk regulator and effectively represent the U.S. internationally on trade and regulatory matters.

We would like to thank Representatives Bean and Royce for introducing H.R. 1880, the National Insurance Consumer Protection Act. This legislation sets forth the fundamental elements of a federal insurance charter that would dovetail appropriately with a broader financial regulatory reform measure.

There is one final structural point on insurance regulatory reform that we would like to raise, and that pertains to insurance solvency regulation. There are many regulatory elements that collectively constitute solvency regulation for a life insurance company, including capital and surplus, reserves, underwriting, risk classification, nonforfeiture, investments, accounting and, pertinent to this point, product regulation. For a life insurer, solvency regulation is inherently linked to the products it sells. Factors such as what is guaranteed, when the guarantee is triggered, the length of time the guarantee is in force and others product features are crucial to a determination of how the premiums are invested to assure assets will be available to pay claims. Effective solvency oversight necessitates that a single regulator have authority over all aspects of solvency, including product regulation. If different regulators assumed responsibility for any of these aspects of insurance solvency oversight, the net result would be an increase in systemic risk, not

a reduction of it. For this reason, concepts such as a financial product safety commission, if made applicable to life insurance, would raise significant concerns.

**International Considerations**

Today's markets are global, as are the operations of a great many financial service firms. Consequently, systemic risk regulation necessarily involves both domestic and global elements. While state insurance regulators are certainly involved in discussions with financial regulators from other countries, they do not have the authority to set U.S. policy on insurance regulation nor do they have the authority to negotiate and enter into treaties, mutual recognition agreements or other binding agreements with their foreign regulatory counterparts in order to address financial regulatory issues on a global basis. How can multinational insurance companies be effectively regulated and how can U.S. policy on financial regulation – systemic or otherwise – be coordinated and harmonized as necessary with other countries around the globe?

Regulators, central governmental economic policy makers and legislators in Europe, Japan, Canada and many other developed and developing markets point to the lack of a comprehensive federal-level U.S. regulatory authority for financial services as one factor that led to the current instability of at least one of the largest U.S. financial institutions. The G20 is clearly focusing on the need to coordinate a global response to the economic crisis.

We believe Congress needs to fill this systemic regulatory gap through the creation of a federal insurance regulatory authority like every other member of the G20. This federal authority is necessary for a comprehensive approach to systemic risk allowing U.S. regulators to respond to a crisis nimbly and in coordination with other major global regulators. Only in this way will policy makers and regulators have confidence in the equivalency of supervision, and the authority to share sensitive regulatory information and the ability to provide mutual recognition as appropriate.

**Office of Insurance Information**

Mr. Chairman, as we have stated in the past, we appreciate and support your continued efforts to advance insurance regulatory reform through the creation of an Office of Insurance Information within the Department of the Treasury. While our ultimate goal with respect to modernizing the insurance regulatory system remains an optional federal charter for life insurance, we believe H.R. 2609 is a good first step consistent with this objective and would be beneficial to Congress as it considers issues that are vitally important to our business; would facilitate the handling of certain international insurance matters; and would provide a means for effectively involving the insurance industry as national policy decisions are made affecting U.S. financial institutions.

**"Federal Tools" Approach**

There has been discussion among some policymakers that an alternative approach to insurance regulatory reform could be the establishment of "federal tools" or "federal standards" that would be enforced by the existing state insurance regulatory regime. This approach is fatally flawed and would not achieve meaningful insurance regulatory reform.

The 10th Amendment to the U.S. Constitution prevents the federal government from commanding the states to carryout federal law. Although the federal government can constitutionally preempt state law in certain circumstances, or offer "incentives" in hopes that states will act in accordance with federal wishes, such action in response to the question at hand would leave a large and unacceptable enforcement void. In addition, even if states did agree to carry out federal law, absent a federal enforcement mechanism application of a "federal tools" approach would lack uniformity in both interpretation and application.

We have seen this approach fail before, most recently with the enactment of the original NARAB legislation. In 1999, Congress attempted to help the states standardize insurance producer licensing standards through the NARAB provisions in the Gramm-Leach-Bliley Act. States were given three years to have at least 29 jurisdictions enact uniform or

reciprocal producer licensing laws or lose their licensing authority. While the states initially met the 29 state/three year requirement, it is clear that subsequently many states have drifted away from the uniform standards imposed by NARAB with the result that today there is a real question regarding how many states are in fact in compliance with the applicable standards. The bottom line is that after ten years we are still waiting for the states to adhere to this federal standard.

Two final points argue against a "federal tools" approach. First, the international trade issues important to both policymakers and the life insurance industry would be left unresolved. There would be no means of addressing the many problems that both Congress and the Administration have heard about from leaders of other nations regarding the inability of the U.S. to enter treaties or mutual recognition agreements on insurance. Second, the concept is a far greater affront to states rights than an optional federal charter. Mandating that state regulators apply federal standards for all insurers and agents would essentially supplant a significant portion of state regulatory prerogatives.

**Conclusion**

Mr. Chairman, I again want to thank you for holding today's hearing. Regulatory reform is unquestionably one of the most important matters before Congress, and determining how best to deal with insurance as part of the structural changes you will be making will be critical in assuring that the resulting regulatory framework works effectively and minimizes the risk that a crisis such as the one we are presently experiencing will occur in the future. We pledge to work diligently with you and with members of this Subcommittee to see that effective regulatory reform becomes a reality.

**STATEMENT OF TERESA BRYCE BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES**
**June 16, 2009**

I am Teresa Bryce, president of Radian Guaranty Inc. I am here today on behalf of the Mortgage Insurance Companies of America (MICA), the trade association representing the private mortgage insurance industry. The Subcommittee today is discussing critical issues on which to focus, issues that must be addressed before Congress considers pending initiatives to address systemic risk and U. S. insurance regulation. This debate is complex, and often overlooks the role insurance plays in mitigating risk to homeowners, retirees, families and corporations -- a role that must be preserved and promoted as broad financial reform legislation advances. We look forward to providing our expertise to the Subcommittee on our portion of the insurance industry.

I should note that the mortgage insurance (MI) industry is not significantly engaged in international activities, so I will not address these issues in my statement. In addition, MI does not pose systemic risk. To the contrary, the ability of mortgage insurers to pay claims under unprecedented stress has helped to stabilize the market despite the ongoing crisis. In my testimony, I will describe the capital and regulatory structure that has allowed private MI to play this critical role, a structure bank regulators are only now seeking to institute for insured depositories and their holding companies.

The mortgage insurers' reserve structure is mandated by state law. It has been a vital bulwark against systemic risk in housing finance and will play a critical role in the recovery. MICA thus supports maintaining this state regulatory structure. Federal regulators were in many ways less prepared with their capital standards and other requirements than the state insurance regulators who applied the existing rules governing MI.

Finally, I will also address how MI is helping with the housing recovery by responsibly expanding the number of new homebuyers. This, in turn, will restore overall investor confidence in the economy.

**The Role of Mortgage Insurance**

MI enables borrowers to buy homes with less than a 20% down payment because MI stands in front of investors if borrowers default. When the borrower defaults, the MI coverage pays the investor 20% to 25% of the loan amount plus expenses. That insurance payment, along with the proceeds from the sale of the house, makes up for much, but not all, of the investor's losses. Without MI standing in this first loss position, borrowers would have to put 20% down to buy a home.

Mortgage insurers are aligned with both the borrower and the investor (most prominently the Government Sponsored Enterprises (GSEs)), thus ensuring better quality mortgages. Mortgage insurers act as review underwriters for the credit and collateral risks related to individual loans. In effect, they are a second set of eyes determining the safety and soundness of

an individual mortgage. This role not only protects both borrowers and investors and helps to ensure that the home is affordable not only at the time of purchase, but throughout the years of homeownership.

Having their own capital at risk also means that mortgage insurers have very clear incentives to mitigate their losses if loans are in default. The best way to do that, of course, is to avoid foreclosures altogether by working with borrowers to keep them in their homes. Mortgage insurers have a history of partnering with lenders, investors and community groups to work with borrowers in default. This often means that, with the servicers' permission, mortgage insurers counsel the borrowers personally and determine if their financial problems can be resolved. In today's devastating mortgage market, mortgage insurers continue to play a leadership role in working with all parties, including with the Obama Administration. In 2008 alone mortgage insurers were able to save almost 100,000 people from losing their homes.

Since 1957, the private mortgage insurance industry has helped more than 25 million families buy homes. Today, the MI industry's capital stands behind almost 1 trillion of mortgage loans. That is approximately 10% of all home mortgages outstanding. In 2007 and 2008, mortgage insurers paid approximately $15 billion in claims and continue to significantly support their insured mortgage lender clients in 2009.

According to the 2007 Home Mortgage Disclosure Act (HMDA) data (the most recent data available), 51% of the borrowers who received mortgages insured by private mortgage insurers made less than area median income and 35% made less than 80% of area median income. The income distribution of mortgage insurers customers combined with the fact that numerous studies have determined that the lack of a substantial down payment is the major barrier to homeownership leads us to believe that a substantial share of our purchase business is comprised of first-time homebuyers who would not be able to get into an affordable home without the benefit of mortgage insurance.

**Strong Reserve and Regulatory Structure to Better Manage Risk**

The backbone of the industry's financial strength is its state-imposed reserve requirements. The requirements are specifically structured to address the long-term nature of MI risk. They enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur normally throughout the cycle.

Mortgage insurers are required to keep three types of reserves, the most important of which is the contingency reserve. Half of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. It ensures that significant reserves are accumulated during good times not only to handle claims under stress, but also to avoid boom-bust cycles. Therefore, unlike other financial institutions that may pay high dividends during profitable periods, MI companies build their contingency reserves during these periods in order to have the capital ready to pay the higher claims that inevitably occur during periods of market corrections such as the one the U.S. is now experiencing.

Mortgage insurers' contingency reserves are directly comparable to the "dynamic provisioning" bank regulators now know they need. Mortgage insurers are subject to similar mortgage default risk as banks but only mortgage insurers raise capital counter-cyclically. Bank regulators are only now working to construct a similar system for banks in the U.S. and around the world, with Chairman Bernanke recently highlighting this as a critical initiative.

The history of the MI industry proves that they have paid their claims through good and bad economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated—particularly in energy-oriented regions of the country—defaults began to rise, resulting in numerous foreclosures. The MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims primarily in California and the Northeast. Policyholders included the GSEs, commercial banks, savings institutions, institutional mortgage investors, mortgage bankers, the Federal Deposit Insurance Corporation, and the Federal Savings and Loan Insurance Corporation.

The attached appendix is composed of three charts. They show how the MI industry statutory structure and resulting capital build-up allowed it to handle these various regional recessions described above. Mortgage insurers built capital after the oil patch recession and then were able to pay claims during the recessions in California and the Northeast. Once again the industry built capital so mortgage insurers are able to meet the challenges of today.

The other two reserves that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for losses on individual policies when the insurer is notified of defaults and when foreclosures occur. Premiums received for the term of a policy are placed in unearned premium reserves and are earned over time in accordance with state regulation.

Beyond the reserves requirements, state regulators have detailed and comprehensive regulations designed to protect policyholders. State insurance regulation addresses among other things, the licensing of companies to transact business, policy forms, claims handling, financial statements, periodic reporting, permissible investments, adherence to financial standards, and premium rates. The premium rates and policy forms are generally subject to regulation in every state and are intended to protect policyholders against the effects of excessive, inadequate or unfairly discriminatory rates and to encourage competition.

**Sustainable and Affordable Housing**

As the Subcommittee knows, the members of MICA have requested capital assistance from Treasury. I want to emphasize that we are not asking for assistance because we cannot meet our claim obligations. As previously noted the industry's rigorous reserve system assures mortgage insurers can pay their claims. However, with additional capital, we could work more effectively with our lender and investor partners to expand the mortgage market which, in turn, would help spur the economic recovery.

One of the unique features of the MI industry is the way in which mortgage insurers' capital supports significant incremental growth in housing. First, it enables people to responsibly purchase homes with less than a 20% down payment, thus enabling them to buy homes much sooner than they otherwise could. Since many of those home buyers are lower-income or first-time home buyers, their purchases enable homeowners who are ready to "trade-up" their existing homes to do so.

MI also provides capital relief for banks who originate and hold mortgages with a loan-to-value ratio (LTV) greater than 90%. This frees up bank capital to prudently support more mortgage lending. Importantly, the GSEs are our largest and primary counterparties. Mortgage insurers' private capital stands in front of loans held by the GSEs, enabling them to better serve the mortgage market.

As illustrated in the table below, every billion dollars of capital mortgage insurers hold translates into approximately $100 billion of new funding for home purchases. This means there will be 666,667 new mortgage loans.

Value of MI Capital
(per every $1 billion dollars invested)

| | |
|---|---|
| New Mortgage Funds Insured | $100 billion |
| Average MI coverage | 25% |
| Incremental Risk Insured | $ 25 billion |
| Risk to Capital Ratio | 25:1 |
| Average Insured Loan Amount (for home purchase loans) | $150,000 |
| **Number of Incremental Homes Financed** | **666,667** |

Such a capital investment would dramatically benefit housing and housing finance, enable more borrowers to realize the dream of homeownership on terms they can afford and sustain, and generally restore investor confidence in the overall U.S. economy. Industry estimates call for $2.3 trillion and $2.0 trillion in originations for 2009 and 2010, respectively, with as much as 20% being low-down payment mortgages that will require MI. That means mortgage insurers will be asked to provide approximately $840 billion of new insurance written, which in turn translates into a need for $7 billion to $10 billion in new capital investment to support that production. With this capital flexibility, over six million new loans could be insured, facilitating a reduction in the unprecedented levels of excess housing inventory that the market is currently experiencing.

MICA has worked closely with the Federal Housing Finance Agency (FHFA) in the industry's request for assistance from the Treasury Department. FHFA is the regulator of the GSEs and since the vast majority of privately insured loans are held by the GSEs, it is imperative that FHFA understand the value MI brings when its capital stands in front of the GSEs on their riskiest loans. In fact, shortly after Director Lockhart came to FHFA's predecessor agency MICA began to have regular meetings with him and his staff to discuss MI issues as they relate to the GSEs.

FHFA has been fully supportive of the industry's request to Treasury and we have worked in partnership with them in our attempt to receive capital assistance. The state insurance regulators from the states where MICA's members are domiciled also have spoken frequently with the FHFA on our behalf. Indeed, Director Lockhart testified before this subcommittee two weeks ago that he supported MICA's request for assistance. We are extremely grateful for his support and pledge to continue to work with FHFA to ensure that the GSEs are properly protected.

**Systemic Risk**

MICA believes it is absolutely critical for Congress, Treasury and regulators – including state insurance agencies – to grapple with the dangers firms and products can pose to the financial system as a whole. However, neither private mortgage insurance firms nor private mortgage insurance contracts pose systemic risk, as has been proven throughout this crisis. To the contrary, mortgage insurance is part of the solution.

The reason why MI does not now or in the future pose systemic risk is simple. Mortgage insurers' substantive reserve requirements have long included a critical counter-cyclical provision that bank regulators are only now putting in place for the banking system. This capital at risk is buttressed with disciplined underwriting that has ensured that MIs can meet anticipated claims.

MICA has no specific suggestions on ways to address systemic risk in the broader financial market. However, one reason MICA supports action to address systemic risk is that the industry problems we are experiencing today are largely the result of systemic risks outside the control of private MI and its regulatory construct. As noted, mortgage insurers can meet current claims because our capital requirements are designed even for catastrophic situations.

**Conclusion**

Once again, thank you for the opportunity to comment. As you will note, MICA strongly supports the state regulatory system and, indeed, believes that structure has ensured that mortgage insurers can continue to meet their obligations during these very challenging times. We also would like to more significantly help in the economic recovery by giving deserving lower-income and first-time homebuyers a leg up on the homeownership ladder. With some assistance we believe that we can do that to the fullest extent possible.

# Appendix

## Chart A

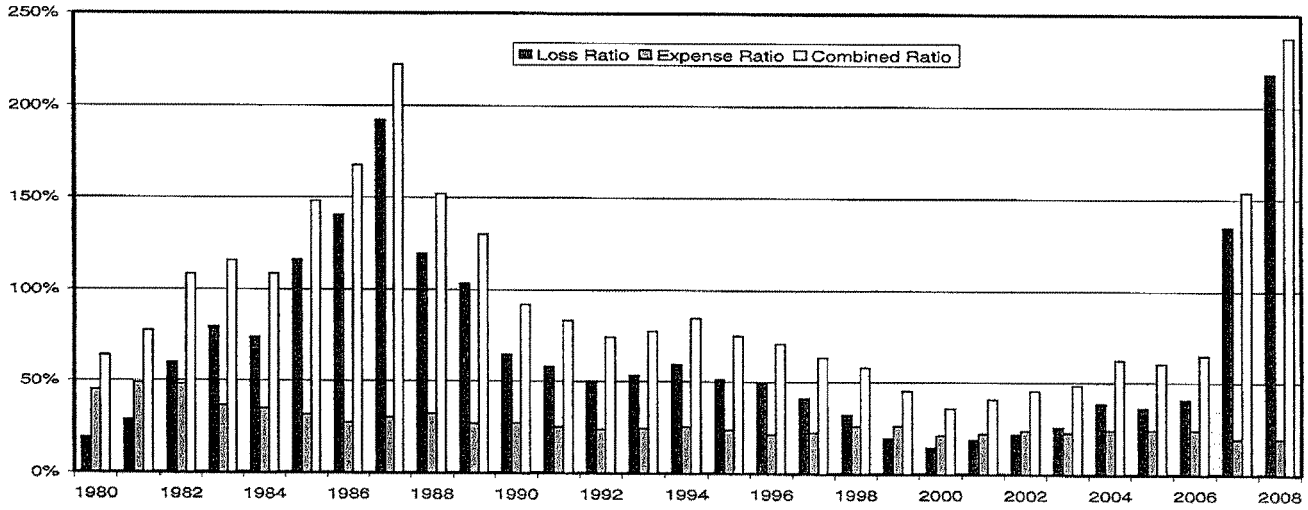


Chart A above shows the critical ratios for the MI industry from 1980 through 2008. The current stress in the housing market matches that experienced by the MI industry during the oil patch decline of the mid-1980s. However, note that the annual combined ratios exceeded 100% or more for eight straight years beginning in 1982 and the industry paid all claims and grew during that period. The reason for the continued strong claims paying ability of the MI industry is tied to its state capital and reserve requirements.

**Chart B**

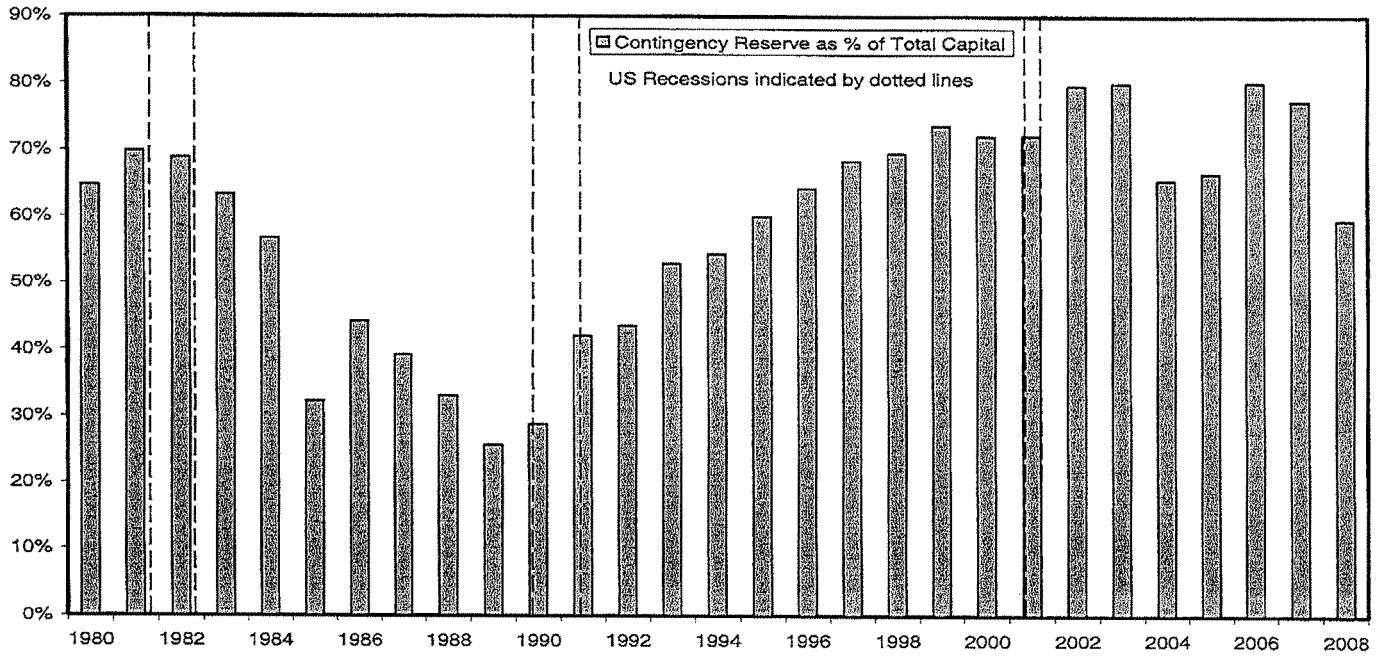


Chart B above shows how contingency reserves are built up during periods of low claims and economic prosperity to be used during periods of economic stress as we are currently experiencing.

**Chart C**

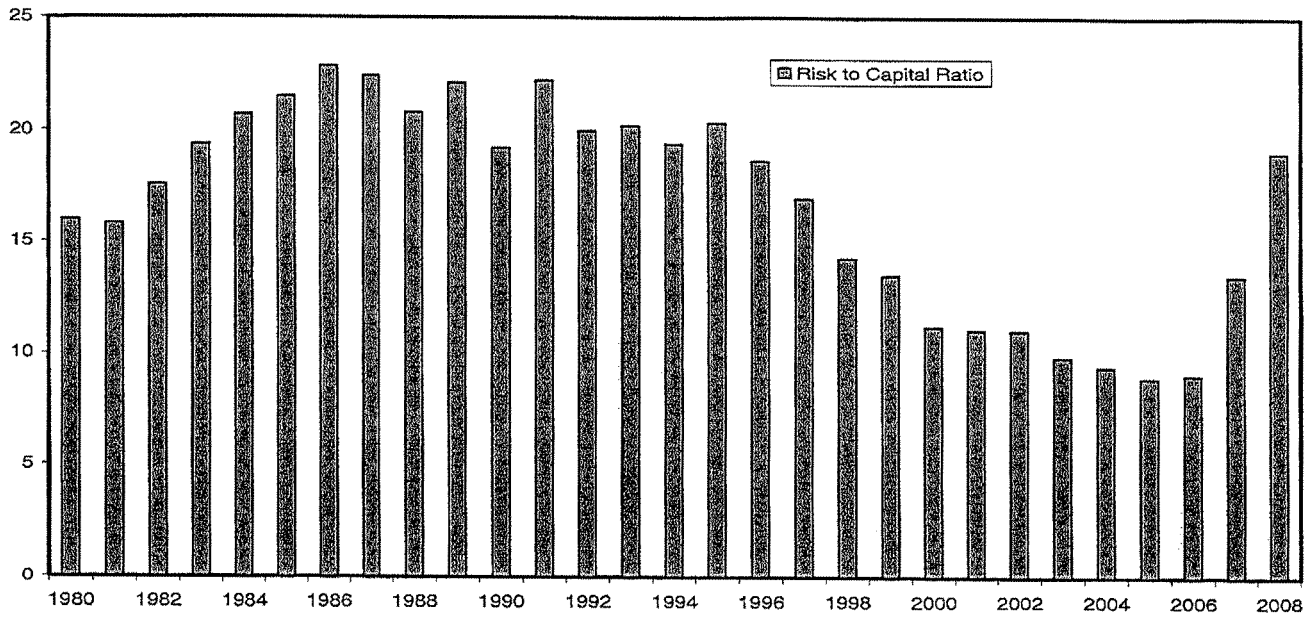


Chart C above shows the industry risk to capital ratio which now stands at 19 to 1, but still below levels seen in the mid-1990s and well below the levels reached during the mind-1980s house price declines.

Statement

of

John T. Hill

President and Chief Operating Officer

Magna Carta Companies

on behalf of the

National Association of Mutual Insurance Companies

to the

Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee

House Financial Services Committee

hearing on

Systemic Risk and Insurance

June 16, 2009

The National Association of Mutual Insurance Companies ("NAMIC") is pleased to offer comments to the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee on systemic risk and insurance.

My name is John T. Hill. I address the Committee in my capacity as chairman-elect of NAMIC and as the president and chief operating officer of the Magna Carta Companies. Magna Carta was founded in New York in 1925 as a mutual insurance carrier for the taxicab industry. Though we no longer insure taxicabs, today we employ 240 individuals and write primarily commercial lines of insurance in 22 states. We very much remain a small main street mutual insurer, with $170 million in direct written premiums.

I also serve as chairman of NAMIC's Financial Services Task Force, which was created specifically to develop NAMIC's policy response to the financial services crisis. The views I will share with the Committee are based on my own 28 years of experience in the property/casualty industry and the perspective of over 1,400 NAMIC members.

Founded in 1895, the National Association of Mutual Insurance Companies (NAMIC) is a full-service national trade association that promotes the interests of its property/casualty insurance company members and their policyholders throughout North America. The association is the advocacy, policy, services, training and communications provider for 1,400 insurers which collectively underwrite 40 percent of the property/casualty insurance premium in the United States. NAMIC's diverse membership includes small farm mutual companies, one-state and regional insurers, and national writers.

The property/casualty insurance industry is highly competitive, well capitalized, and poses no systemic risk. The nature of property/casualty insurance products, the industry's low leverage ratios, its relatively liquid assets, and the lack of concentrations in the marketplace make our industry truly unique within the financial services sector. Because of these characteristics, the risk that property/casualty insurance companies pose to the overall financial system is negligible. Nor are property/casualty insurers as susceptible to the adverse systemic consequences of activities engaged in by banks and other financial institutions that are the principal generators of systemic risk.

Because of these considerations, NAMIC urges Congress to focus on the products, activities, and market-oriented events and developments that do pose systemic risk. This is in contrast to an approach that would publicly identify and regulate "systemically significant institutions" based on size or perceived importance.

To be clear, NAMIC is a property/casualty insurance trade association. Property/casualty insurance products are fundamentally different than those of the other two major components of the insurance business, life and health. Our products did not cause the present crisis, our companies are well-regulated at the state level for solvency, and we believe that any federal systemic risk regulator should focus on those products and markets that have the potential to cause large-scale economic crises. My testimony goes into detail on the elements of systemic risk and the role of risk management in the property/casualty industry.

**Systemic Risk**

In considering the relationship between systemic risk and the insurance industry, it is important to understand what is meant by "systemic risk."

Systemic risk is often defined as the probability that the failure of one financial market participant to meet its contractual obligations will cause other participants to default on their obligations, leading to a chain of defaults that spreads throughout the entire financial system, and eventually to the nonfinancial economy generally. Another type of systemic risk results from the possibility that a major external event could produce nearly simultaneous, large, adverse effects on most or all of the financial system (rather than just one or a few institutions) such that the entire economy is adversely affected. In this scenario, the threat to the system is a market-oriented crisis rather than an institution-oriented crisis. That is, the crisis occurs because of a widespread event or trend that occurs throughout the financial system, rather than because of the behavior of a particular institution or industry. Market-oriented crises tend to begin with a large change—usually a decline—in the price of a particular asset; the change then becomes self-sustaining over time.

The current global financial crisis is a market-oriented crisis. The financial system broke down not because of a contagion that radiated from one or a few troubled institutions to a host of otherwise healthy entities. What happened instead is that market participants around the world independently speculated that a particular asset class—housing, in this case—would continue indefinitely to increase in value. As economist Scott Harrington of the Wharton School succinctly explained in his testimony before this

subcommittee just last month, the crisis occurred because "many commercial banks, investment banks, thrifts, hedge funds, mortgage originators, sub-prime borrowers, and [the Financial Products unit of] AIG placed heavy bets on continued housing price appreciation and against any fall in prices. They gambled, and the losses have been both huge and widespread."

Future crises are likely to arise from similar types of asset bubbles and instances of widespread failure by market participants in evaluating certain types of risk. Any new regulation that is intended to curtail systemic risk should be carefully designed to address the kind of market-oriented problems that caused the current crisis and might potentially lead to future crises. The record shows that property/casualty insurers did not cause the current financial crisis. What is more, it is exceedingly unlikely that property/casualty insurers - either individually or collectively - could cause a financial crisis in the future.

**Systemic Risk in the Insurance Industry**

In the wake of the problems facing the financial services industry, there have been calls for the creation of a federal or international systemic risk regulatory body. As a trade association that represents property/casualty insurers, NAMIC's primary concern is the potential impact of institution-oriented systemic risk regulation on our member companies and the consumers they serve.

There are six primary factors that affect the probability that a financial institution will create or facilitate systemic risk: *leverage, liquidity, correlation, concentration, sensitivities, and connectedness.* An examination of these factors will demonstrate that there is no basis for regulating property/casualty insurance companies, with the possible exception of financial guaranty insurers, for systemic risk because they do not present such a risk. Again, let me emphasize that I am addressing only property/casualty insurance products, which are far different, in particular, from life insurance products that may offer investment features similar to bank and securities products and, as such, may warrant a different regulatory structure.

- **Leverage**

  Very few property/casualty insurers use commercial paper, short-term debt or other leverage instruments in their capital structures, a fact that makes them less vulnerable than highly leveraged institutions when financial markets collapse. Because of their basic business model and strict capital requirements imposed by state regulators, property/casualty insurers are much more heavily capitalized, in terms of their asset-to-liabilities ratios, than banks and hedge funds. At the time that the financial crisis began to unfold, many large commercial and investment banks were operating at very high leverage ratios, often borrowing $15 to $25 for every $1 in capital they held. When the crisis struck, pools of available credit dried up and the cost of borrowing soared, destroying or severely impairing these firms' operating models. By contrast, property/casualty insurers neither borrow to make investments, nor borrow to pay claims. Thus, even when some of their investments perform

poorly, the effect on property/casualty insurers is not magnified as it is when investments are highly leveraged. This explains why the property/casualty insurance industry is not suffering from a credit or liquidity crisis.

- **Liquidity**

Unlike most other types of financial institutions, the nature of the products that property/casualty insurers provide makes them inherently less vulnerable to disintermediation risk. While banks are exposed to the risk that customer withdrawals can exceed available liquidity, the risk of a liquidity shortfall is minimal for property/casualty insurance companies. Our companies are financed by premiums paid in advance, and payments are subject to the occurrence of insured events. Insurance policies are also in force for a contracted period of time, the terms of which are agreed to by both parties. If a property/casualty insurance customer cancels a policy before the end of the contract, the premium is refunded on a pro-rata basis and coverage is canceled. Whereas bank liabilities are short-term and assets are long-term, the converse is true of property/casualty insurance, which has liquid assets but longer-term liabilities. It is for both business and regulatory reasons property/casualty insurers carry a liquid investment portfolio. As long as the insurance company has built up reserves and its investments are calibrated to match the statistically anticipated claims payments, there is no liquidity risk and no possibility of a "run on the bank" scenario.

- **Correlation**

Property/casualty insurers use underwriting tools specifically designed to identify and control certain types of correlation, including market concentration, in order to control catastrophe and underwriting exposures. Identifying and managing risks are at the core of insurance; these tools allow insurers to accurately price and underwrite risk. The side benefit of rigorous underwriting is a reduction in systemic risk exposure.

It is also important to note the difference between asset-backed securities and other derivative products, and property/casualty insurance. In the former, the underlying risk is a financial or market factor (such as credit, price, interest rate, or exchange rate), whereas in property/casualty insurance, the underlying risk is a real event, such as an automobile accident, fire, or theft. While the financial risks are likely to be correlated, in that they will be affected by similar cyclical economic or financial factors, the latter are largely individual, non-cyclical, idiosyncratic risks. Banking risks are often highly correlated, particularly in economic downturns. Traditional property/casualty insurance, in contrast, pools uncorrelated, idiosyncratic risks, and is not subject to systemic crises in the same way as banks.

- **Connectedness/Sensitivities/Concentration**

Property/casualty insurers manage concentrations of investments and have regulatory limitations on both the type and concentrations of the assets in which they

invest. These limitations have the effect of reducing the property/casualty insurance industry's connectedness and sensitivity to the actions and conditions of other sectors of the financial services industry.

The one possible exception to this rule is the small subset of monoline financial guaranty insurers that offer specialized products such as bond and mortgage insurance. Because financial guaranty insurance is by definition directly connected to financial products, it is conceivable that these specialty insurers could play a role in propagating systemic risk.

The aberrant business model of financial guaranty insurers, however, hardly provides justification for subjecting mainstream property/casualty insurers to systemic risk regulation. While property/casualty insurers, like virtually all investors, have suffered investment losses, no financial contagion has spread throughout the industry or to other financial markets. Even where a property/casualty insurer is held by a holding company that also holds other types of financial services companies, regulatory restrictions designed to protect policyholders operate to "ring-fence" the property/casualty insurer's capital and protect it from incursions caused by any problems of the other subsidiaries.

Unlike lightly regulated financial institutions such as investment banks and hedge funds, most of the obligations of property/casualty insurers are protected by the insurance guaranty fund system. This nationwide system, which is financed by the property/casualty insurers of each state, reduces the systemic impact of any failing

property/casualty insurer by providing claimants assurance that the insurer's obligations will be satisfied on a timely basis.

It is clear that property/casualty insurers pose no systemic risk to the nation's economy or financial structure. Efforts to include property/casualty insurers simply by virtue of their classification as financial service providers ignore the underlying business models and financial structure of the industry. Arguably many other industries are more concentrated and interconnected, such as energy, telecommunications, and transportation, and pose a more serious threat to the nation's economy in the event of failure, than does the diverse and financially stable property/casualty industry.

While insurers did not cause the current crisis, it is true that some insurers have been adversely affected by the fallout from the crisis. But even here the effect has been minimal and confined to a handful of companies in the life insurance industry, as Professor Harrington noted in his testimony last month: "That some large life insurers need to replenish capital is hardly surprising, given the sharp fall in equity values, the reductions in values of mortgages and other real estate holdings, and minimum return guarantees provided on many of their products."

**Potential Consequences of Institution-Oriented Systemic Risk Regulation**

Some commentators have suggested that systemic risk regulation should focus on particular financial institutions that are considered to be "systemically significant." Systemic risk regulation and oversight focused on particular institutions based on size,

nature of business, or perceived significance may well miss market-oriented events and trends that are the true sources of systemic risk. While the criteria for determining which companies are systemically significant are unclear at this point, most proponents of this approach seem to have in mind companies that are thought to be "too big to fail" or "too interconnected to fail."

The act of publicly identifying and regulating "systemically significant institutions" is likely to have unintended negative consequences, particularly if property/casualty insurance companies are among the institutions designated as systemically significant. If any company is deemed systemically significant, investors and consumers will see it as an official declaration that the company will not be allowed to fail.

It seems quite likely that insurers designated as systemically important would gain a competitive advantage over other insurers. Companies carrying the official "systemically significant" designation would be able to attract more customers and investment capital than their rivals, thanks to the perception that "systemically significant" insurers will be backed by the federal government. Moreover, the implicit guarantee of a government bailout for systemically significant insurers would create a moral hazard that could manifest itself in regulatory arbitrage, a strategy of identifying and exploiting loopholes in the systemic risk regulatory apparatus that would enable the company to engage in riskier – but potentially more profitable – underwriting or investment practices.

To counteract the moral hazard produced by the "systemically significant" designation, the systemic risk regulator might err on the side of caution by preventing systemically significant insurers from engaging in any business practice that, in its view, could even remotely contribute to systemic risk. Overly restrictive regulation of this kind could decrease the availability of insurance coverage while increasing its cost.

While systemic risk poses economic costs, so does regulation. The costs, both direct and indirect, of a systemic regulatory system could be high, and care must be taken to avoid situations in which the costs outweigh the benefits. In addition to the direct costs of additional regulation, Congress must be wary of the moral hazard and disruption of the efficient evolution of markets that can result from inappropriate regulatory intervention.

**Effective Systemic Risk Regulation**

NAMIC believes that regulators should work to identify, monitor, and address systemic risk. However, a systemic risk regulator should complement existing regulatory resources. Furthermore, NAMIC does not believe that the business or legal characterization of any institution should be used as a basis for assessing systemic risk. Oversight and regulation of systemic risk should focus on the impact of products or transactions used by financial intermediaries.

Attempting to define and regulate "systemically significant institutions" on the basis of size, business line, or legal classification -- such as including all property/casualty

insurers - would do little to prevent future financial crises. Indeed, a regime of systemic risk regulation that is institution-oriented rather than focused on specific financial products and services could divert attention and resources from where they are most needed, while at the same time producing distortions in property/casualty insurance markets that would be harmful to consumers.

The next crisis will likely arise from a set of circumstances quite different from those that produced the current crisis. However, at this time there is no evidence that the property/casualty insurance industry contributes any systemic risk to the global financial system. A new systemic risk regulator should not be tasked with supervising property/casualty insurers that are arbitrarily presumed to be "systemically significant." Instead, any new systemic regulatory system should be given the flexibility to adapt to changing developments in the marketplace, and to anticipate events that could potentially cause a cataclysmic shock to the financial system and the broader economy.

**Additional Reforms**

The current crisis demands that Congress act, but Congress must act prudently and responsibly. NAMIC believes there are a number of finite and concrete reforms that Congress could undertake to strengthen our nation's financial regulatory system, including enhanced regulatory coordination, improved international information sharing, creation of an Office of Insurance Information, and adoption of selected national

standards. All of these actions would complement a targeted, national focus on identifying, analyzing, and addressing systemic risk.

NAMIC recognizes the interconnectedness of the industry segments within the financial industry and of the U.S. and international financial communities. We understand the need for greater coordination and cooperation among and between U.S. prudential regulators and foreign regulatory bodies. We believe, however, that it is not necessary to replace the current functional regulatory framework to successfully achieve federal interests in these areas. Rather, we believe that the following reforms are great examples of the type of steps that Congress can take to improve and modernize property/casualty insurance regulation without supplanting the current state-based system:

- **Formalized coordination between functional prudential regulators**. A closer and more formalized working relationship between state regulators and their federal counterparts is essential to ensure timely and effective information exchange and coordination of regulatory actions. Expansion of the President's Financial Working Group to include participation by state regulators, coupled with enhanced information sharing between and among the participants would provide a unique forum to integrate and coordinate financial services regulation, while preserving the benefits of prudential regulation.

- **Enhanced international regulatory cooperation and coordination**. Enhanced cooperation and coordination among the various global financial services regulatory bodies should not come at the cost of abrogation of regulatory authority to foreign jurisdictions or quasi-governmental bodies.

  International movement of capital intended for risk or insurance generally flows freely at present. Coordination of reporting or presentation standards to permit review and evaluation helps foster greater regulatory transparency and encourage competition. Present cooperation between the European Union and U.S. provide a sound basis for further collaborative efforts.

  Through the National Association of Insurance Commissioners, U.S. insurance regulators participate in the International Association of Insurance Supervisors ("IAIS"). The IAIS develops international standards for insurance supervision, provides training to its members, and fosters cooperation between insurance regulators, as well as forging dialogue between insurance regulators and regulators in other financial and international sectors. Regulators and their staff participate in the work of the IAIS on a variety of issues including, international solvency supervision, accounting standards, reinsurance regulation and other issues of regulation of the business of insurance.

- **Creation of an Office of Insurance Information**. Legislation introduced by Rep. Paul Kanjorski and Rep. Judy Biggert could provide greater autonomy to the

Department of the Treasury through a newly created Office of Insurance Information ("OII") to engage with foreign jurisdictions on insurance matters. NAMIC supports greater coordination and limited preemptory authority over international insurance issues.

Similarly, NAMIC acknowledges the need for increased insurance industry information at the federal level. This legislation would authorize the OII to collect and analyze insurance industry information and make recommendations to Congress. NAMIC supports the creation of an OII with proper protections for the privilege and confidentiality of company data.

**Conclusion**

Appropriate regulation of financial markets serves the public interest by efficiently mitigating market failures. Any financial services regulatory reform should therefore demonstrate that the proposed regulatory interventions will efficiently address the specific market failure. Moreover, the benefits of regulation should outweigh its direct and indirect costs. This is particularly true as Congress continues to debate fundamental reform of the nation's financial services industry.

NAMIC supports regulatory measures designed to prevent future financial crises. However, we recognize that enacting new regulations and creating new regulatory structures could do more harm than good if they are not narrowly tailored to address the particular deficiencies in the existing regulatory system that have been revealed by the

current crisis. This means Congress must avoid measures that would weaken or impair those regulatory systems that have functioned well throughout the crisis i.e. the state-based system of property/casualty insurance regulation. As it considers measures to curtail systemic risk, it is critical that Congress distinguish between those financial products and activities that propagate systemic risk and those that do not. Congress should recognize that no property/casualty insurer is "too big" or "too important" to fail. It would be a serious and potentially harmful mistake if Congress were to assume, despite abundant evidence to the contrary, that the property/casualty insurance industry creates systemic risk and should therefore be regulated as if it did.

National Association of Mutual Insurance Companies
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Testimony on Regulation of Financial Guaranty Industry

Submitted by Séan W. McCarthy, President and Chief Operating Officer of

Financial Security Assurance Holdings Ltd.

Assured Guaranty Corp.

Before the

Subcommittee on Capital Markets, Insurance, and

Government Sponsored Enterprises

United States House of Representatives

June 16, 2009

Chairman Kanjorski, ranking member Garrett and members of the subcommittee, we respectfully submit this white paper, which I will summarize in my testimony today. I am Séan McCarthy and I am President and Chief Operating Office of Financial Security Assurance (FSA). Today, I am testifying on behalf of FSA and Assured Guaranty Corp. (Assured). Our two companies are coming together after Assured completes their acquisition of FSA on July 1. In the new company, I will be President and Chief Operating Officer.

We appreciate the opportunity to testify at the hearing to improve oversight of the insurance industry and a restructuring of the federal government's role with regard to insurance products.

**Pertinent background on the U.S. municipal bond insurance industry**

I had the honor to testify before the full Committee just a few weeks ago about the state of the municipal bond market and what the Congress and the Administration could do in the short term to provide targeted assistance. Our companies have been involved in helping states and localities access the municipal bond market in the most cost efficient manner, saving billions of dollars for taxpayers.

I am here today because it is not just the market conditions and the credit crisis that is making it more difficult for our companies to offer the best value to our municipal and other customers.

As monoline insurance companies, we provide, in the case of FSA, bond insurance for the U.S. municipal and global infrastructure markets, and, in the case of Assured Guaranty Corp., bond insurance for U.S. municipal, global infrastructure and structured financings. We are in the business of guaranteeing bonds and related products only, and do not provide other types of insurance products.

The industry's basic guaranty insurance policy ensures that if the issuer of an insured bond fails to make any scheduled principal or interest payment, the bond insurer will make the scheduled payment on time and in full. This unconditional, irrevocable guaranty covers all types of risk, including fraud. The guaranty bridges differences between the needs of investors and debt issuers and offers significant benefits to both sides.

We also provide significant benefits that go beyond the guaranty. These include analysis and structuring of municipal transactions, on-going surveillance, and remediation of the issues we insure. We believe that we have had a significant role in making municipal bonds safe for investors, not only because we have insured them, but particularly because the monitoring and remediation of the bonds we insure allows us to identify issues before they grow into problems that could result in default.

**The bond insurance industry occupies a unique space in the insurance industry and requires the consistency of standards and oversight that a Federal regulator can provide.**

Financial guaranty insurance is utilized only in the financial markets. It is a very different product from that of property and casualty, life and health insurance companies, and we desire and require regulatory differentiation. Article 69 was enacted by New York State to segregate financial guaranty insurance from multiline products and the risks those entail. While it was a good step, it was not strong enough. Therefore, we believe we require mandatory federal regulation that is closer to that of banks, that being centralized and encompassing all aspects of regulation, including required capital. Most states do not have the resources to properly regulate such a specialized industry.

The current decentralized regulatory regime for monolines is aimed at specifying what types of business they can insure rather than a high level of capital. There are no uniform, consistent credit, capital and financial strength standards. The states have

limited tools and have done their best to focus on companies whose solvency is tested but they are not in a position to focus on stronger capitalized companies that market participants rely on. New York State Insurance Commissioner Eric Dinallo, who recently announced that he was leaving office, has stated the potential need for Federal regulation of bond insurers. Due to the lack of a single consistent regulator, the rating agencies have become the de facto regulators of our industry, all with different requirements and models that are not transparent and do not result in consistent outcomes, which are necessary for regulation and oversight.

While we will continue to strive to achieve the highest possible ratings, we believe that credit rating agency views currently play too singular a role in the evaluation of our financial strength. Ratings are based on criteria that vary and include many subjective characteristics and employ methodologies that are not readily transparent. Additionally, all three rating agencies have different sets of guidelines, which present conflicting goals that make it impossible to manage a stable company. Importantly, investors cannot easily evaluate rating agency conclusions. Due to the impact of ratings on the trading value of the securities monolines insure, investors are forced to accept the impact of ratings with respect to the financial guarantors.

The end result of this de facto "regulation by rating" has been to destabilize markets and reduce municipal issuers' cost-effective access to the capital markets. This has negatively affected smaller municipal issuers particularly and municipal issuers of complex bonds—where bond insurance homogenizes the credits and provides market liquidity. Additionally, bond insurers have become the primary source for credit enhancement in today's municipal market. Bond insurance penetration for the first five months of 2009 was 13%. Market penetration for LOCs for the first five months of this year was down to about 6%.

**What happened and where is the industry headed?**

There is no question that several financial guarantors took large, concentrated risks in the most volatile and risky mortgage-backed securities that severely underperformed, which in turn led to the downgrades or failures of five of the original seven primary bond insurers. Notably, many of these now problematic transactions were rated triple-A by the rating agencies at the time those securities were issued.

The financial guaranty industry is currently in a rebuilding phase with a number of potential new entrants to the market. FSA, Assured Guaranty and Berkshire Hathaway are established and participating in the market.

FSA and Assured Guaranty, which were established in 1985 and 1988, respectively, have come through this unprecedented period of turmoil in strong capital positions, and despite the understandable concerns that the market has expressed about the financial guaranty model, we are confident that investors will continue to see value in guarantors that combine capital strength with diligent, experienced credit selection skills. The ultimate beneficiary of the investor seeing continued value in bond insurance is the issuer of the bond and the consumer of what is financed. In the case of municipal bonds, those consumers are state and local citizens and taxpayers.

**Rationale for Federal Regulation**

We would like to see federal oversight of our industry that would provide regulation by design, rather than default. Uniform federal regulation of the financial guaranty industry would increase investor confidence and provide much needed transparency and stability to the capital markets.

We believe that licensing requirements should be stringent and require high but predictable capitalization levels; guarantors should provide detailed disclosure on risks to

all constituencies (e.g., issuers and policyholders); and should be subject to an annual stress test that would be applied equally to all companies.

Our industry would benefit from federal regulation because:

It would be objective and fact-based and made without conflicts of interest;

It would allow for uniform standards and regulation across the entire country; and

It would be transparent and understandable.

Importantly, investors would rely on the balance sheet of the financial guaranty company rather than an arbitrary and volatile rating.

In conclusion, uniform federal regulation of the financial guaranty industry would bolster investor confidence, which would increase market liquidity for municipal bonds, and that in turn, would help issuers to gain greater access to the capital markets at lower funding costs. Bond insurance has for decades played this important role in the U.S. municipal market, and today, as states and cities face declining tax bases and increasing public infrastructure needs, we believe our role has taken on even greater currency.

As long as bond insurers are able to provide value to state and local municipal bond issuers by reducing their cost of borrowing, saving taxpayers money and attracting a broader based of investors, issuers will continue to utilize insurance. Providing consistent, transparent requirements, standards and oversight by a single Federal regulator will ensure that all active monoline insurers have the financial standing and capability to carry through on their insurance commitments.

Thank you for giving us the opportunity to state the case for federal regulation of the bond insurance industry.

# Testimony of the
# National Association of Insurance Commissioners

Before the
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Regarding:
"Systemic Risk and Insurance"

Tuesday, June 16, 2009

Michael T. McRaith
Director of Insurance
State of Illinois
On Behalf of the National Association of Insurance Commissioners

# Testimony of Michael T. McRaith
## Director of Insurance
## State of Illinois
## On Behalf of the National Association of Insurance Commissioners

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for inviting me to testify before the Subcommittee on the topic of financial systemic risk and insurance.

My name is Michael McRaith. I am the Director of the Department of Insurance for the State of Illinois, and I speak today on behalf of the National Association of Insurance Commissioners (NAIC). I am pleased to be here today to discuss systemic risk to the extent it involves insurance and the inherently compatible role of state regulation in any sound approach to systemic risk regulation.

**Introduction**

State insurance regulators have a demonstrable record of consumer protection and industry oversight. Consumer protection has been, is and will remain priority one for state insurance officials. Each day our responsibilities focus on ensuring that the insurance safety net remains available when individuals, families and businesses are in need. We advocate for insurance consumers and objectively regulate the U.S. insurance market, relying upon the strength of local, accountable oversight and national collaboration.

With continually modernized financial solvency regulation, state insurance regulators supervise the world's most competitive insurance markets. Twenty-eight (28) of the world's fifty (50) largest insurance markets are individual states within our nation. As a whole, the U.S. insurance market surpasses the combined size of the second, third and fourth next largest markets. The insurance market of Connecticut is larger than the markets in Brazil or Sweden. The markets in California, New York and Florida are each larger than the markets in India, Ireland or South Africa.

More than 2,000 insurers have been formed since 1995 – leading to a total of more than 7,661 in the U.S. – with combined premiums of more than $1.6 trillion. States derive $17.5 billion in taxes and fees from insurers, with approximately eight percent (8%) used to support regulation and the remainder supporting state general revenue funds.

**Relation of Insurance to Systemic Risk**

As the NAIC testified before this Subcommittee in March, sustained stability in the financial sector requires seasoned regulators with the authority, expertise and resources to fulfill their professional responsibilities, combined with a commitment among all financial regulators to construct collaboratively a system-wide view or understanding of the financial sector. The current financial crisis illustrates the interconnectedness of the national and global financial system, and highlights the need to strengthen the cooperative interaction of our regulatory system.

In the view of state insurance regulators, an entity poses systemic risk when that entity's status and activities have the ability to ripple into the broader financial system and initiate problems for other counterparties, thereby requiring extraordinary mitigation efforts. When defining a "systemically significant" institution, empirical or date-driven factors aid but do not conclude an analysis. The Group of Thirty (G30) report released on January 15, 2009, describes considerations with which regulators agree: (1) size, (2) leverage, (3) scale of interconnectedness and (4) the systemic significance of infrastructure services.

Insurance companies are more often the conduits or receivers of risk rather than the creators – the assumption of risk, after all, is fundamental to the insurance business. With respect to systemic risk, insurers also do not originate risk but most often receive risk, a fact that provides ample motivation to close regulatory gaps and encourage greater financial stability.

Insurers' exposure to systemic risk typically flows from linkages to the capital markets. For example, AIG's unregulated credit default swap (CDS) transactions impaired the holding company, resulting in a downgrade that threatened policyholders' confidence in the otherwise stable insurance subsidiaries. AIG's insurance companies were also directly exposed to systemic risk through securities lending partnerships with other financial institutions. As a result, AIG encountered a severe liquidity crunch when a massive deterioration in the value of traditionally

conservative, fixed income securities caused AIG's counterparties to attempt to exit the marketplace at roughly the same time.

Indeed, due to the AIG experience, insurance regulators have already imposed an additional capital charge (as part of our national risk-based-capital system) relating to securities lending, added increased financial disclosure for such transactions so that regulators are better able to anticipate challenges, and charged a national working group with evaluating statutory accounting changes to reflect an insurer's exposure to securities lending. No company operates conservatively enough to withstand a "run on the bank" scenario, but financial stability regulation can and should be designed to ensure that such scenarios are promptly identified and mitigated.

Insurance illustrates the difference between systemic risk and the risk of large failures. Given that the U.S. has the world's most vibrant and competitive insurance marketplace, it is unlikely that any one insurer is "too big to fail." If an insurer were to fail, regardless of size, state-based guaranty funds would protect existing policyholders and pay claims. As history demonstrates, competition and capacity allow other insurers to fill marketplace voids left by the failed insurer. For example, if the largest auto insurer in the U.S. were to fail, its policyholders would be quickly absorbed by other insurers, and policyholders would be further protected by the state guaranty fund system. Such a scenario would not pose systemic risk because the impact would be isolated, would not ripple to other financial sectors and would not require extraordinary intervention to mitigate. States also operate residual markets to cover consumers unable to receive an offer of insurance in the conventional market

The insurance industry has weathered large failures and multiple concurrent failures in the past. Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant. Therefore, even a major insurer failure, while traumatic in terms of job displacement and, perhaps, for shareholders, will generally not impose systemic risk. Any system of financial stability regulation should focus on truly systemic risk, and not create redundant mechanisms for dealing with isolated disruptions.

**Insurance Lines Most Affected by Systemic Risk**

As mentioned previously, insurers are primarily the conduits or receivers of systemic risk rather then creators of it. In the current financial crisis, reduced mortgage loan standards combined with the mostly unregulated originators of structured securities and derivatives triggered systemic disruption in the U.S. financial sector. For example, while AIG's holding company participated in these types of unregulated transactions, the AIG insurers did not generate systemic risk.

Importantly, insurers did not generate the toxic financial products because the NAIC Accounting Practices and Procedures Manual, adopted by all states as stipulated in the NAIC's Accreditation Program, includes a requirement that insurers "cover" (be capable of paying any losses in full) the risk for any derivative written by the insurer. Needless to say, the non-insurance originators of the faulty derivatives were not subject to similar reserving or collateral requirements.

Insurers are major participants in the bond and equity markets, and life insurers, more than other lines, are impacted by mortgage-related products. For that reason, the life insurance industry has experienced the effects of systemic risk caused by downturns in the mortgage loan/structured securities and derivatives markets. To be clear, though, the business of life insurance, in and of itself, does not pose systemic risk to the broader economy or the U.S. financial system.

To the extent that mortgage banking activities impose systemic risk, the role of mortgage guaranty insurance and title insurance in the overall function of those markets must be examined. However, such examination must be premised on the reality that these mortgage and title insurers do not generate systemic risk; rather, mortgage and title insurers facilitate the underlying loan transaction. The quality of the underlying banking transaction, and related underwriting, determine whether proliferation of these transactions increases systemic risk.

Similarly, financial guaranty insurers facilitate the securities markets. The underlying insured products reflect the inherent systemic risk, while the insurance function supports proliferation of the securities transactions. If the underlying transactions, and related underwriting, are of high

quality, then proliferation activity, including financial guaranty insurers, will not be a systemic concern.

For reasons illustrated by the above examples, state insurance regulators believe the "too big to fail" concept does not apply to insurers. While isolated lines of insurance may be susceptible to systemic risk, and while insurers are exposed to market risk as are other investors, the current insurance regulatory system closely supervises and manages any purported insurance sector risk to the economy.

Of course several significantly large financial holding companies include insurance subsidiaries. AIG was deemed to be a financial holding company that was too big to fail. However, absent other systemic problems, insurance operations in a troubled enterprise would typically be purchased by a third party not within a troubled financial holding company. Even with AIG, the insurance subsidiaries are now being sold. Any attempt to regulate systemic risk should trace that risk to the root source. As a factual matter, that source will clarify that the vast majority of insurance does not impose systemic risk.

**Enhancing the Effectiveness of Consolidated Oversight**

Identifying and managing exposure to systemic risk is a shared objective among all regulators and calls for a collaborative approach. Vesting broad authority in a single entity creates a consolidation of regulatory power, and increases the potential for regulatory mistakes. Any single authority would duplicate information and expertise that already exists among functional regulators. Accordingly, state insurance regulators, along with our colleagues in the state and federal agencies, support a council of regulators that would build on the existing information and expertise of functional regulators – including state insurance regulators. A council could enhance collaboration among financial services regulators while supplementing existing expertise and reaffirm the fundamental strength of functional regulation. Any framework established to regulate financial stability must integrate, but not displace, the successful state-based system of insurance regulation.

A federal financial stability regulatory scheme must provide for sharing of information and formal collaboration among all financial regulators. Appropriate information sharing authority

and confidentiality protocols should be established among all federal and state financial services regulators, and with law enforcement. Federal legislation, such as the Financial Services Anti-Fraud Network Act which passed the House in 2001, may be necessary for this purpose. This protection will ensure that all financial services regulators are on equal footing in access to needed information, and will help mitigate regulatory arbitrage.

Federal financial stability regulation should ensure effective coordination, collaboration and communication among the various and relevant state and federal financial regulators. Formal structures for cooperation should be enhanced or introduced to provide a forum for all financial regulators to consult about emerging issues and trends, thereby allowing early identification and action on issues potentially imposing systemic risk.

In consultation with functional regulators, any financial stability regulator should develop best practices for enterprise risk management. Preservation of functional regulation should be a fundamental goal of federal financial stability regulation. Financial stability regulation, as it relates to insurance, can only be stronger with the added expertise of the approximately 13,000 employees working with state insurance departments.

Preemption of functional regulatory authority, if ever appropriate or necessary, should be limited to extraordinary circumstances that threaten the stability of the financial system. To support understanding of systemic risk posed by large institutions or holding company structures, "supervisory colleges" should be utilized to understand the risks within the holding company structure. Such "colleges" should consist of functional regulators from each financial services sector represented within institutions or holding company structures deemed to pose systemic risk.

Financial stability regulation must operate in a transparent, accountable and collaborative manner, and should defer to the functional regulator in proposing, recommending or requiring any action related to a regulated entity's capital, reserves or solvency. The health of one company within the holding company structure should not be compromised simply for the benefit of another company within another sector of the holding company. Decisions affecting an entity's finances can affect millions of policyholders and consumers, thereby requiring the greatest care and expertise.

**Ensuring Access to Information**

Today's hearing is focused on systemic risk and insurance, but some will again take the opportunity to argue for a federal regulator for the insurance sector. A federal regulator would be unnecessary, duplicative and adverse to consumer interests, but as I have testified previously to this Subcommittee, state insurance regulators endorse the goal of increasing knowledge of insurance at the federal level. The federal government should have immediate, fingertip access to data regarding the insurance sector. For that reason, state insurance regulators supported Chairman Kanjorski's bill to create the Office of Insurance Information in the last Congress, and we continue to support that legislation in this Congress. We agree that institutional knowledge of insurance issues at the federal level is critical in this age of global competition and commercial challenges. This federal knowledge, of course, should be partnered with the state insurance regulatory system and the institutional knowledge that, for over 138 years, has nurtured the world's most profitable and vibrant insurance marketplace.

States, through the NAIC, maintain a vast compendium and analyses of financial and subject matter information on all facets of insurance. The collection and interpretation of that information, and its continual development and refinement over the years, has been of immense benefit to state insurance regulators and consumers. This information has informed market trends, strengthened consumer protections, and aided regulators and lawmakers when making public policy decisions.

On behalf of the states, the NAIC's comprehensive collection of insurance information is the largest in the world. We have also invested heavily in software tools to analyze and enhance the data. For a federal agency to re-originate this vast archive would be an unnecessary taxpayer expense and a redundant effort. The states, individually or collectively through the NAIC, are pleased to coordinate delivery of any and all data sought by the federal government.

State insurance regulators have worked with Congressional sponsors and constructive industry representatives in support of legislation that would reform producer licensing, the assessment and collection of multi-state surplus lines taxes and, as mentioned, the Office of Insurance Information. State regulators have also formulated a proposal for comprehensive reform of reinsurance regulation. In addition, state regulators are developing a framework to address other

areas of concern and, in the near term, anticipate constructive dialogue with state government allies, Congress and other interested parties regarding that framework.

**Global Developments Affecting the U.S. Insurance Industry**

Several current international developments are likely to affect the U.S. insurance industry, and illustrate once again the interconnectedness of U.S. and global financial markets.

Foremost is the convergence project between the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on international accounting issues. This project is expected to result, in the 2012-2013 timeframe, in the U.S. changing its accounting standards from the traditional Generally Accepted Accounting Principles (GAAP) to the international standards included in International Financial Reporting Standards (IFRS). Other countries are also moving toward adoption of these same standards.

The G20 has reinforced the role of international financial regulatory standard setters, including the International Association of Insurance Supervisors (IAIS), in converging international regulatory practices toward globally accepted practices. Policymakers currently are devoting an inordinate amount of attention to the European Union's (EU) Solvency II reforms, set to come into effect in late 2012 but which will directly impact only a small number of internationally active U.S. companies conducting business in Europe. Nevertheless, Solvency II incorporates a process for determining "equivalence" of non-EU countries' regulatory practices with those in Solvency II, apparently in an attempt by the EU to establish the as-yet untested Solvency II as the international standard for insurer oversight.

We commend the EU for its development of the Solvency II concept. At this stage, years from implementation, we know Solvency II will continue to add essential but currently absent detail. Over the next several years, assuming continued improvement to the EU proposal, U.S. insurance regulators anticipate recognition of our European counterparts as Solvency II moves from its present nascent stages to eventual implementation and maturity.

State insurance regulators, through the NAIC, continuously monitor and adjust the existing solvency framework for U.S. insurance regulation. This constantly evolving process has resulted in a strong solvency baseline of regulation in the U.S. Independent of the EU's initiatives, the states are currently engaged in a comprehensive review of their systems of solvency monitoring and regulation to evaluate the success of the many capital-related initiatives, including risk-based capital (RBC), codification of statutory accounting principles, risk-focused examinations and the Accreditation Program. Titled the NAIC Solvency Modernization Initiative (SMI), this review also seeks to respond to lessons learned from the recent market turbulence as well as international developments in solvency regulation in both the insurance and banking sectors. SMI attempts to identify and put in place a comprehensive solvency framework representing the best solution for the U.S. market. SMI aims to retain solvency framework components that represent best practices while considering entirely new concepts as well. A study of other countries' solvency regimes and modernization projects is included as part of this project to identify best practices for U.S. insurance regulation.

**Effectiveness of U.S. Coordination and Communication with Foreign Governments**

The United States has the largest and most competitive insurance market in the world. U.S. consumer, solvency and transparency standards are a model for developing markets. State insurance regulators, through the NAIC, are leading efforts to develop international standards of insurance regulation.

State insurance regulators regularly collaborate with the federal government on issues of global financial stability and market access. State regulators, through the NAIC, engage regularly with its foreign regulatory counterparts to develop international regulatory standards and promote sound U.S. regulatory standards. The NAIC also aids in establishing sound regulatory regimes in developing countries to ensure stable, open and competitive insurance markets for U.S. companies.

The NAIC holds key leadership positions in a number of major international bodies of financial regulators, such as the IAIS, whose membership includes insurance regulators worldwide. Through the NAIC, U.S. insurance regulators are leading the effort with regulators from around

the world to create global standards and to minimize differences in fundamental areas of insurance regulation.

The NAIC contributes actively to the work of the Joint Forum, where banking, securities and insurance supervisors address cross-sectoral regulatory issues, and the Financial Stability Forum, where finance ministers from the world's largest economies address financial sector developments that could threaten global economic stability.

The NAIC serves as a technical expert for federal agencies – such as the U.S. Trade Representative and the Departments of Treasury and Commerce – in developing financial policy and pursuing U.S. trade objectives, including implementation of the North American Free Trade Agreement (NAFTA) and the General Agreement on Trade in Services (GATS). Since 1999, the U.S. has held semiannual NAIC-EU Regulatory Dialogues to address issues affecting transatlantic insurance, leading to negotiation of a memorandum of understanding (MOU) on information exchange and discussions on supervision of reinsurance, critical for spreading insurance risk around the world. Similar exchanges have taken place with Japan, India, Brazil, Russia, Switzerland, Latin America and China.

**State Insurance Regulators' Coordination and Cooperation Efforts within the U.S. Government**

State insurance regulators interact with their federal financial regulatory counterparts and other federal entities on a regular basis, and NAIC staff brief federal regulators at the Office of Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS) and Federal Reserve before each NAIC national meeting to discuss issues of common interest. The NAIC is a member of the Financial and Banking Information Infrastructure Committee (FBIIC), which reports to the Department of Homeland Security and the Office of Cyberspace Security. FBIIC is charged with coordinating efforts across the financial services sector to improve the security and reliability of the infrastructure necessary for financial markets to function. The NAIC also actively participates in meetings of the Financial Stability Forum (FSF), representing the U.S. and international insurance sectors in meetings with banking and securities regulators from the world's largest economies and those sectors' representative bodies.

The NAIC is a member of the U.S. Department of Treasury's National Financial Education Network, composed of federal, state and local government organizations for the purpose of advancing financial education for consumers. The Treasury Department selected the NAIC to participate after reviewing the NAIC's premier consumer outreach campaign *Insure U* (www.insureuonline.org) and its "virtual" curriculum based around specific life stages.

State insurance regulators have entered into MOUs with a number of federal agencies to facilitate information sharing. The NAIC is working with the Centers for Medicare and Medicaid Services (CMS), and recently drafted an MOU for states to share complaint information regarding health insurance plans and producers. The NAIC has worked with the U.S. Department of Health and Human Services, CMS and Congressional staff on a variety of issues raised by states as they create long-term care partnership programs. We have also provided testimony and other technical assistance to address Medicare prescription drug implementation issues identified by state insurance regulators in working with consumers and companies during the roll-out period.

Finally, the NAIC and its members have worked closely with the U.S. Department of Defense, sharing information and protect military personnel and their families from improper sales of insurance and investment products on military bases.

**Monitoring Solvency and Capital Flows Across Borders**

The NAIC has established a minimum baseline of solvency standards in its Accreditation Program. The program includes periodic, on-site examinations to ensure that each U.S. jurisdiction complies with the Accreditation Program requirements. This provides each U.S. jurisdiction – and consumers within each jurisdiction – with certainty about the efficacy of solvency regulation. Elements of these examinations include periodic financial analysis and on-site examinations of insurers, conservative statutory accounting and standardized financial reporting with extensive detail. Schedules in the statutory financial statement disclose individual reinsurance transactions and display non-routine transactions between affiliated entities. As the NAIC updates its solvency framework as a part of its maintenance agenda, the Accreditation Program's requirements are updated accordingly.

The NAIC also has a Financial Analysis Working Group (FAWG) that leverages the chief financial regulators in several states to serve as an additional layer of national solvency assessment. FAWG reviews nationally prominent insurers or insurer groups to identify problems or companies that may be trending toward financial trouble. FAWG also serves as regulator-to-regulator forum to identify market trends and emerging financial issues in the insurance sector. FAWG interacts with domiciliary regulators and lead states to assist and advise on appropriate regulatory strategy or action. In this way, FAWG encourages multi-state coordination for solvency assessment.

As mentioned, U.S. insurance regulators, through the NAIC, participate in the IAIS, and are actively engaged in solvency standard development on the international front. Through the NAIC, states meet regularly with regulators and policymakers in other jurisdictions to better understand regulatory reforms underway in those countries, and to contribute to a greater understanding of U.S. regulatory practices internationally. To enhance the oversight of internationally active insurers, individual U.S. states often enter into regulatory information sharing agreements with regulators in other countries.

**Insolvency and the Role of Guaranty Funds**

The current economic crisis has focused attention on the solvency and insolvency systems for financial institutions. Consumers are understandably questioning the safety of deposits, investments and insurance policies. Due to state regulators' strong, national solvency standards, the insurance industry has weathered the economic turmoil relatively well. However, we recognize the importance of educating state and national policymakers regarding the state system of receivership and guaranty funds.

The failure of an insurance holding company in and of itself would not implicate the guaranty fund in any respect. State insurance commissioners have broad receivership authority over insurance companies, which effectively "walls off" insurance companies, including insurers within holding companies. The insurer's assets cannot be used to satisfy the debts of the holding company. Indeed, non-insurance holding companies have gone into types of bankruptcy proceedings while solvent insurance subsidiaries were placed into receivership or protected by

other administrative orders entered by state insurance regulators. That option can and should continue because insurance statutes prioritize policyholders over other creditors in the receivership process. Policyholders are the first to be "made whole" in the event of insolvency, further illustrating the appropriateness of state regulatory authority over the business of insurance.

State insurance regulation also encompasses an effective guaranty fund system that serves as a backstop for policyholders when an insurer faces financial difficulties. State guaranty funds ensure that policyholders are made whole by paying claims and meeting contractual obligations to insurance consumers. With the current economic turmoil, some have debated the ability of the guaranty funds to manage big insolvencies. This system has managed big insolvencies in the past, and can do so going forward. The guaranty fund system is not replacing a consumer's cash, but rather is replacing his or her insurance coverage. Insurance claims do not all occur simultaneously for that reason, and the guaranty fund system can manage an insolvent insurer's obligations and spread out its assessment capacity over a period of years.

Insurers' high capitalization requirements and low leverage have kept them from incurring the steep losses faced by other financial institutions, such as investment banks, hedge funds and commercial banks, in the current financial crisis. Even if a number of insurer insolvencies were to arise, the guaranty system would operate as it has in the past when it has been called upon to respond in a difficult environment. In the four decades in which the guaranty system has operated, it has responded to hundreds of insurance company insolvencies through several bad economic cycles. Most of those failures have involved small insurers, but some have been household names like Reliance and Home on the property/casualty side of the business. On the life side, the last bad economic cycle caused the guaranty system to respond simultaneously to the failure of three major national insurers – Executive Life, Mutual Benefit and Confederation Life – while also handling the failures of more than fifty other small and medium-sized companies, with plenty of financial capacity left over.

While the financial capacity of the guaranty system is substantial in and of itself, the costs of delivering its protections in the hundreds of insolvencies I just mentioned have never approached the system's financial capacity. Unlike bank deposits, insurance policy accounts are not all due and payable on the day an insurer fails. Many or most of the obligations of a failed insurer do not

come due for years, decades or even generations after an insurer fails. Moreover, and again because of the conservative nature of insurance capital requirements, when an insurer fails it usually has substantial assets on hand. As a result, the assets often fall short of the liabilities by only a small percentage, especially for life insurance companies, and those assets must all be applied to pay policyholders in full before general and subordinated creditors are paid anything.

Even if a completely unprecedented strain were placed on the guaranty system (such as the simultaneous failure of several very large companies), the ability of the system to assess the industry over future years – when policy liabilities of the failed insurers would be coming due – would serve as a secure base for any conventional or extraordinary borrowing that the system might require in order to meet a short-term liquidity need.

The state guaranty fund system relies upon the state regulator's ability to monitor and regulate insurer solvency. Any expansion of a resolution authority at the federal level must assure that the state receivership and guaranty fund priorities remain in place for consumers. For example, if a systemic resolution authority could raid the assets of an insurance company, the regulator's ability to monitor solvency would be compromised and undue stress imposed on the guaranty fund system – to which all licensed insurers contribute. Additionally, the states' guaranty fund system has a tailored assessment process that should be separated from any broader resolution authority. If Congress considers a mechanism for resolving the failure of large, complex financial institutions that pose systemic risk, that mechanism should leverage the existing authority of states to resolve insurance companies.

**Conclusion**

State insurance regulators agree that a collaborative approach is needed to deal with large, complex systemically risky financial enterprises. I repeat today our pledge of full, honest cooperation and participation in efforts to devise the best possible approach to improving the financial regulatory system and promoting financial stability. The state-based insurance regulatory system is one of critical checks and balances, without the perils of a single point of failure and omnipotent decision making. States have a long history of consumer protection and market stability – the two pillars on which any system of financial stability regulation can, and must, be built.

Thank you for the opportunity to testify, and I would be happy to answer your questions.

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**TESTIMONY**

**OF**

**FRANKLIN W. NUTTER**
**PRESIDENT**
**REINSURANCE ASSOCIATION OF AMERICA**

# SYSTEMIC RISK AND INSURANCE

**UNITED STATES**
**HOUSE OF REPRESENTATIVES**
**SUBCOMMITTEE ON**
**CAPITAL MARKETS, INSURANCE AND**
**GOVERNMENT ENTERPRISES**

**JUNE 16, 2009**

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S., and those that conduct business on a cross border basis.

I am pleased to appear before you today to provide the reinsurance industry's perspective on systemic risk, how to improve oversight of the reinsurance industry, and how to restructure the federal government's role with regard to reinsurance. I commend Chairman Kanjorksi and Ranking Member Garrett for holding this important hearing and welcome the opportunity to address the Subcommittee. My testimony will highlight how reinsurance is regulated in the United States; why the current state-based insurance regulatory system does not work well for the sophisticated global reinsurance marketplace; how a federal reinsurance regulator could satisfy the concept of a systemic risk regulator of reinsurers; the need for a federal role in reinsurance; and the RAA's position in support of a single national regulator at the federal level for the reinsurance industry.

## I. Background on Reinsurance

### a. The U.S. Reinsurance Market

Reinsurance is critical to the insurance marketplace. It is a risk management tool for insurance companies to improve their capacity and financial performance, enhance financial security, and reduce financial volatility. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to enable insurers to transfer major natural and man-made catastrophe risk; and to increase insurance capacity. Reinsurance is the most efficient capital management tool available to insurers.

Reinsurers have helped the U.S. recover from every major catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11, 2001 were absorbed by the global reinsurance industry, and in 2005, 61% of Hurricanes Katrina, Rita and Wilma losses were ultimately borne by reinsurers. In 2008, approximately one-third of insured losses from Hurricanes Ike and Gustav were reinsured.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential because reinsurance provides the much needed capacity in the U.S. for property, casualty and life risks. In 2008, for example, 20 of the world's leading life reinsurers held $7.6 trillion of U.S. life insurer mortality risk, and more than 2,600 foreign reinsurers from 70 jurisdictions[1] assumed property and casualty business from U.S. ceding insurers. Including their U.S. subsidiaries, foreign-owned reinsurance companies accounted for 83.6 percent of property casualty premiums ceded, while U.S. reinsurance companies accounted for 16.4 percent. Although the majority of U.S. premiums ceded offshore are assumed by reinsurers domiciled in ten countries, the entire market is required to bring much needed capital and capacity to support the extraordinary property, casualty and life risk exposure in the U.S. and to spread the risk throughout the world's financial markets.

**b. U.S. Reinsurance Regulation**

The state-based insurance regulatory system is focused on solvency regulation, with significant emphasis on regulating market conduct, contract terms, rates and consumer protection. The regulation of reinsurance, however, focuses almost exclusively on prudential regulation ensuring the reinsurer's financial solvency so that it can meet its future obligations to ceding insurers. Because the reinsurance transaction is between sophisticated business parties,

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market--2008 Data (2009)

with no consumer component, there are no regulatory requirements relating to the rates that are negotiated between the parties or the forms used to evidence contractual terms.

Reinsurance is regulated by the states utilizing two different methods: direct regulation of U.S.-licensed reinsurers and indirect regulation of reinsurance transactions. States directly regulate reinsurers that are domiciled in their state, as well as those U.S. reinsurers that are simply licensed in their state, even if domiciled in another state. These reinsurers are subject to the full spectrum of solvency laws and regulations to which an insurer is subject, including: minimum capital and surplus requirements, risk-based capital (RBC) requirements, investment restrictions, required disclosure of material transactions, licensing, asset valuation requirements, examinations, mandated disclosures, unfair trade practices laws, annual statement requirements and actuarial-certified loss reserve opinion requirements.

The second method is indirect regulation of reinsurance transactions through the credit for reinsurance mechanism, which results in a financial statement accounting benefit given to an insurer if the reinsurance it has purchased meets certain prescribed criteria. If these criteria are met, the insurer may record a reduction in its insurance liabilities as a result of its reinsurance transactions. These criteria are contained in the state credit for reinsurance laws. In general, reinsurance credit is granted if the reinsurer is licensed in the same state as the cedent, if the reinsurer is accredited by the cedent's state of domicile, or if neither of these conditions apply, if the reinsurer has posted adequate security for its reinsurance obligations. One of the most widely utilized methods of security for a non-licensed reinsurer is the establishment of a U.S. trust fund or other security in the U.S., such as a clean, irrevocable and unconditional letter of credit issued by an acceptable institution, to cover its potential liabilities to the insurer. This provision is based on the historic premise that state regulators do not have the capability or resources to assess the legal, regulatory or accounting regimes of foreign jurisdictions, or the financial

strength or claims-paying ability of reinsurers that are not authorized or licensed in the United States.

For several reasons, including the cumbersome nature of a multi-state licensing system, many new entrants into the reinsurance market have opted to establish a reinsurance platform outside the U.S. These new companies conduct business either through a U.S. subsidiary or by providing security through a trust or with collateral. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of this new capital came from U.S. capital markets, yet no new reinsurer was formed in the United States. Other than the U.S. subsidiaries of some of these new companies, not one U.S.-domiciled reinsurer has been formed since 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-U.S. jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in multiple U.S. states.

**c. Guaranty Fund System**

Reinsurance is a business-to-business transaction involving knowledgeable commercial parties. State insurance guaranty funds were designed to provide a mechanism for the prompt payment of covered claims of an insolvent insurer to protect consumers and unsophisticated buyers of insurance products. Because the purpose behind establishing guaranty funds does not exist in reinsurance transactions, there are no reinsurance guaranty funds at the state level and there is no need to create one at the federal level.

## II. Understanding Potential Systemic Risks and Access to Information about the Reinsurance Industry

As this Subcommittee is well aware, there is no federal entity with statutory authority or designated responsibility for oversight of insurance. There is also no committed expertise to advise Congress or the Administration on policy matters related to insurance or reinsurance.

Consequently, when an insurance issue arises, there is no source of information at the federal level to appropriately advise policymakers. As recent economic and natural catastrophe events suggest, the federal government has a strong interest in understanding this important market as it responds to these crises. At a minimum, there is a need for a federal entity that can utilize information and data from state regulators, but which is empowered to conduct its own analysis and provide advice based on a broader perspective than is driven by individual state interests. We believe Chairman Kanjorski's Office of Insurance Information legislation is good and timely, and goes a long way towards addressing this problem.

Reinsurance is an important part of the risk transfer mechanism of modern financial and insurance markets. Yet, there are clear distinctions between risk finance and management products that are relatively new financial tools developed in unregulated markets, and risk transfer products like reinsurance whose issuers are regulated by U.S. regulators or by their non-U.S. domiciliary regulator and whose business model has existed for centuries. In the case of reinsurance, regulatory reform is necessary to improve regulatory and market efficiency and maximize capacity in the U.S. That reform should address licensing, prudential regulation and international coordination and cooperation.

It has been suggested that the authority of a systemic risk regulator should encompass traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, authority to take regulatory action as necessary and, if need be, regulatory action independent of any functional regulator. At a recent speech before the Council of Foreign Relations, for example, Federal Reserve Board Chairman Ben Bernanke acknowledged that such a systemic regulator should work as seamlessly as possible with other regulators, but that "simply relying on existing structures likely would be insufficient."

As I noted earlier in my testimony, the purpose of reinsurance regulation is primarily to ensure the collectability of reinsurance recoverables and reporting of financial information for use by regulators, insurers and investors. Because reinsurance is exclusively a sophisticated business-to-business relationship, reinsurance regulation should be focused on prudential or solvency regulation. We are concerned the systemic risk regulator envisioned by some—one without clear, delineated lines of federal authority and strong preemptive powers—would be redundant with the existing stated-based regulatory system. We also note that without reinsurance regulatory reform and a prudential federal reinsurance regulator, a federal systemic risk regulator would: (1) be an additional layer of regulation with limited added value; (2) create due process issues for applicable firms; and (3) be in regular conflict with the existing multi-state system of regulation.

## III. International Developments, Coordination and Communication

The financial crisis of the last year demonstrated the importance of international coordination and communication across all financial services industries. Even before that, the 2008 U.S. Treasury's Blueprint for Financial Regulatory Reform ("the Treasury Blueprint") noted that the U.S. state-based insurance regulatory system creates increasing tensions in this global marketplace, both in the ability of U.S.-based firms to compete abroad and in the allowance of greater participation of foreign firms in the U.S. market. Foreign government officials have continued to raise issues associated with having at least 50 different U.S. insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies.

The Treasury Blueprint also noted that, while the NAIC attempts to facilitate communication among the states on international regulatory issues, it is not a regulator. The Blueprint further noted that because of the NAIC's status as a non-governmental coordinating

body and the inherent patchwork nature of the state-based system, it will be increasingly difficult for the U.S. to speak effectively with one voice on international regulatory issues.

The time has already arrived where this lack of a single voice is adversely impacting U.S. reinsurers. The interaction between the U.S. and its foreign counterparts on issues like the European Union's Solvency II effort will likely impact not only the ability of U.S. companies to conduct business abroad, but also the flow of capital to the U.S. For U.S. reinsurers, Solvency II will set forth a process for determining which countries are "equivalent" for purposes of doing business in the European Union. Although this issue is still being discussed, the RAA understands the European Parliament obtained a legal opinion that stated that the European Commission cannot grant equivalence to a U.S. state under Solvency II. The possibility that the entire 50-state system in the U.S. will be deemed "equivalent" appears questionable, at best. Thus, without federal involvement by a knowledgeable entity tasked with responsibility for international policy issues, the U.S. reinsurance industry will continue to be disadvantaged in these equivalence discussions.

The United States also needs to be able to speak with one voice on international accounting issues. International consensus on this ongoing global project is central to the ability of the reinsurance industry to attract risk capital. The substance of these standards as part of a single, common global insurance accounting model is critical.

## IV. Need for Authority to Recognize Foreign Supervisory Authorities

An informed federal voice with the authority to establish federal policy on international issues is critical not only to U.S. reinsurers, who do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the U.S. marketplace. The current multi-state U.S. regulatory system is an anomaly in the global insurance regulatory world. Following the recent financial crisis, the rest of the world continues

to work towards global regulatory harmonization and international standards. The U.S. is disadvantaged by the lack of a federal entity with Constitutional authority to make decisions for the country and to negotiate international insurance agreements. In the area of reinsurance, there is a need for a process for assessing the equivalence and recognition on a reciprocal basis of non-U.S. regulatory regimes. This process would assist non-U.S. reinsurers that supply significant reinsurance capacity to the U.S. insurance market by facilitating cross-border transactions through binding and enforceable international supervisory arrangements.

U.S. states impose a highly structured and conservative level of regulation on licensed reinsurers. However, it has long been recognized that there are several globally-recognized methods of conducting reinsurance regulation.

The RAA was encouraged by the inclusion of a system of supervisory recognition among countries in "The National Insurance Act of 2008" (S. 40), introduced during the last Congress. Supervisory recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, non-U.S. domiciled reinsurers would be permitted, for example, to assume reinsurance risk from the U.S. on the basis of regulation in their home country. In return, such a system would allow U.S. reinsurers to conduct business in that market or country, based on U.S. regulatory oversight.

A single national regulator with federal statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of regulatory standards, enforcement, trust, and confidence with their counterparts in the U.S.

## V. Financial Services Regulatory Modernization

Most, if not all participants in the dialogue about financial services modernization, acknowledge that most financial markets are global and interconnected. Federal Reserve Board

Chairman Bernanke noted that the global nature of finance makes it abundantly clear that any reform in the financial services sector must be coordinated internationally. Among the financial services providers, no sector is more global in nature than reinsurance. Even the NAIC has acknowledged that "in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the U.S. is warranted."

As Congress proceeds with financial services modernization, we emphasize the global nature of reinsurance, the utilization by reinsurers of both U.S. and non-U.S. holding company structures, the exclusive focus of reinsurance regulation on prudential oversight (i.e., no rate and form regulation or consumer element) and that only the federal government currently has the requisite Constitutional authority, functional agencies and experience in matters of foreign trade to easily modernize reinsurance regulation. Multi-state regulatory agencies in matters of international trade are at best inefficient, pose barriers to global reinsurance transactions, and do not result in greater transparency.

The RAA recommends that reinsurance regulatory modernization be included in any meaningful and comprehensive financial services reform through the creation of a federal regulator that would have exclusive regulatory authority over reinsurers that obtain a federal charter and make clear that there is no redundancy with state regulation. We recommend further that any such financial reform incorporate authority for a system of regulatory recognition to facilitate cooperation and enforcement with foreign insurance regulators.

## VI. Conclusion

The RAA thanks Chairman Kanjorski, Ranking Member Garrett and the Subcommittee for this opportunity to comment on the reinsurance industry's perspective on systemic risk, how to improve oversight of the reinsurance industry and how to restructure the federal government's

role with regard to reinsurance We look forward to working with all Members of the House Financial Services Committee as it considers these important issues.

**TESTIMONY OF THE HONOURABLE PETER SKINNER MEP**

**BEFORE THE**
**UNITED STATES HOUSE OF REPRESENTATIVES**
**COMMITTEE ON FINANCIAL SERVICES**
**SUBCOMMITTEE ON CAPITAL MARKETS**

**HEARING ON**
**"SYSTEMIC RISK AND INSURANCE"**

**June 16, 2009**

**Introduction**

Thank you Chairman Kanjorski, Congressman Garrett, and Honorable Members of this Subcommittee for inviting me to attend and give evidence today on this important issue.

I am Peter Skinner. I have been a Member of the European Parliament since 1994. I represent the South East of England Region with a population of over six million Britons. This month I was reelected to a fourth term in the European Parliament.

I have been a Member of the Economic and Monetary Affairs Committee for 13 years and am the European Parliamentary Labour Party's spokesperson on Financial and Economic Affairs.

I chair EPIC, the European Parliamentary Insurance Caucus, and also am the Chair of the European Parliamentary Financial Services Forum. I also take a leading role on issues relating to EU/USA economic cooperation. I have been Transatlantic Economic Council (TEC) Advisor for the European Parliament as part of the Transatlantic Legislators Dialogue, and have been a senior member of the EU Parliament's USA delegation for a decade.

I am the Rapporteur - sponsor of the bill - of the Reinsurance Directive (2005) and most recently, the Solvency II insurance legislation in the European Parliament. This new Solvency II legislation has been passed recently in the European Union and will become law across 27 member countries in 2012. The approach taken for the agreement of such a law was based on a series of Quantitative Impact Assessments, the results of which have been broadly the same across Europe. The Committee of European Insurance and Pension Supervisors (CEIOPS) – an organization of insurance regulators in EU member states - has worked closely with European Parliament and EU Member States on this law.

I hope my testimony to you today will inform you of how Europe's approach may be complementary to or even mirror your own efforts to modernize such laws in the USA

I fully understand and respect the need for each trading bloc to establish its own sovereign rules and practices and therefore, wish the committee every success in its deliberations. I completely understand what a tremendous responsibility you have as legislators, and believe me when I say "I have been there". I also recognize that we are, broadly speaking, dealing with the same questions and therefore have the similar difficult tasks in reconciling issues in our multi-jurisdictional regions or states.

As to cooperation between the European Union and the United States, I wish to point out that the principle of "recognition of equivalence" of our respective regulatory regimes does not imply for the rules and principles to be the same, but rather to be recognized as similar in terms of their effect and outcome.

Instead of taking divergent approaches, the impact of the near-meltdown of the financial services sector means that politicians across the Atlantic and around the globe have to agree to common approaches and regulatory structures. I am pleased that we have been able to collaborate effectively so far, and hope that we can continue to do so.

**Systemic risk and the insurance industry**

The insurance industry largely concerns the spread of risk and the determination to manage such risk. As a result, Europe is aiming at a harmonized/uniform understanding of what constitutes risks as well as how to manage it in a similar way across all EU 27 member states. Although there are different products across Europe, the member states are all expected to apply the same rules and tests to those products.

It is the management of risk that is important here for the EU. The chain of events which leads to systemic risk begins with the failure of management and supervision of the risks. The EU's focus has been to try to eliminate any failure by predicting behavior using reasonable models and testing against them. Whilst it is difficult to predict outcomes with exact certainty, the size of an organization may cause more difficulty than anything else.

On the institutional set-up for identifying and managing systemic risk in Europe, a Committee of so-called "Wise Men" led by Jacques De Larosière, former Managing Director of the International Monetary Fund, have proposed sweeping changes to the way European financial services are regulated. These proposals have been endorsed by the European Commission in its recent communication on European financial supervision.

If implemented, these changes would result in the creation of a European Systemic Risk Council, a new independent body responsible for safeguarding financial stability and conducting macro-prudential supervision at the European level. The European Systemic Risk Council would:

a) collect and analyse all information relevant for monitoring and assessing potential threats to financial stability that arise from the macro-economic developments and developments within the financial system as a whole;

b) identify and prioritise such risks;

c) issue warnings where risks appear to be significant;

d) where necessary give recommendations on the measures to be taken in reaction to the risks identified;

e) monitor the required follow-up to warnings and recommendations; and

f) liaise effectively with the IMF, the Financial Stability Board and other third country counterparts

Whilst it is clear that the EU and USA regulatory structures differ, experience of the financial crisis has brought to light important failures and gaps in the financial supervisory framework of both jurisdictions, in particular with respect to macro-prudential supervision. For this reason, I believe there is a good case to be made for a body such as the European Systemic Risk Council to be created in the EU. This model might be useful for the USA to consider in its current deliberations on what changes need to be made to its regulatory system.

**How Europe gets information about the insurance industry**

There are 27 regulators representing each of the Member States of the EU and these individuals meet under the umbrella of CEIOPS. Although CEIOPS reports regularly to the Parliament and Member States, the EU still has challenges of multi-jurisdictional approaches and separate laws and rules governing the insurance industry as a whole. This is set to improve substantially with the implementation of Solvency II in 2012. The EU still needs to finalize the structure for a single supervisory authority. The European Parliament has called for a consistent approach and passed a non-binding report proposing just such an integrated financial supervisor with legal powers.

**Cross border oversight holding companies and the call for integrated supervision**

The EU is moving rapidly towards a *one-point-of-contact* system. The details of this system are in negotiation between EU Countries. This system was developed from the De Larosiere report and highlights a need for greater integrated supervision. The proposal is to bring together the work of the three committees, the Committee of European Securities Regulators (CESR), CEIOPS, and the Committee of European Banking Supervisors (CEBS), dealing with EU oversight of financial sector regulation. It is not yet decided whether these bodies will work as a single integrated supervisor or will have legally binding powers. The work on day -to-day supervision will be handled by a collegially based system, so those countries with a cross border enterprise will all be responsible for its supervision with the mainstay of its core Group activities being supervised by the home supervising country. For example, a UK- based company will be licensed and its core group activities will supervised out of the UK even if it does business in 20 other countries. The UK Financial Services Authority (FSA) therefore will be the "lead supervisor" or otherwise known as the "group supervisor".

On Holding companies the approach of the EU has been to pursue a specific Law governing these enterprises as they offer a multiple of differing problems for single regulators in specific industrial sectors such as insurance.

Current legislation in this field is the Financial Conglomerates Directive which is subject to imminent review. Again the nature of the integrated financial supervisor will have an impact on this area of supervision.

**Developments abroad will have an effect in the U.S. insurance industry**

The reality of recent experiences in the financial services sector worldwide can lead to no other conclusion than that our systems are very closely linked. We must do all we can to improve our financial services regulatory systems, working together as much as possible. As a result, insurance regulation must improve also. We must end the regulatory arbitrage which allows the choice to be in the hands of the industry and citizens of our countries without sufficient consumer protections.

Solvency II will radically overhaul the prudential regime for insurers in the EU. The objectives of Solvency II are to deepen integration of the EU insurance market, enhance policyholder protection, and improve the international competitiveness of EU insurers and reinsurers. Solvency II will not only apply to the European operations of foreign insurers, it will also require European supervisors to assess the group supervision applied at the level of the parent to insurance companies incorporated within the EU whose parent is outside the EU. If the group supervision applied to the parent is not equivalent to that required under EU law, then the supervisor will have to take other measures such as requiring the group to set up an EU holding company covering all of its EU insurance operations.

To ensure a consistent assessment of the equivalence of other jurisdictions' supervision, Solvency II provides the European Commission with the power to make binding equivalence decisions about individual third countries based on criteria agreed with the European Parliament. The Commission will also be given the power to make binding equivalence decisions about individual third country's reinsurance supervision based on criteria agreed with the European Parliament. Where a third country's reinsurance supervision has been found equivalent reinsurers from that jurisdiction will be treated in exactly the same manner as EU reinsurers, in particular, they will not be subject to collateral requirements. If no equivalence decision has been made it is up to Member States to determine the treatment of EU reinsurers in their territory. This could include introducing additional requirements such as requiring the posting of collateral.

**International communications among regulators**

The USA's state-based regulatory system makes the dialogue between the EU and USA much more complicated. The significant divergence in regulatory systems also makes it more difficult to resolve problems such as the perennial issue of the discriminatory collateral requirements applied by USA regulators to non-USA reinsurers.

Next year as work begins on third country equivalence in the context of Solvency II we will be faced with the same question we always face with the USA when discussing insurance. Who should we talk to? Who speaks for the United States as a whole on insurance matters? Since equivalence decisions will have to be made at country level, this fact alone will make it almost impossible to find the USA equivalent under Solvency II, unless changes are made to the current insurance regulatory framework in the USA.

Whilst it is the case that cooperation agreements can be signed between individual European countries and individual USA States, nothing can be agreed to that undermines the EU's Solvency II standards and rules, which have legal primacy over the laws of EU member states. This means that the equivalency approach required for regime recognition can only be concluded between the EU and the USA as a whole,

**Maintaining standards and enforcing the rules**

The European Commission ensures that European Directives are correctly transposed and implemented in Member States. CEIOPS' Financial Stability Committee runs a macro-prudential surveillance programme designed to monitor the interplay between (re)insurance and financial stability.

Added to this Group Supervision is the approach employed by the EU to allow for the cross-border groups to operate in the 27 Member states. As each group is licensed inside their own home Member State these groups are given an effective "passport" to trade in any Member state. Approval by one country is approval by all. Each Country in turn has to adhere strictly to the Solvency II regime.

As part of Solvency II we have introduced new rules on group supervision that will greatly improve the supervision of insurance groups within the EU as well as coordination and cooperation arrangements between Member State supervisors including requirements regarding exchange of information. Solvency II also includes new enhanced disclosure requirements for both supervisors and insurers that will greatly increase transparency regarding supervisory practice and the financial standing of insurance companies. CEIOPS will also be given an enhanced role in the new system in a number of specific areas related to the supervision of EU insurance groups (e.g. approval of internal models).

**Systemic risk and insurance**

During the current crisis the insurance companies that were most likely to cause or be affected by systemic risks were those involved in significant quasi-banking activities (e.g. bond insurers and AIG's financial products activities). Life and pensions businesses have suffered from the second order effects of the crisis, in particular the reduction in interest rates and the fall in asset values. Non-life activities have tended to suffer less, although the economic downturn will likely have some impact on premiums and claims.

The failure to use appropriate controls and manage the risk leads to the problem of systemic risk. Reliance on too narrow a set of assets or not charging the right premium for

the business written could be two examples of poorly managed risk. There are business considerations but also ethical considerations and dependent on the view taken of appropriate incentives to write business supervisors' could intervene to ensure that solvency is maintained appropriately.

**Europe's attitude to guarantee funds**

Burden sharing by compensation schemes is a practice used in some member states, Germany and the UK for example. The EU is now about to consider whether burden sharing should be changed in line with recent negotiations between the European Parliament and the EU member states so as to allow group support across borders in times of stress.

As a result, and following the recent crisis, most commentators agree that more harmonisation is required and the Commission has indicated in its communication that it supports acceleration of work to build a comprehensive cross border framework to strengthen the EU's financial crisis management/resolution systems, including guarantee schemes and burden sharing.

**Conclusion**

If there's anyone who's been close to being in this Subcommittee's "shoes" as you wrestle with these issues, it is I. I hope the EU's experience – and my own experience – with these difficult and important issues will illuminate your own debates, and that my observations today will prove useful to you as you deal with these issues. I stand ready to be a resource to you in any way I can.

Thank you again for the opportunity to testify before you today. I look forward to your questions and our discussion.

**Statement of**

**Kenneth F. Spence III**

**Executive Vice President and General Counsel**

**The Travelers Companies, Inc.**

**Before**

**The House of Representatives Committee on Financial Services**

**Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises**

**Regarding**

**Systemic Risk and Insurance**

**June 16, 2009**

Chairman Kanjorski, Ranking Member Garrett, and Subcommittee Members, thank you for the opportunity to testify before you today on systemic risk and insurance. My name is Ken Spence, and I am Executive Vice President and General Counsel of Travelers. The Travelers family of companies offers a wide variety of property casualty insurance products, surety and risk management services to numerous business, organizations and individuals in the U.S. and abroad. Our products are distributed primarily through independent insurance agents and brokers and the company is a member of the American Insurance Association.

We welcome the opportunity to speak to you today on the issues of systemic risk and insurance regulation. The decisions you make in the next several months will determine the course of financial services oversight for years to come. We appreciate your consideration of

Travelers' views on these issues, which are so critical to the well-being of our company, our industry and our Nation.

## I. Introduction

The current financial crisis has demonstrated the need for significant improvements to the financial regulatory system that must be addressed to mitigate and to potentially avoid financial disruptions in the future. There is a need for government and the private sector to work together to develop mechanisms to understand and address these systemic problems. Any thoughtful and effective response will be comprehensive and have significant long-term consequences to the health of the U.S. and global economies.

Insurance must be a central part of this effort. Recent problems have revealed gaps in insurance regulation that demonstrate that the current insurance regulatory structure is unable to adequately oversee the diverse industry that insurance has become and the sophisticated players that are involved in the insurance marketplace at the highest levels. Moreover, the absence of a federal presence in insurance regulation results in a lack of "big picture" oversight for the insurance sector and leaves the federal government with no expertise to address insurance issues as they arise.

## II. The Need For Federal Insurance Expertise

At Travelers, we have first-hand experience with the lack of insurance knowledge at the federal level. For a number of years, Travelers was part of a financial holding company and, as such, was directly regulated by the Federal Reserve – one of two insurance entities subject to such oversight. The lack of insurance expertise within the agency, however, and the inability of agency personnel to be able to access non-existent federal insurance expertise through any other resource created difficult challenges for both the regulator and the company.

We have seen the lack of federal insurance expertise affect other issues, as well. With no "federal presence" in insurance regulation, you and other policymakers in Washington have had

no resident insurance experts upon whom to rely for counsel on policy matters that affect the insurance industry and insurance policyholders, nor do you have anyone to turn to for insurance expertise during times of crisis. This deficiency is readily apparent in the current financial crisis, and is evident in the debate over terrorism insurance coverage after 9/11 and in the on-going debate over natural catastrophe insurance. These are national problems that demand national solutions – but with no national expertise in the federal government, there is a huge gap in our ability to address them properly.

Thus, at a minimum, it is critical that this void of federal expertise be addressed as you move forward with financial services regulatory reform. There is an emerging consensus that there will be some form of systemic risk regulation at the federal level. We have specific suggestions with respect to systemic risk that I will discuss in Part III of my testimony below but, for any systemic-level oversight to be meaningful across financial services sectors, there must be an insurance regulatory presence at the federal level to ensure that the appropriate information is provided and analyzed and to ensure that any systemic-level directives are effectively implemented.

To that end, the creation of an Office of Insurance Information, as the Chairman has proposed in his legislation, would bolster the federal government's presence in and understanding of the insurance sector. The OII would bring needed information about the insurance marketplace to Washington, and would give the United States a single voice with which to speak on international insurance policy and trade matters. Presumably, an OII could work in conjunction with a systemic regulator to provide and exchange information and ensure that the resources of both agencies are fully utilized.

We believe that a comprehensive approach to federal financial services modernization will not be complete unless it includes a broader federal insurance presence that encompasses federal chartering for insurers. Such federal insurance regulation is critical to ensure robust regulatory oversight, strong consumer protections, and a healthy insurance industry. A single federal regulator also will bring efficiencies to regulation that will benefit all stakeholders. We support federal regulation because insurance is a sophisticated and diverse international business

involving large national and multinational conglomerates, and as such demands strong oversight. We believe the federal government is the only entity with the resources to provide adequate oversight for such an important sector of the economy. In light of the current crises engulfing the financial sector, it is critical that consumers and other market participants have confidence that their insurers are in strong financial condition. Although the states have performed admirably, the current financial problems of several large insurance holding companies illustrate the limitations of the current state system, and the need for federal government oversight to ensure the financial soundness and stability of the industry.

## III. Systemic Risk

### A. What's At Stake?

Whatever the causes, the financial crisis has exposed gaps in the financial regulatory system that must be addressed to avoid a repeat of the current problems and soften the impact of corporate failures going forward. The most widely-agreed upon target to address regulatory effectiveness is the area of systemic risk. We have been carefully considering the notion of systemic risk regulation, both with respect to how property casualty carriers may be implicated in systemic risk and how to approach systemic risk oversight more broadly. As an initial matter, we are mindful that the determination as to whether a company is systemically important does not necessarily depend upon its size or industry, but rather the extent to which its financial condition is potentially so inter-related with other institutions that its failure could cause widespread and substantial economic harm, extending beyond those stakeholders who had assumed the risk. Determination as to whether a company is systemically important does not necessarily depend upon its size ("too big to fail"), but rather the extent to which its financial health is – or could be – so inter-related with other institutions that its failure would cause broader and substantial economic dislocation. Limiting sensible systemic oversight to only large financial institutions may thus leave significant risk in the economy unaccounted for in any meaningful way.

**B. The Property-Casualty Industry & Systemic Risk**

Property casualty insurance companies, other than those that concentrate in a few specialized areas such as reinsurers or financial guaranty insurers, generally present significantly less systemic risk – at least directly – than other financial services companies. There are several reasons for this:

1. Property casualty insurers generally take on relatively little counter-party risk and their liabilities generally are independent of economic cycles or other systemic failures.

2. Property casualty insurers operate in a highly regulated market, which often includes the amount of premium charged (rate) and the wording of the policy (form). Property casualty insurers prepare financial statements in conformity with statutory accounting practices, which are generally more conservative than GAAP (generally accepted accounting practices). In addition, there are investment and capital limitations and reserve requirements. These limit the types and amounts of investments that insurers may acquire, including the use of derivatives, and require that a set amount of capital must be held based upon the risks it writes and its investment portfolio. The Insurance Holding Company Act, which has been enacted in every state, reduces the amount of systemic risk for property casualty insurers by requiring regulatory approval for dividends and transactions with affiliates that exceed specified thresholds.

3. Risk management of property casualty insurers also plays a key role in limiting systemic risk by its focus on underwriting risk, i.e. the types, amount, and concentration of risk the company is willing to write. As discussed in more detail below, at Travelers, given our size and complexity, our board of directors has for many years maintained a dedicated risk committee to assist our board in fulfilling its obligation to oversee risk and contributed meaningfully to our ability to avoid many of the problems other financial institutions faced during the current crisis.

4. Importantly, property and casualty insurers also can be distinguished from banks by the response of consumers to financial crises. Consumers, when faced with a banking crisis, may go to their depository institutions and withdraw their accounts. In contrast, property casualty insurers do not have asset accumulation products, such as variable annuities or variable life products like those written by the life insurers, so there is no withdrawal demand risk. Moreover, consumers, both commercial and personal, generally cannot go without insurance to protect their businesses, homes, and automobiles, so general economic conditions have less impact on demand for property and casualty coverage.

5. Finally, the types of asset classes that property casualty insurers hold are more conservative in nature because of the need, at any given time, to have large amounts of assets available to respond to catastrophic events, including wind storms and fires. For

> example, last fall during the financial crisis, Travelers and other property casualty insurers responded to hurricanes along the Texas coast that caused billions of dollars in insured losses. Property casualty insurers generally avoided holding significant quantities of investments linked to commercial and residential mortgages because they already had risk tied to writing property coverage. Indeed, potential systemic risk to property casualty insurers is better expressed from the threat of large scale catastrophic events in areas of high density and development than from investment driven financial crises.

Although property casualty insurers thus generally should not be perceived as posing systemic-type risks directly, an essentially unregulated holding company that owns such insurers could represent such a risk. For example, any unregulated holding company with a strong credit rating from its underlying operations could have underwritten credit default swaps, which played an important role in the current financial crisis.

In addition to considering the systemic risk that may be presented by a single entity, we think it also is relevant to consider the systemic risk that may be presented on an aggregate, industry-wide basis. For example, even if a particular community bank or insurance company would not present systemic risk, the widespread failure of community banks or insurance companies could present systemic risk. One or more natural or man-made catastrophic events or a set of circumstances materially and adversely impacting a number of insurers' investment portfolios are examples of circumstances that could cause more than an isolated failure of property casualty insurance companies which, in turn, could be systemically significant.

Another area of concern for systemic risk in the property casualty sector relates to reinsurance. Property casualty insurers may reduce the amount of risk they hold by purchasing insurance from reinsurers. Because reinsurers can accumulate risks from many insurers over an extended period of time, a reinsurer can pose systemic risk to insurers that have large amounts due from an insolvent reinsurer. If there is an insolvency of a property casualty insurer, individual policyholders would be largely protected by the existing guaranty fund system and the policyholders could easily and quickly switch their coverage to other insurers. That system has worked well historically. There is, however, no such guaranty fund protection to pay the claims of an insolvent reinsurer.

### C. A Systemic Risk Regulatory Framework

Ultimately, a company's systemic importance should be evaluated not on its size or products, but on its relationships with other institutions and the effect its failure would have on those institutions and, as a result, on the economy at large. In addressing the dangers that arise from such relationships, the government's goal should be to prevent companies from being so financially extended that their failure would create a chain-reaction of failure of other companies such that government intervention would become appropriate. In other words – the primary goal should be to prevent any company (or its failure) from posing a systemic risk at all as opposed to attempting to minimize the systemic risk after the failure occurs. There are two elements in particular that we recommend for your consideration in a reform proposal: mandated internal enterprise risk oversight through board-level risk committees and substantially enhanced disclosure requirements related to risk. I should note one caveat at the outset: what is outlined below is not a comprehensive mechanism for implementing federal systemic risk regulation but a framework for what we believe should be essential components of any such regulatory scheme; many of the details and precise boundaries need to be fleshed out and clarified, including, for example, how and to what extent these suggestions should apply to non-public companies and non-financial services oriented public companies, and the circumstances under which some of the information we suggest be disclosed could be done confidentially if public disclosure would threaten the discloser's competitive position in any way.

#### 1. Corporate Risk Committees

Any response to the current crisis should include corporate governance reform requiring systemically important institutions to assign responsibility for risk oversight to an existing or new committee of independent directors of their Boards of Directors. A board's risk committee should have a management risk officer that reports directly to the committee on a regular basis. This approach is similar to the current relationship between a board's audit committee and the company's chief internal auditor, who often reports directly to that committee.

A board's risk committee would be responsible for overseeing the company's risk-related controls and procedures, and the chief risk officer would be responsible for implementing and managing those controls and procedures. This protocol recognizes the importance of risk management and provides clear responsibility and accountability for the management of risk

The committee's role as educator is important. Financial instruments are constantly evolving and ever-more complicated and it can be challenging for a company's board of directors to get a good understanding of the company's risk profile. A board's risk committee should expect – and be expected to – educate its board members with respect to risks with which they might not be familiar.

At Travelers, for example, our board has for many years maintained a dedicated risk committee to assist the full board in fulfilling its obligation to oversee risk. Our chief risk officer reports to, and works with, the board risk committee on an on-going basis. We also have a separate management risk committee responsible for monitoring and managing the company's overall risk profile and exposure. This management committee meets regularly on its own, as well as with the board's risk committee. The work of the board's risk committee, together with management's focus on risk, is complemented by the work of other board committees, including the audit committee and an investment and capital markets committee. The effective operation of our board risk committee, together with our other board committees, contributed meaningfully to our ability to avoid many of the pitfalls that other insurance and financial institutions recently have faced.

**2. Enhanced Disclosure Requirements**

In addition to corporate self-policing, there is clearly a role for government oversight of systemically important institutions. Regulation can take different forms and could range from disclosure requirements to prescriptive rules that require and/or restrict certain corporate behavior or encompass a combination of approaches. One of the goals of this regulation should be to enhance the current disclosure regime in order to provide regulators, rating agencies and the public with information necessary to provide a comprehensive understanding of the

company's overall risk profile/exposure and be able to identify those institutions that pose a systemic risk to the economy. Market forces would, in turn, help to limit a company's incentive to take risks that could potentially undermine its own long-term success and, as a result, the larger economy. For example, if a company were to disclose that a ratings downgrade would trigger a requirement to post a significant, and quantified, amount of additional collateral, investors may well demand that the company reduce its exposure to this type of risk.

Moreover, additional disclosure would increase the effectiveness and judgment of regulators, rating agencies, and investors. By providing regulators, rating agencies, and the public with the full picture of a company's risk profile, disclosure allows the market to work efficiently and fairly; provides rating agencies with a more robust set of information on which to base their judgments; and gives regulators the information they need to make and enforce applicable prescriptive rules.

For instance, had companies been required to disclose additional information related to their credit default swap exposure - thus putting regulators and rating agencies on notice as to the serious level of risk that certain companies had undertaken with respect to these instruments - such disclosure could have led to appropriate ratings downgrades earlier on and, perhaps, may have resulted in market pressure and, as a result, earlier government intervention.

A robust disclosure regime would require quantitative disclosure of transactions, risks and other factors that could cause a systemically important company to fail. In addition, disclosure rules should include stress test requirements – requiring financial instruments, products and transactions to be put through stress tests to determine their effect on the company under a range of economic scenarios and requiring disclosures of the results of such tests. Any such regime also should provide a mechanism for identifying new financial instruments and transactions entered into by the disclosing entity of which a rating agency or regulator might not be aware. This is critical to ensure that information regarding new risks is not kept under the radar until it is too late for rating agencies, regulators, or consumers to do anything about it.

Finally, disclosure requirements should be principles-based and flexible, designed to

address today's financial products and tomorrow's innovations. We operate in a fluid and evolving marketplace. Limiting any disclosure regime to static rules without overarching disclosure principles would result in the rules lagging behind the development of new and sophisticated products and financial structures and keep regulators, ratings agencies, investors and other constituencies from having a complete and accurate understanding of a company's risk profile and financial health. Two major risks of relying on principles – that they cannot be enforced as effectively as rules and that the regulated entities are less certain about the application – can be addressed by insisting on good faith compliance by the regulated entities and vigilance by regulators, and by fostering ongoing communication between the regulated and regulators. Notwithstanding what we see as the potential benefit of principles-based regulation, we could also support incremental rules-based disclosure regulation.

We believe that the combination of private sector self-policing through corporate board risk committees and government oversight through mandatory disclosures and/or prescriptive rules together will provide an effective structure to manage systemic risks. The public and private elements bolster each other. The corporate board risk committees work internally, to ensure understanding of the company's risk exposures and to provide leadership for regulatory compliance, and they work externally, to ensure robust communications with regulators, rating agencies and other stakeholders. At the same time, the regulators impose prescriptive rules and/or disclosure requirements on companies and look to the CROs as their corporate contacts.

## IV. Conclusion

More effective regulation in the current environment is both advisable and inevitable and getting it right is imperative. One of the significant regulatory gaps is with respect to insurance oversight at the federal level. It is critical that this issue be addressed as part of your regulatory reform efforts.

Any regulatory structure designed to manage systemic risk will impact the country's economic success for generations to come. We believe that the combination of private sector self-policing and government oversight would be an effective and common-sense approach to

implement systemic risk regulation. But, in so doing, we must be careful to avoid unintended consequences, such as competitively disadvantaging some businesses relative to others in the same industry or U.S. businesses relative to non-U.S. competitors.

Now more than ever, we need thoughtful and effective regulatory oversight that will strengthen our economy and instill confidence in our financial institutions. The regulatory response must reach across disciplines and transcend political agendas in order to be successful. We appreciate the opportunity to testify today on this issue that is so critical to consumers and to our country, and welcome the opportunity to assist you in any way that we can as the legislative process moves forward.

# # #

Director General

To: The Honorable Barney Frank
Chairman, Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member, Committee on Financial Services
United States House of Representatives
2129 Rayburn House Office Building
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The Honorable Paul Kanjorski
Chairman, Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
House Committee on Financial Services
2129 Rayburn House Office Building
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The Honorable Scott Garrett
Ranking Member, Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Our reference: (MK) 09-034

Subject: **Modernisation of US (re)insurance regulation**

Brussels, 15 June 2009

Dear Congressmen,

We are writing to you today in connection with the upcoming hearings that will relate to financial services and insurance regulatory reform in the full Financial Services Committee and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, which are taking place on 18 and 16 June respectively.

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance firms, e.g. pan-European companies, monoliners, mutuals and SMEs. The CEA represents insurers and reinsurers that account for approximately 94% of total European premium income. European insurers generate premium income of €1 100bn, employ over one million people and invest more than €6 800bn in the economy. The CEA is also the voice of the European insurance industry at international level. Many of our member companies operate through branches or subsidiaries throughout the United States.

We welcome and follow with close interest the debate in the US with regard to the modernisation of the insurance services regulatory framework and the different initiatives under consideration at state and federal level. Therefore, we would like to emphasise the following points as your committee considers reform:

- While recognising the ongoing efforts of the National Association of Insurance Commissioners (NAIC) to harmonise and modernise the state regulatory system, the current state system makes it difficult to do business in the United States at national level, and in certain instances has created barriers to the free movement of (re)insurance services. We as European insurers and reinsurers therefore welcome the discussion of federal involvement in US insurance regulation.

Michaela Koller • Director General
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- In our view a modernised and more harmonised US regulatory framework should provide for a national representative body for insurance that can be an effective counterparty to international regulators, is legally recognised by other regulatory jurisdictions and is able to facilitate effective supervision of internationally active insurance groups and cross-border (re)insurance transactions.

- The European Union and the United States are the largest insurance and reinsurance marketplaces in the world and are strongly interlinked. The financial crisis has made it clear that it is essential for both insurance and reinsurance companies – but also for foreign governments and supervisory authorities – to have one single point of contact. This would create a level playing field that is also favourable for US insurers and reinsurers.

- With the agreement on the EU's new insurance regulatory framework, Solvency II, it will now become possible to agree on regulatory equivalence or mutual recognition with third countries at EU level. This allows (re)insurers from third countries to be treated in the same way as EU (re)insurers if the supervisory regime of their domicile is recognised by the EU as being equivalent and/or when a (mutual recognition) agreement has been reached between the EU and a third country. The possibility of reaching such agreements at EU level removes the need for Member States' supervisory authorities to have to decide individually on the treatment of third-country insurers and reinsurers operating under their authority. However, there appears to be currently no adequate national US counterpart with which the EU can launch discussions on equivalence.

- We urge you to consider the work of the NAIC in the development of its "Reinsurance Regulatory Modernization Framework". This Framework and its implementing legislation is not complete, and in its current form it has some parts to which international markets object. Nevertheless, this Framework is a positive first step and it demonstrates broad-based recognition by US insurance regulators that the US requires a new system of reinsurance regulation. The CEA commends the NAIC, and in particular Commissioner Goldman's leadership, in pursuing this proposal. The NAIC will need the assistance of Federal laws to adopt this framework and, as noted, we believe certain changes to legislation are still required, particularly regarding the discriminatory collateral requirements for non-US reinsurers. There are many parts of this framework, however, that should be considered seriously.

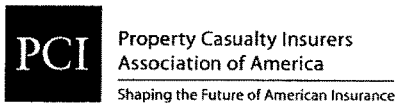
We will continue to follow the US regulatory developments with close interest and hope that these will result in an appropriate solution for the domestic and international insurance markets.

Yours sincerely,

Michaela Koller
Director General

cc The Honorable Nancy Pelosi
Speaker of the US House of Representatives
H-232 Capitol Building
Washington, DC 20515-6501

The Honorable John Boehner
Minority Leader, US House of Representatives
H-204 Capitol Building
Washington, DC 20515-6537



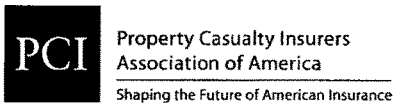

**Testimony**
**Property Casualty Insurers Association of America (PCI)**
**Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises**
**Committee on Financial Services**
**United States House of Representatives**
**Tuesday, June 16, 2009**

Chairman Kanjorski, Ranking Member Garrett, and other Members of the Subcommittee, thank you for the opportunity to present testimony today on "Systemic Risk and Insurance." The Property Casualty Insurers Association of America (PCI) is the leading property-casualty trade association representing more than 1,000 insurers, the broadest cross-section of insurers on any national trade association.

PCI appeared before your Subcommittee in early March as the first financial services trade association to present a comprehensive proposal to address systemic risk on a nationwide basis, including for diversified holding companies with insurance subsidiaries. Appendix A summarizes some of these proposals. We have also presented specific data to the Committee on historical financial marketplace data to prove that insurance, particularly property-casualty insurance, is not systemically risky. PCI continues to appreciate the ability to work with your Subcommittee and provide specific input on these critical issues facing Congress today, and we are grateful for your leadership, and that of the full Committee Chairman and Ranking Member.

## The Property Casualty Industry is Financially Strong and Not Systemically Risky

As the Congress considers changes in the regulation of the financial services industry, and particularly how insurance and insurance regulation fit into the larger picture, we urge you to be guided by two key observations.




First, the insurance industry did not cause the current economic crisis, the vast majority of property-casualty companies continue to be relatively stable and solvent, and we have repeatedly eschewed federal bailouts for our industry. Although last year the property casualty (PC) industry suffered the fourth most expensive hurricane loss in our history, followed by the greatest investment market crash in half a century, there have been no major resulting property-casualty insolvencies. Our industry's credit ratings have remained relatively stable and our underwriting obligations continue to be backed by historically strong levels of capital and surplus. While many groups have used this economic crisis to advance a broader regulatory agenda, at least with respect to solvency oversight, the state regulatory system has worked extremely well – particularly in contrast to comparable federal oversight. PCI supports a number of targeted regulatory reforms (as laid out in our March 5 testimony before the Subcommittee) and we appreciate this Subcommittee's leadership in considering these reforms. But the failure of several large financial conglomerates outside of their non-insurance affiliates should not be used as a justification for undermining an effective state regulatory system by creating a duplicative, costly federal bureaucracy. The pressing effort by Congress to address existing gaps in systemic risk oversight should not be allowed to get bogged down in unrelated long-term disputes over federal versus state regulation of the property-casualty industry.

Second, traditional property-casualty insurers are not systemically risky. Property-casualty firms have relatively low likelihood of failing, low cyclicality of risk, and little economic impact caused by their impairments. Statistical information measuring these systemic risk factors is readily available to Congress from financial regulators and independent market analysts, portions of which have previously been analyzed by the Government Accountability Office and Congressional Budget Office.

The attached charts demonstrate the relatively low historical impairment rate for the property-casualty industry over the last several decades. This is because property-casualty insurers are highly liquid, invest their own money with significant diversification

and relatively low leveraging, are required to implement sophisticated risk management procedures, and are relatively transparent.

The charts also demonstrate that property-casualty firms have a very low cyclicality of risk. There is very little correlation between industry impairments and larger systemic or economic downturns (the grey vertical bars). This is in part because property-casualty insurers have risks that are generally independent of larger economic and systemic cycles, product demand is highly inelastic (most products are effectively mandatory so annual variances in supply and demand are relatively limited), property-casualty insurers own and are responsible for their own risk, are not highly leveraged, and are not subject to a "run on the bank." For example, recessions or third party failures do not significantly increase workers' injuries, auto accidents, or house fires despite popular belief to the contrary. Property-casualty insurance contracts are not typically subject to further hedging or risk arbitrage. While some portions of primary risks are passed on to reinsurers, the risks are not further multiplied or leveraged, and the primary company almost always remains obligated and retains a portion of the underlying risk.

Finally, property-casualty insurers are not systemically risky because their individual impairments would not result in a negative economic impact massive enough to require government intervention. For example, there has been no constriction in property-casualty supply related to the recent economic downturn, and in fact, public reports of declining rates for most commercial lines suggests a relative higher level of supply versus product demand. There are no counterparties or suppliers who would be crippled by a traditional insurer's failure and policyholders would be largely reimbursed for any failures by the state insurance guaranty funds. In fact, the property-casualty market place is highly unconcentrated with relatively very low barriers to entry. The attached chart lists the Herfindahl-Hirschman Index (HHI) that is used to determine whether an industry or product line is concentrated for antitrust purposes. No line of property-casualty insurance is highly concentrated, and only monoline insurance is even moderately concentrated (the Appendix also includes a break-down of systemic risk for

each line of property-casualty insurance). The failure of even large property-casualty firms would not cause medium-term significant price increases in critical secondary markets. Ultimately, while the economy is highly dependent on the property-casualty industry, the industry's risks are independent and relatively walled off from other systemic impairments with stringent state solvency protections. In sum, on a measurable historic basis, property-casualty insurers are simply not systemically risky.

That fact has been illustrated vividly over the past year as large parts of the financial services sectors have suffered devastating losses while the property-casualty insurance industry's core business has remained sound and has continued operating with little disruption.

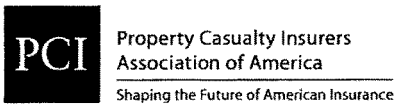
As an illustrative example, it may be helpful to consider the numerous reasons why even a very large auto insurer poses very little systemic risk to the larger economy.

- It does not create any counter-party risk.

- Its exposures are not correlated with other systemic waves or economic cycles. A downturn in the larger economy does not necessarily lead to more auto insurance claims. Its investment portfolio is required to be relatively conservative and unleveraged.

- Unlike banks and securities firms, a property-casualty insurer failure would not cause a "run" on the industry since the products are often mandatory and overall demand is relatively inelastic.

- There are many competing auto insurers, so the failure of even a very large auto insurer would have minimal sequential systemic risk impact. New business could be switched relatively easily to other providers or to a state residual market provider.



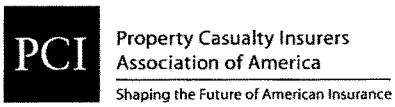

- The insurer's contracts with its agents and other suppliers would migrate quickly to new underwriters and the beneficiaries of its investments would similarly migrate over a relatively short period of time.

- Policyholders would be largely protected by existing state guaranty funds. Third party accident claimants would be similarly protected by such funds (as well as under their uninsured motorist coverage).

While the failure of a large auto insurer would be undesirable, the negative economic consequences to the larger economy would be relatively limited, primarily to transition costs and any net losses of the specific company.

**Congress Should Focus on Filling Gaps in Consolidated Systemic Risk Oversight of Holding Companies**

The recent financial crisis has taught us the painful lesson that there are gaps in the regulation of systemic risk in the U.S. financial services sector. Although the Gramm-Leach-Bliley Act granted the Federal Reserve Board systemic risk oversight authority over financial holding companies, the Board does not have oversight authority over a number of other entities, including thrifts and thrift holding companies (such as Indymac, Countrywide, Merrill Lynch, AIG, and Washington Mutual), investment bank holding companies (such as Lehman Brothers and Bear Stearns) and other firms trading in derivatives. Moreover, the Board's focus has tended to be solely on risks stemming from banks and from holding company subsidiaries to banks, and not the systemic risks that activities such as derivatives or investment banking pose to the larger economy. PCI believes that these regulatory gaps must be filled and that the regulatory understanding of systemic risk must no longer be bank-centric but must be broadened to encompass all systemic risks found in the financial services sector. At the same time, any new systemic risk regulation must also be based on a solid understanding of which entities within the




sector do and do not pose systemic risk, with clear standards for non-duplicative regulatory implementation.

**Federal Systemic Risk Regulatory Authority Over Insurance Must Be Limited**

Because the property-casualty insurance industry presents little to no systemic risk, federal systemic risk regulation requires minimal extension over property-casualty insurers. That authority should be limited to non-insurer subsidiaries of holding companies that are systemically risky. For example, with respect to several recently impaired major financial conglomerates, none of the failures have been generated by their property-casualty insurance affiliates which continue to be well-regulated and are not systemically risky. In fact, most impairments have been generated by non-insurer parent companies or affiliates engaged in relatively unregulated activities. While PCI supports creating a systemic risk regulator to monitor and flag risky activities of non-insurance holding company parents, it would have been inappropriate and unhelpful for a regulator to have interfered in the activities of the insurance affiliates that were healthy and already subject to robust prudential regulation. Unlike many other financial providers, insurers are subject to stringent capital and surplus requirements that are in place to ensure that they can meet their obligations to policyholders. No federal systemic risk regulator or resolution authority should be permitted to jeopardize state insurance policyholder protection and create massive moral hazards by "reaching down" into and weakening insurer subsidiaries whose subsequent failure costs would then be spread into the state guaranty funds and ultimately individual insurance consumers.

**Resolution of Insurers Already Handled by State Insurance Guaranty Funds**

Any federal systemic risk regulation should also consider that the impact of insolvencies in the insurance industry is mitigated significantly by the existing insurance guaranty fund system as a state guaranty fund pays consumers' insurance claims if their insurer becomes insolvent. When a state's insurance commissioner finds that an insurer

has financial problems, he or she will initiate increasingly robust levels of oversight and activity to correct those deficiencies. If an insurer does become insolvent, the state guaranty funds are available and well-positioned to help honor policyholder claims. Creating a duplicative federal resolution system for insurance would create significant regulatory conflicts of interest, moral hazard, market uncertainty, and potential cross-subsidies for risky activities.

Furthermore, any ability by a federal resolution agency to cross-assess systemic risk costs will expose insurers to paying two levels of assessments. Resolution funding should be assessed separately for each financial industry. Industries should not subsidize each others' activities. Insurers, banks, and broker-dealers already have assessment systems to pay for the failures generated by their industries. To the extent that new systemic risks are being created by activities without government guarantees (investment banking, derivatives, etc.), those industries should bear their own risk costs and have it factored into their pricing. This minimizes moral hazards, cross-subsidies, and regulatory arbitrage; reduces market distortion and ensures accurate risk pricing; limits failures from contaminating other industries; increases the risk pool; and maximizes the incentives for each industry to work with its regulator to create the optimal balance between solvency protection and risk. To the extent any additional funding is necessary for holding company resolutions unrelated to a particular financial activity (this should be minimal), it should be systemic risk weighted/scalable and post-event. Any assessments should be risk-based and only imposed on systemically risky entities not otherwise subject to risk assessments. Activities that are not systemically risky should be excluded from calculations for covered financial companies and assessments.

In sum, there is already a robust resolution system to handle nationwide insurance insolvencies. In the last 40 years, the U.S. property/casualty guaranty system has paid out roughly $21 billion in policyholder claims on behalf of insolvent insurers. The existing system of state guaranty funds has served the insurance industry and its consumers well and any new federal regulation of the financial services industry should recognize and

preserve the strong protections that system provides, not only to insurance consumers, but to the larger economy. The appendix includes a joint property-casualty trade association letter noting that even the failure of one of the largest property-casualty holding companies would not create systemic risk or require government intervention beyond the existing state guaranty fund system.

**Information Sharing and Coordination with International Regulation**

PCI recognizes that, while a federal systemic risk regulator should largely defer to state insurance regulators and refrain from interfering in the activities of non-systemically risky insurance entities, a free flow of relevant information about the industry and its role in the global marketplace may nevertheless be appropriate.

As an initial matter, we note that the federal government already has access to voluminous annual financial statements for all licensed insurers, which are filed with the National Association of Insurance Commissioners (NAIC) and with each state in which the insurer is licensed to do business. These are public records, which contain substantially more financial information than that normally found in an annual report to shareholders. Data is available on both an individual company and an aggregate basis. Additional information is available for publicly traded stock companies as they also file a variety of financial documents with the Securities and Exchange Commission (SEC).

PCI has offered two specific proposals that would facilitate the free flow of: (1) holding company solvency information among all prudential regulators and a systemic risk regulator; and (2) antifraud information among relevant regulators and law enforcement authorities.

**Holding Company Solvency Information Sharing**. PCI recommends that the President's Working Group on Financial Markets (PWG) develop and implement a plan for information sharing coordination with international overseers regarding holding

company solvency and potential threats to cross-border market stability. This coordination should be done in a manner that:

- does not exceed the scope of domestic information sharing activities;
- protects the confidentiality and privileges of both the overseer and the subject companies;
- clearly designates a lead holding company overseer and its responsibility and is preemptive with respect to duplicative information requests;
- is based on cost-benefit analysis, so that the benefits of the information outweigh the collection costs; and
- is limited to currently reported group level financial information related to solvency, such as capital levels and off-balance sheet or significant cross-affiliate obligations.

In addition, the overseers should establish regular information sharing protocols and transfers with other domestic and foreign overseers, consistent with the above objectives, so that the lead overseers of a holding company collects and redistributes to the other relevant financial overseers appropriate information on the holding company's solvency.

**Antifraud Network Act**. In 2001, the House of Representatives passed the Antifraud Network Act, but it was never signed into law. PCI supports enactment of the ANA now, to include the following provisions:

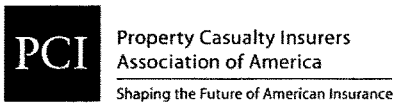
- requiring the financial overseers to establish an automated system for sharing antifraud information, primarily to cross-check public disciplinary information for background checks on key individuals and companies;
- create a confidentiality supervisory information privilege – anything collected by a financial overseers related to its supervisory role can only be publicly disclosed with the permission of the originating overseer;

- ensure that any existing confidentiality protections follow the information;
- provide limited legal immunity to overseers for good faith actions within the scope of duty; and
- create a streamlined agent background check, requiring the FBI to do fingerprint background checks on all insurance professionals and the NAIC to act as a clearing house for background checks upon which all states could rely.

**Developments in International Regulation and Information Coordination with Foreign Regulators**. PCI believes it is appropriate for the federal government to work with the financial services regulatory activities of foreign governments to better understand how the U.S. financial services regulatory structure fits within the global marketplace and coordinate efforts as appropriate. This is particularly important given that, even in the current economic turmoil, large property-casualty and life insurers are looking to grow outside their home jurisdictions. A recent study by Accenture found that 75 percent of a group of more than 100 leading insurers "believe that the current economic and financial turmoil will offer more opportunities to grow outside of their home market in the next three years."[1] As the insurance marketplace continues to grow more global in scope, international regulatory developments will have an increasing impact on U.S. financial institutions. Several key developments should be emphasized.

First, the European Union's Solvency II initiative represents a significant modernization and restructuring of the EU's insurance regulatory system, and will be one of the sources of regulatory modernization developments that the NAIC examines as it conducts its own Solvency Modernization Initiative (SMI). U.S. regulators, including state regulators and any future federal systemic risk regulator, are following EU regulatory efforts closely, and should ensure coordination where appropriate.

[1] Press Release, Accenture, Majority of Insurers Plan to Expand Internationally in Next 12 Months, Accenture Survey Finds, (June 10, 2009). (http://newsroom.accenture.com/article_display.cfm?article_id=4838)

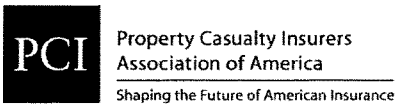



Second, the International Association of Insurance Supervisors' (IAIS) is an association representing insurance supervisors in over 140 countries and seeks to develop international insurance regulatory standards. The United States is represented by state regulators and the NAIC. The IAIS is developing a "suite" of international solvency standards, beginning with standards applicable to single legal entities which are likely to be broadened to apply to insurance groups as well. The IAIS is considering whether it should develop an international framework for the supervision of "internationally active insurance groups."

Third, we note that there has been considerable discussion recently of the concept of "supervisory colleges," consisting of a collection of the supervisors with prudential regulatory authority over the entities in a group. In the insurance industry, such "colleges" are already being held between the supervisors of insurance companies located in different countries, and we believe that this concept holds promise.

PCI appreciates the leadership of the Subcommittee and particularly the Subcommittee Chairman in seeking additional measures to coordinate and provide a focal point for U.S. leadership on international insurance issues. We hope that this goal can be accomplished without creating a long-term preemption standard that is either too broad or limiting as a precedent or imposing additional information burdens on the marketplace, and very much appreciate your openness and wisdom in working on these issues.

Thank you for the opportunity to submit this testimony as the Subcommittee members and staff consider the vitally important issues surrounding financial services regulatory reform. In closing, PCI urges you to focus on appropriate systemic risk regulation for systemically risky activities and not sweep in healthy industries that pose no systemic risk, such as the property-casualty industry. PCI looks forward to continuing to be a resource in this critical endeavor.

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PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

FINANCIAL SERVICES REGULATORY REFORM
www.pciaa.net/reg-reform

# Systemic Risk Regulation Proposal

**In brief**

- The Federal Reserve Board should be the systemic risk regulator.
- All institutions presenting a significant systemic risk should be in the Federal Reserve Board's jurisdiction.
- The Federal Reserve Board should coordinate systemic risk standards within its jurisdiction with international regulators after a full public review.

## Systemic Risk Definition

The systemic risk of a financial institution is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects.

"Too Interconnected to Fail" (TICTF) is the appropriate measure of the likelihood and amount of medium-term net negative impact to the larger economy of an institution's failure to be able to conduct its ongoing business. The impact is measured not just on the institution's products and activities, but also the economic multiplier of all other commercial activities dependent specifically on that institution. It is also dependent on how correlated an institution's business is with other systemic risks.

## Regulator

The Federal Reserve Board should be the systemic risk regulator. It has the appropriate institutional culture, mission, and expertise. However, the Federal Reserve Board's systemic risk regulation should be completely separate from its other bank holding company regulatory powers.

## Regulatory Jurisdiction

Any institution engaged in financial activities that present a significant systemic risk.

Also any institution engaged in financial activities that chooses to submit to federal systemic risk regulation (e.g., typically for international equivalency treatment).

## Regulatory Powers

### Authority to require:

- Appropriate transparency and disclosure to regulators for all entities within the regulatory jurisdiction.
- Coordination with other US and international regulators.
- Risk management for systemic risk for specific entities whose financial activities present a significant systemic risk.

PCI is comprised of more than 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write over $176 billion in annual premium, 35.9 percent of the nation's property casualty insurance. Member companies write 43.8 percent of the U.S. automobile insurance market, 29.6 percent of the homeowners market, 32.8 percent of the commercial property and liability market, and 38.4 percent of the private workers compensation market.

**Systemic risk regulation should not include:**

- Solvency regulation for individual companies.
- Business conduct regulation (licensing, market conduct, product approval, rate approval).
- Duplicative disclosure or transparency information requirements.
- General federal compliance (with privacy standards, etc.).
- Other elements of bank holding company regulation.

## Regulation of risk management

**Systemic risk regulation standards might consist of:**

- Regulating holding company capital standards and group risk management.
- Monitoring of affiliate transactions and significant off-balance sheet obligations.
- Collecting and sharing information related to group systemic risk and holding company solvency.
- Requiring coordination of examinations and visits regarding systemic risk as appropriate.
- Eliminating duplicative regulation and oversight of holding companies.

## Authority to coordinate with international regulation

Greater global financial harmonization is necessary to prevent global regulatory arbitrage. The Federal Reserve Board should coordinate systemic risk standards within its jurisdiction with international regulators after a full public review, including an examination of the effects on small companies. The regulator should not delegate regulatory oversight, and should retain the ability to provide exceptions or withdraw its deferral or mutual recognition as necessary.

PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance



# Impairment Experience of the Financial Services Industry

**In brief**

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The data clearly demonstrate that the insurance industry, particularly the property casualty insurance industry, experiences far lower average impairments than their industry counterparts. The Assets of Impaired Firms table indicates the average annual dollar amount of impairments in each of the four sectors. The Percentage of Industry Impairments table compares the impairments as a percentage of each industry's assets. The corresponding charts illustrate the level of impairment (in dollars and percentage) during four key periods of financial crisis over the last thirty years.

| | Depository Institutions | | Insurance | |
|---|---|---|---|---|
| | Thrifts | Banks | Life / Health | Property / Casualty |
| **Assets of Impaired Firms, $million*** *(Annual Average)* | | | | |
| *2008* | $62,320 | $56,477 | $382 | $51 |
| *2007* | 2,474 | 125 | 137 | 7 |
| *2006* | 0 | 0 | 118 | 42 |
| *2005* | 0 | 0 | 22 | 12 |
| *2000-2008* | 7,406 | 6,388 | 170 | 89 |
| *1990-1999* | 327 | 130 | 282 | 44 |
| *1980-1989* | 324 | 193 | 100 | 41 |
| *1980-2008* | 2,523 | 2,094 | 185 | 57 |
| **Percentage of Industry Impairments** *(Annual Average Assets)* | | | | |
| *2008* | 31.18% | 10.55% | 0.06% | 0.02% |
| *2007* | 0.16% | 0.00% | 0.02% | 0.00% |
| *2006* | 0.00% | 0.00% | 0.01% | 0.04% |
| *2005* | 0.00% | 0.00% | 0.00% | 0.01% |
| *2000-2008* | 3.50% | 1.18% | 0.03% | 0.30% |
| *1990-1999* | 2.91% | 0.22% | 0.60% | 0.19% |
| *1980-1989* | 3.13% | 0.57% | 0.29% | 0.39% |
| *1980-2008* | 3.19% | 0.65% | 0.32% | 0.29% |

PCI is comprised of more than 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write over $176 billion in annual premium, 35.9 percent of the nation's property casualty insurance. Member companies write 43.8 percent of the U.S. automobile insurance market, 29.6 percent of the homeowners market, 32.8 percent of the commercial property and liability market, and 38.4 percent of the private workers compensation market.

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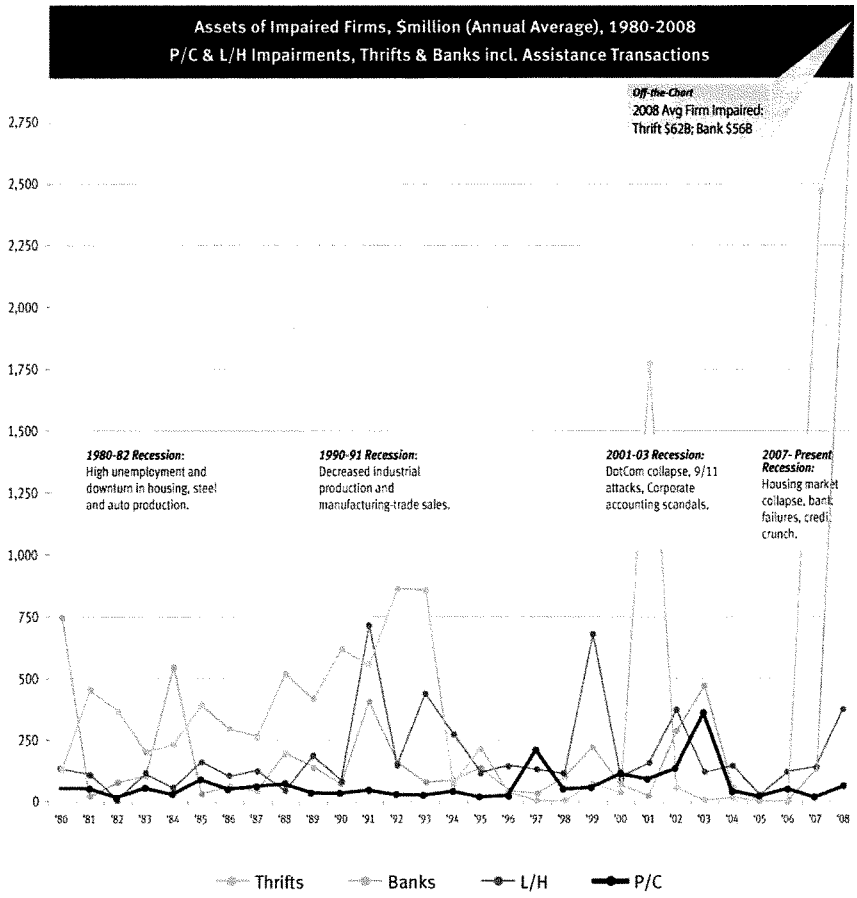
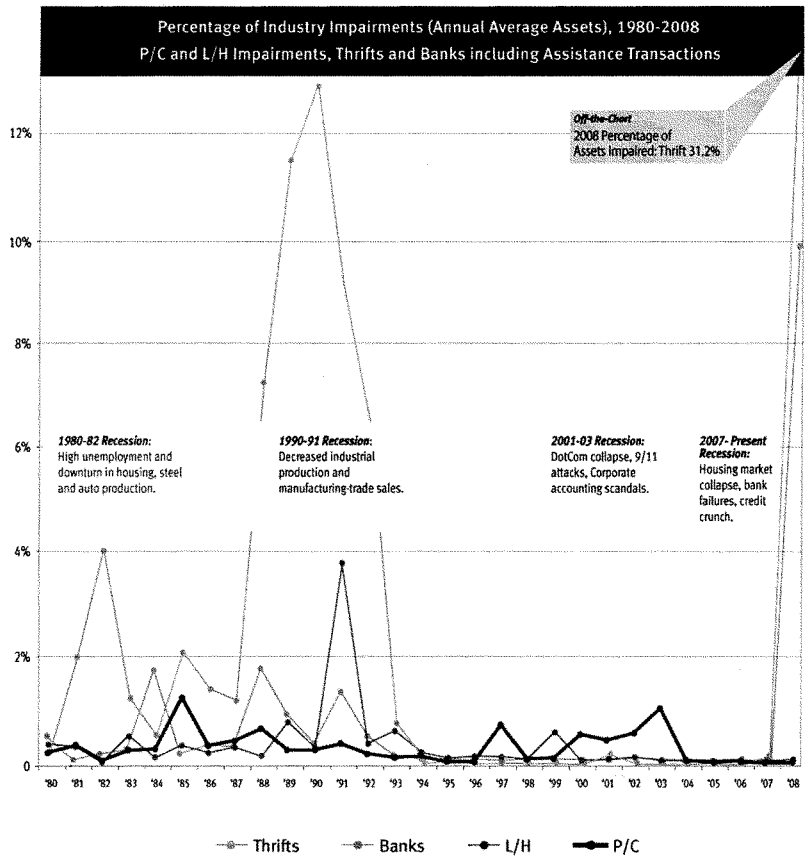

Assets of Impaired Firms, $million (Annual Average), 1980-2008
P/C & L/H Impairments, Thrifts & Banks incl. Assistance Transactions
Off-the-Chart
2008 Avg Firm Impaired:
Thrift $62B; Bank $56B
2,750
2,500
2,250
2,000
1,750
1,500
1,250
1,000
750
500
250
0
1980-82 Recession:
High unemployment and downturn in housing, steel and auto production.
1990-91 Recession:
Decreased industrial production and manufacturing-trade sales.
2001-03 Recession:
DotCom collapse, 9/11 attacks, Corporate accounting scandals.
2007- Present Recession:
Housing market collapse, bank failures, credit crunch.
'80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08
Thrifts
Banks
L/H
P/C




Source: A.M. Best Company; Office of Thrift Supervision (OTS); and Federal Deposit Insurance Corporation (FDIC).

Notes:

* Asset dollars are not inflation-adjusted.

Property Casualty Insurance Industry –

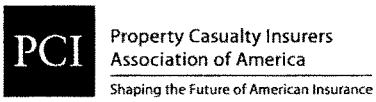
'In 2003, a spike in impaired assets was driven by Kemper Insurance Companies - caused primarily by deficient loss reserves and inadequate pricing, according to A.M. Best, accounting for over 70% of the year's aggregate impaired insurer assets.

'In 2008, the only property casualty insurers declared financially impaired were seven very small companies that did not maintain an A.M. Best financial strength rating. Four were mortgage title insurance companies. It is also notable that A.M. Best U.S. Property/Casualty Report indicates that over the last 40 years the majority of property casualty financial impairments were caused by either deficient loss reserves, inadequate pricing or rapid growth (as opposed to over-leveraged assets).

Thrifts -
'Through May 22, 2009, there have been four thrift impairments with assets of $14.8 billion.

Banks -
'Through May 22, 2009, there have been 32 commercial bank impairments with assets of $19.5 billion.

As of 5-22-09




# Resolution Authority – Priority Issues

**PCI supports creation of a federal resolution authority to resolve systemically risky financial companies that are not otherwise subject to federal or state regulatory resolution.**

**Resolution Funding: Industries Should Pay Their Own Risk Costs**

- Resolution funding should be assessed separately for each financial industry. Industries should not subsidize each others' activities. Insurers, banks, and broker-dealers already have assessment systems to pay for the failure risks generated by their industries. To the extent that new systemic risks are being created by activities without government guarantees (investment banking, derivatives, etc.) then those industries should bear their own risk costs and have it factored into their pricing. This minimizes moral hazards, cross-subsidies, and regulatory arbitrage; reduces market distortion and ensures accurate risk pricing; limits failures from contaminating other industries; increases the risk pool; and maximizes the incentives for each industry to work with its regulator to create the optimal balance between solvency protection and risk.
- To the extent any additional funding is necessary for holding company resolutions unrelated to a particular financial activity (this should be minimal), it should be systemic risk weighted/scalable and post-event.
- Any assessments should be risk-based and only imposed on systemically risky entities not otherwise subject to risk assessments.
- Activities that are not systemically risky should be excluded from calculations for covered financial companies and assessments.

**Reach-Down: Don't Punish the Innocent**

- The resolution agency should be able to manage a parent holding company's equity interests, but should not be able to reach down into affiliates subject to separate resolution authority. Denuding the assets of an insurer, bank, or broker-dealer affiliate would then unfairly subject the less risky competitors of that entity to potential assessments to pay the failed company's liabilities – potentially twice (once at the systemic risk level and a second time through the guaranty funds). This is a particular concern in protecting insurance surplus, which is necessary to cover long-term uncertain liabilities of policyholders, in comparison to banking liabilities that the resolution agency might be more familiar with that could be more immediate and quantifiable.
- Limited reach-down authority may be necessary only to the extent of:
    1) Preventing fraudulent conveyances (last minute transactions to shield assets)
    2) Coordinating with primary regulators to unwind contractual agreements between heavily regulated entities (insurers, banks, broker-dealers) and the parent company or other affiliates

**Resolution Scope: Focus on Systemically Risky Gaps**

- Insurance is not generally systemically risky and insurers are already subject to a system of resolution. Systemic resolution authority should only apply to:
    1) Entities not currently subject to resolution (exclude insurance companies)
    2) Systemically risky companies (insurance is not generally systemically risky)
    3) Define systemically risky by the amount of interconnectedness (the correlation of a company's failure with economic downturns and the additional economic ripple effects of its failure)
    4) Limit resolutions to cases where a failure would actually cause a significant systemic impact that outweighs the moral hazards of intervention

**Resolution Powers: Retain Existing Contracts and Priorities**

- Insurance law prioritizing policyholder (and reinsurance) claims should be retained to ensure they are made whole before other creditors.
- Insurance contracts should not be repudiated except as absolutely necessary to disentangle entities.
- Bridge insurers with separate charters should not be created and not given competitive advantages.

**Resolution Goals: Clear Rule of Law**

- Establish in advance clear goals, process, and criteria for resolution
- The goals of resolution authority should include:
  (1) Provide an orderly unwinding of systemically risky failing firms to maximize resolution value;
  (2) Activities should bear their own risk costs (no cross-industry subsidizations);
  (3) Depoliticize resolutions – Predetermined formulas and prioritization of claims (recognizing some claims take longer to mature);
  (4) Avoid destabilizing markets
  (5) Minimize moral hazards

**Resolution Agency: Avoid Perception of Conflicts**

- Resolutions should be determined by Treasury after consulting with the FRB and the primary regulators of any involved affiliates (such as an insurer's lead state regulator). Treasury should report to Congress and the President on any disagreements among involved regulators.
- Resolution funds should be managed by Treasury's designee (that is not a primary regulator).
- Resolutions should be performed by a separate resolution agency overseen by Treasury.
- Avoid regulatory moral hazard that requires an agency with primary responsibility for a particular market segment to resolve competing claims from other financial markets.

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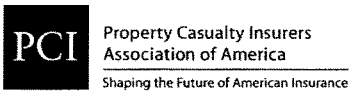


## P/C Market Concentration Analysis

Herfindahl-Hirschman Index (HHI) based on 2007 US total (all states and DC)

| Line of Business | HHI Indiv. Cos. | HHI Groups | Number of Indiv. Cos. | Number of Groups |
|---|---|---|---|---|
| Financial Guaranty | 1771 | 1785 | 19 | 15 |
| Mortgage Guaranty | 1511 | 1603 | 23 | 11 |
| Credit | 667 | 835 | 76 | 48 |
| Surety | 532 | 778 | 373 | 217 |
| Personal Auto | 348 | 665 | 998 | 371 |
| Homeowners | 326 | 778 | 904 | 431 |
| Product Liability | 217 | 468 | 504 | 161 |
| Medical Malpractice | 208 | 303 | 326 | 233 |
| Other Liability | 137 | 633 | 1439 | 690 |
| Workers Compensation | 109 | 495 | 717 | 310 |
| Commercial Multi-Peril | 99 | 346 | 802 | 359 |
| Commercial Auto | 68 | 298 | 934 | 391 |

Source: NAIC Annual Statement Database via National Underwriter Insurance Data Services/Highline Data

Notes:

1. The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.

2. Markets in which the HHI is between 1000 and 1800 points are considered to be moderately concentrated, and those in which the HHI is in excess of 1800 points are considered to be concentrated.

The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration and indicator of the level of competition amongst firms within an industry. It is an economic concept but widely applied in competition law and antitrust, and utilized by the U.S. Department of Justice and the Federal Trade Commission.

The HHI shown above is calculated on an individual company and company group basis for comparison. Financial guaranty is the only P/C line of insurance that nears the 1800 point concentrated market threshold.

For more information, please go to: www.pciaa.net/reg-reform

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Shaping the Future of American Insurance

FINANCIAL SERVICES REGULATORY REFORM
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# Insurance Line Systemic Risk Grouping

**In brief**

- Most insurance lines, particularly in the area of property casualty, carry no significant systemic risk.
- Insurance lines, excluding life and accident/health insurance products, can be categorized as High, Less Low and No Significant Systemic Risk.

## High Systemic Risk

### Financial Guaranty

An insurance policy, or an indemnity contract (when issued by an insurer), or similar guaranty types under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnitee as a result of failure to perform a financial obligation, e.g. involving municipal and infrastructure bonds; a change in interest rates; a change in currency exchange rates; or, a change in the value of specific assets, commodities or financial indices. These contracts usually involve sophisticated insureds, and therefore rates may be exempt from general statutory standards.

## Less Systemic Risk

### Mortgage Guaranty

Coverage for the mortgagee (usually a financial institution) in the event that a mortgage holder defaults on a loan; also called private mortgage insurance (PMI).

## Low Systemic Risk

### Credit

*Commercial* – Various coverages purchased by manufacturers, merchants, educational institutions, or other providers of goods and services extending credit, for indemnification of losses or damages resulting from the nonpayment of debts owed to them for goods or services provided in the normal course of their business.

*Personal* - Personal property credit may be either "single interest" or "dual interest". Single interest means insurance that protects only the creditor's interest in the collateral securing a debtor's credit transaction. Dual interest (also commonly referred to as "limited dual interest") means insurance that protects the creditor's and the debtor's interest in the collateral securing the debtor's credit transaction. Examples include, but are not limited to, Placed Home, Placed Auto, Personal Property, Credit Involuntary Unemployment and Personal GAP Insurance.

### Surety

A three-party agreement where the insurer agrees to pay a second party (the obligee) or make complete an obligation in response to the default, acts, or omissions of a third party (the principal or obligor). Contractors are often required to purchase surety bonds if they are working on public projects. The surety company becomes responsible for carrying out the work or paying for the loss up to the bond "penalty" if the contractor fails to perform.

continued

## No Significant Systemic Risk

### Accident and Health

Coverage for accidental injury, accidental death, and related health expenses. Benefits will pay for preventative services, medical expenses and catastrophic care.

### Aircraft

Coverage for aircraft (hull) and their contents; aircraft owners' and aircraft manufacturers' liability to passengers, airports and other third parties.

### Allied Lines

Property insurance that is usually bought in conjunction with fire insurance; it includes wind, water damage and vandalism coverage.

### Boiler and Machinery

Coverage for the failure of boilers, machinery and other electrical equipment (e.g., air conditioners, heating, electrical, telephone and computer systems). Benefits include (i) property of the insured, which has been directly damaged by the accident; (ii) costs of temporary repairs and expediting expenses; and (iii) liability for damage to the property of others. Coverage also includes inspection of the equipment.

### Commercial Auto

Coverage for motor vehicles owned by a business engaged in commerce that protects the insured against financial loss because of legal liability for motor vehicle related injuries, or damage to the property of others caused by accidents arising out of the ownership, maintenance, use, or care-custody & control of a motor vehicle. Examples include business auto (Auto Liability, PIP, MP, UM/UIM, Specified Causes of Loss, Comprehensive, and Collision); garage policies (Garage Liability, Garagekeepers Legal Liability, PIP, MP, UM/UIM, Specified Causes of Loss, Comprehensive, and Collision) and truckers policies (coverage for persons or organizations engaged in the business of transporting property by auto for hire, including coverage of the specialized liability exposure created by trailer interchange agreements).

### Commercial Multiple Peril

The policy packages two or more insurance coverages protecting an enterprise from various property and liability risk exposures. Frequently includes fire, allied lines, various other coverages (e.g., difference in conditions) and liability coverage. Such coverages would be included in other annual statement lines, if written individually. Examples of CMP policies include builders risk, business owners (BOP), e-commerce, and commercial farm and ranch.

### Crop

Coverage protecting the insured against loss or damage to crops from a variety of perils, including but not limited to fire, lightening, loss of revenue, tornado, windstorm, hail, flood, rain, or damage by insects.

### Earthquake

Coverage for building and contents losses resulting from a sudden trembling or shaking of the earth, including that caused by volcanic eruption. A special policy or endorsement is available because earthquakes are not covered by standard homeowners or most business policies.

### Farmowners

Farmowners insurance sold for personal, family or household purposes. This package policy is similar to a homeowners policy, in that it has been developed for farms and ranches and includes both property and liability coverage for personal and business losses. Coverage includes farm dwellings and their contents, barns, stables, other farm structures and farm inland marine, such as mobile equipment and livestock.

### Fidelity

A bond or policy covering an employer's loss resulting from an employee's dishonest act (e.g., loss of cash, securities, valuables, etc.)

### Fire

Coverage protecting property against losses caused by a fire or lightning that is usually included in homeowners or commercial multiple peril policies.

### Flood

Basic flood insurance is provided by the federal government (the NFIP) and sold through private companies and agents. Private insurers also provide excess flood policies and may cover flood damage under the comprehensive portion of an auto insurance policy.

### Homeowners

The typical homeowners insurance policy covers the house, the garage and other structures on the property, as well as personal possessions inside the house such as furniture, appliances and clothing, against a wide variety of perils including windstorms, fire and theft. Homeowners insurance also covers additional living expenses which reimburses the policyholder for the extra cost of living elsewhere while the house is being restored after a disaster. The liability portion of the policy covers the homeowner for accidental injuries caused to third parties and/or their property. Coverage for flood and earthquake damage is excluded and may be purchased separately. This applies similarly to condos, renters/tenants and mobile homes at a fixed location.

### Inland Marine

Coverage for property that may be in transit by all forms of land and air transportation, held by a bailee, at a fixed location, or movable goods that are often at different locations (e.g., off-road construction equipment), or scheduled property (e.g., Homeowners Personal Property Floater). These lines also include instrumentalities of transportation and communication, such as bridges, tunnels, piers, wharves, docks, pipelines, power and phone lines, and radio and television towers. Also includes policies for electronic data processing equipment/software, pet insurance, animal mortality, event cancellation and travel coverage.

### Medical Malpractice

Insurance coverage protecting a licensed health care provider or health care facility against legal liability resulting from the death or injury of any person due to the insured's misconduct, negligence, or incompetence, in rendering or failure to render professional services.

### Ocean Marine

Coverage for ocean and inland water transportation exposures; goods or cargoes, ships or hulls, earnings, piracy, the jettisoning of cargo to save the property of others, and liability.

### Other Liability

Coverage protecting the insured against legal liability resulting from negligence, carelessness, or a failure to act resulting in property damage or personal injury to others. Examples include liability coverage for commercial general liability, completed operations, contractual liability, day care centers, D&O, E&O, elevator/escalator, employers liability, liquor liability, municipal liability, environmental pollution liability, Internet liability, etc.

### Other Lines of Business

Coverage not described under previous lines of insurance, such as service contracts and title insurance.

### Personal Auto

Coverage for privately owned motor vehicles and trailers for use on public roads not owned or used for commercial purposes including the following, singularly or in any combination: Auto Liability, Personal Injury Protection (PIP), Medical Payments (MP), Uninsured/Underinsured (UM/UIM); Specified Causes of Loss, Comprehensive, and Collision. Also includes motorcycle and recreational vehicles (RV).

### Products Liability

Coverage for losses or injuries caused by defect or malfunction of the product.

continued

### Surplus Lines

Property/casualty insurance coverage that isn't available from state-licensed/admitted insurers must be purchased from a non-admitted carrier (surplus lines insurer). Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies.

### Workers Compensation

Insurance that covers an employer's liability for injuries, disability or death to persons in their employment, without regard to fault, as prescribed by state or federal workers' compensation laws and other statutes. Coverage may include payments for medical care, physical rehabilitation, and lost wages.

## Reinsurance

The systemic risk exposure generally follows the level associated with the line of coverage generating the risk being ceded. This can change based upon the allocated capital driven-underwriting capacity of the respective reinsurance market.

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June 5, 2009

The Honorable Lawrence H. Summers
Director of the National Economic Council
and Assistant to the President for Economic Policy
The White House
Washington, D.C. 20500

Dear Dr. Summers,

The American Insurance Association (AIA) and its property-casualty insurance member companies are pleased the Administration has made financial services regulatory modernization a high priority. As the Administration considers how to solidify the U.S. financial services regulatory structure to restore consumer confidence and to position U.S. companies to compete more effectively both at home and abroad, we strongly urge you to recommend Congressional enactment of federal insurance charter legislation. Federal charter legislation, patterned after the National Insurance Consumer Protection Act recently introduced by Representatives Melissa Bean (D-IL) and Ed Royce (R-CA), will provide a more robust, smarter, and focused insurance regulatory alternative to current state-based regulation. Equally important, federal chartering legislation will address regulatory cracks that have been exposed during the current financial crisis.

Contrary to the arguments of those seeking to preserve and perhaps enhance the fragmented state regulatory franchise, AIA and its members are not seeking regulatory "arbitrage." In fact, the optional nature of federal chartering legislation was designed to preserve the viability of the state regulatory system for those insurance companies that do not operate on a multi-state, national, or global basis. We are interested, however, in a modern regulatory system nimble enough to evolve with the business models and operations of growing insurers, yet strong enough to focus on core consumer protections like institutional safety and soundness and market behavior. We are in need of a system that also recognizes that vigorous price and product competition provides consumers with leverage and protection that government regulation cannot replicate.

We also firmly believe that property-casualty insurance should be fully included in any federal chartering legislation. Property-casualty insurance is essential to the proper functioning of the U.S. economy. Insurance contributes 2.4% to the annual GDP and accounts for more than $535 billion in capital, purchasing nearly $370 billion in state and municipal bonds and employing 1.5 million Americans. Our products help families and businesses prepare for unforeseen events and spread risk, thus freeing up capital, spurring growth and innovation, and creating new jobs.

Though property-casualty insurance is critical to the economy, our industry does not pose the same type of systemic risk as other financial service sectors. This is predominantly due to the fact that property-casualty insurance companies are generally low-leveraged businesses with lower asset-to-capital ratios than other financial institutions, more conservative investment portfolios, and more predictable cash outflows that are tied to insurance claims, rather than on-demand access to assets.

Nonetheless, our industry can always face huge, unforeseen, multi-billion dollar loss events such as a widespread natural disaster or another terrorist attack on U.S. soil. As a result, a federal insurance regulator would supply national policy leadership and enhance preparedness for times of crisis and catastrophe, while providing needed insurance expertise as part of a well-constructed federal program to analyze, manage and minimize systemic risk.

Establishing an independent federal insurance regulator would also offer the national supervisory authority that is needed to close regulatory gaps that are inextricably part of a state-by-state regulatory structure. Each state only has jurisdiction to address those companies under its regulatory control, and only to the extent of that control. Even where the states have identical insurance codes or regulations, the regulatory outcomes may still be inconsistent because of diverse political environments and regulatory interests. If this crisis has revealed anything, it is the need for more – not less – regulatory efficiency, coordinated activity or tracking, sophisticated analysis of market trends and the capacity to anticipate and deal with potential systemic risk before the crisis is at hand.

The inherent limitations of the state-based insurance regulatory framework are magnified at the global level, where foreign countries cannot turn to a single U.S. insurance regulator with authority to follow through on international commitments. If we are to coordinate with other nations and their financial regulators to address global crises like the current one, we need a single insurance voice at the federal level to do so.

Thank you for taking these views into consideration. We stand ready to work with you to develop a federal regulatory system that addresses our industry's challenges and restores confidence in our financial system.

Sincerely,

Leigh Ann Pusey
President & Chief Executive Officer

CC: The Honorable Timothy F. Geithner, Secretary of the Treasury

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