# Testimony of the New York State Insurance Department

Before the
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
United States House of Representatives

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Bond Insurance

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I would like to thank Chairman Kanjorski, Ranking Member Pryce and the other members of the Capital Markets Subcommittee of the House Financial Services Committee for allowing me to testify today.

My name is Eric Dinallo and I am New York State Insurance Superintendent.

You have already heard Governor Spitzer discuss the broader issues around bond insurance. Last week I provided a letter that gave detailed answers to some important questions from you office, which I trust was helpful. Now, I would like to review what the New York State Insurance Department has done and is doing. As the primary regulator of this industry, we have a unique perspective.

As insurance regulators, it is our responsibility to protect policyholders and ensure a healthy, competitive market for insurance products. In the case of bond insurance, there are two main groups of policyholders. There are the municipal governments who bought insurance for the bonds they issued and by extension the investors who bought those bonds. Then there are the banks and investment banks who bought insurance for the structured securities, including mortgage-backed securities.

The best way to protect all the policyholders is to preserve the triple-A ratings of some of the bond insurers. So we have been attempting to facilitate additions to the capital strength of the bond insurers, not for their own sake, but to protect first policyholders and second the markets and broader economy.

This is an extraordinarily difficult problem. Every single bond insurer is in a different situation with different strengths and weaknesses. They each have a different group of investors and owners, who have different views. They each must deal with a different set of counterparties; that is banks, broker dealers and investment banks, each of which has a different level of exposure. And there are different potential outside investors with differing types of offers.

Absent a government bailout, which is not planned, it is up to each of these insurers and their counterparties to come to an agreement. This is difficult for some obvious reasons. There are billions of dollars at stake. And there is no agreement on, and indeed no way to know with certainty, just how big the losses from the subprime market will be.

That said, we are working hard with all parties to reach agreements.

This is part of our three-point plan, which, as publicly stated first on January 9th, is:

First, bring in new capital and capacity. We invited Berkshire Hathaway to open a new bond insurer in New York, licensed it in record time and worked with the NAIC to help the company get licenses in all 50 states. In November the Insurance Department approved a $1.5 billion capital infusion into CIFG. We approved MBIA's capital raising plan in record time. Just last week MBIA raised $1 billion in an oversubscribed public offering. The company has now added a total of $2.5 billion in capital in the last two

months.

Second, we are seeking a broader solution by working with all parties, the insurers, banks, financial advisors, private equity investors, rating agencies and federal officials. At the moment, that means facilitating efforts to strengthen each individual bond insurer, while also including plans to deal with possibly chronically distressed companies.

Third, we are working on rewriting the regulations for bond insurance to prevent companies from taking on inappropriate risk in the future, while not discouraging the financial creativity that is essential to maintaining our position as the world financial capital. As part of this effort, we continue to discuss many issues with a wide variety of interested parties, and we have already made significant progress toward new regulations that will govern this industry going forward.

While we are doing all that we can to protect all policy holders and strengthen the bond insurers, if it becomes clear that is not possible, our first priority will be to protect the municipal bondholders and issuers. We cannot allow the millions of individual Americans who invested in what was a low-risk investment lose money because of subprime excesses. Nor should subprime problems cause taxpayers to unnecessarily pay more to borrow for essential capital projects.

We have been actively discussing all of the options with the bond insurers and, if necessary, we will consider allowing the bond insurers to split themselves into two companies. One would have the municipal bond policies and any other healthy parts of the business. And there is no reason to believe that this cannot be a healthy business. The other would have the structured finance and problem parts of the business.

We would ensure that the funds paid by municipal governments would go to support their insurance, and not pay for the problems in structured finance. We believe that this plan could produce enough capital to preserve the ratings of and provide protection for the municipal bonds.

It was to ensure a safety net for the municipal bonds that over the Martin Luther King Day weekend in January we asked Berkshire Hathaway to price the entire municipal bond portfolio of the three largest bond insurers. Earlier this month, Berkshire sent its proposal to the three companies. I believe that there may be other investors who would be interested in investing in the municipal side of the business.

In the course of my testimony so far I have made two assumptions I ought to stop and address.

First, I have been assuming that credit ratings will continue to play an important part in the financial markets. There has been much criticism of the performance of the rating agencies and it is other's responsibility to oversee rating agencies and determine what reforms are needed. But we cannot forget that they play an essential role, if they are doing their job properly, of providing information that makes markets more efficient. It's

not practical for every investor to fully vet every issuer of every stock and bond. The issue now is how to ensure that rating information is accurate, credible and that conflicts are managed properly.

Second, the Insurance Department is working to maintain a healthy competitive market in bond insurance because it is our job to make sure there is a market for the insurance that individuals, companies and governments want and need. Now, some muni issuers have decided they no longer need insurance and there are questions about the accuracy of municipal bond ratings.

Time and the market will determine the how much municipal bond insurance is needed. An AAA rating gives municipal bonds the broadest possible distribution among investors. There is more demand for top-rated AAA securities than supply. Again, it is difficult for investors to fully vet the many small public sector issuers. It is likely that a substantial number of government issuers will want the reduced cost of borrowing that a higher rating produces. Project finance, with its one-time or relatively short-lived issuers, is another area where bond insurance makes sense. We have invited in new companies and will work to make sure bond insurance is available to the government issuers that need it.

As to the future, we have just begun to study how to improve regulation in this area. Our main focus is on the need for immediate action to limit the damage. However, we can offer some broad comments now, with the understanding that we expect to develop more specific proposals soon.

The primary goal of insurance regulation with respect to financial oversight is to ensure that the insurer maintains an adequate level of solvency and is able to honor policyholders' claims. The business model for the financial guaranty insurance companies, however, requires that they hold levels of capital that will allow them to maintain the AAA rating necessary to write new business.

It has become clear that the loss of the AAA rating essentially cripples the company's ability to do business as a going concern and puts the insurer in a "run-off' mode. We now are considering whether the sustainability of the business model should be the regulatory standard going forward. While we of course consider claims paying ability as the benchmark, our goal for the future, for all insurers, is to do higher level risk-based examinations.

Financial guaranty insurance is a complicated business, which is largely based on modeling and underwriting of complex capital market instruments. Total reliance on the rating agencies is not prudent. Rather an independent analysis by regulators of risk positions by FGIs could be more appropriate. It would also require greater transparency between the bond insurers and their regulator, by which I mean, more information and oversight regarding the nature of the risks being insured.

Within the current regulatory framework, other steps can be taken to restrict the FGIs' financial leverage to better protect their solvency, and to restrict activities around products that may be too volatile going forward; for example, guaranties of the CDO squared transactions.

We welcome any suggestions about how to improve our regulations.

I welcome your questions.