Introductory Oral 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:
"Perspectives on Systemic Risk"

Thursday, March 5, 2009

Therese M. Vaughan, Ph.D.
Chief Executive Officer
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 perspectives on systemic risk.

My name is Therese Vaughan. I am the Chief Executive Officer of the National Association of Insurance Commissioners (NAIC). Prior to joining the NAIC, I was a Professor of Insurance and Actuarial Science at Drake University where I focused on the management and regulation of financial institutions. I also served as the Iowa Insurance Commissioner from 1994 to 2004, and NAIC president in 2002. I am pleased to be here today to

discuss the NAIC's activities in the area of financial stability regulation, and to offer our assistance and expertise as the Committee tackles the enormous challenge of developing legislative solutions to the current financial crisis.

The NAIC is a full partner with Congress and the Administration in seeking ways to improve the financial regulatory system and promoting financial stability. The state-based insurance regulatory system is one of critical checks and balances. We have a long history of consumer protection, conservative solvency oversight and market stability, so any system of financial stability regulation can, and must, build on this proven regime.

While the current financial crisis illuminates the need for review of regulatory oversight, consumer protections and prudent solvency oversight must not be compromised in the effort to improve or enhance financial stability.

In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it.

The nature of the insurance market and its regulatory structure make the possibility of systemic risk originating in the industry less than in other financial industries. The insurance industry is more likely to be the recipient of systemic risk from other economic agents rather than the driving force that creates systemic risk.

Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant. If the largest auto insurer in the U.S. were to fail, its policyholders would be quickly absorbed by other insurers, and backed up further by the state guaranty fund system. This would not pose systemic risk – as the impact is isolated, does not ripple to other financial sectors and does not require extraordinary intervention to mitigate.

Risks in insurance are different from bank risks for three reasons. First, insurers tend to be less leveraged than banks. Second, insurers tend to have liabilities that are different from those of banks – generally independent of economic cycles. Third, insurers tend to have a longer time horizon. They typically do not have to sell assets on a regular basis to meet short-term demands.

An insurance business having special interconnectedness to capital markets may be capable of generating systemic risk, however. The financial and mortgage guaranty lines have been stressed because of their coverage of mortgage-related securities.

As has been well documented, large complex financial institutions with insurance operations – like AIG – have produced systemic risks within the economy. The insurance businesses in these holding companies have thus far been adequately protected by state insurance regulations.

State insurance regulators recognize that action is needed at the federal level to identify and manage systemic risk within the nation's financial marketplace. That should not be misconstrued, however, as simple acquiescence on our part to federal preemption.

Recognizing the critical need for action in this area, the NAIC has developed a series of principles for systemic risk regulation as it relates to insurance, which we believe must be incorporated into any comprehensive systemic risk system. Our principles recognize that greater collaboration among financial services regulators is needed, preserving the principle 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.

In consultation with functional regulators, any financial stability regulator should develop best practices for systemic risk management.

Preemption of functional regulatory authority, if ever appropriate or necessary, should be limited to extraordinary circumstances that present a material risk to the continued solvency of the holding company or threaten the stability of a financial system.

For more than 150 years, state insurance regulators – working together with state legislators – have continued to improve, enhance and modernize state-based insurance regulation for the benefit of consumers and industry alike. We want to bring the best regulatory minds to bear on the challenges ahead and serve as your resource as you navigate and analyze the current financial landscape.

Thank you for the opportunity to testify, and I would be happy to answer your questions.

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Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for inviting me to testify before the Subcommittee on perspectives on systemic risk.

My name is Therese Vaughan. I am the Chief Executive Officer of the National Association of Insurance Commissioners (NAIC). Prior to joining the NAIC, I was a Professor of Insurance and Actuarial Science at Drake University where I focused on the management and regulation of financial institutions. I also served as the Iowa Insurance Commissioner from 1994 to 2004, and NAIC president in 2002. I am pleased to be here today to discuss the NAIC's activities in the area of regulatory modernization and financial stability regulation, and to offer our assistance and expertise as the Committee tackles the enormous challenge of developing legislative solutions to the current financial crisis.

Identifying Systemic Risk

Sustained stability in the financial sector requires seasoned regulators with the authority, expertise and resources to fulfill their responsibilities, and a commitment among all financial regulators to work collaboratively to construct a system-wide view of the financial sector. The current financial crisis illustrates the interconnectedness of our financial system, and the need to strengthen the interconnectedness of our regulatory system.

"Systemic risk" has become the moniker of choice in most current descriptions of potential threats to the economy. However, this is a term whose meaning has evolved over time. Early on in the discussion, the term "systemic risk" was essentially synonymous with "too big to fail." While the size, scope, or leverage of an organization can be contributing factors to whether it poses systemic risk, these criteria alone are too simplistic a characterization. There is a growing appreciation that the legislative and regulatory structure that has allowed for innovation and synergies between and among financial institutions and their subsidiaries has also created significant interconnectedness and linkages where capital and risk can flow. At the moment, I

would argue that the greatest systemic risk facing our economy is a lack of confidence of the American people in our financial system.

The Government Accountability Office (GAO) in a recent report defines systemic risk as "the risk that an event could broadly affect the entire financial system rather than just one or a few institutions." We would agree. In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it.

The nature of the insurance market and its regulatory structure make the possibility of systemic risk originating in the industry less than in other financial industries. In general, the insurance industry is more likely to be the recipient of systemic risk from other economic agents rather than the driving force that creates systemic risk.

There are several possible ways to look at systemic risk as it relates to the insurance industry. Among the issues to consider are whether systemic risk exists within a single insurer and the insurance industry as a whole, and whether systemic risk elsewhere in the economy could materially harm the insurance industry.

In terms of the size of individual firms, insurance markets in general are quite competitive and well functioning. Though large writers exist in certain lines and in some states, these insurers do not seem to qualify as "too big to fail." If an individual insurer were to fail, even an insurer with dominant market share, state guaranty funds would protect existing policyholders of the failed insurer by paying out claims. Other insurers would step forward in the marketplace to write the business left by the failing insurer. State residual markets are also available to write business. There may be short-term dislocations in the marketplace, but a major failure of an insurer will generally not create systemic risk within the insurance market or other elements of the overall economy. That is not to say that no stress would be felt by the market or consumers, but state regulations dealing with guaranty funds help alleviate the pain by protecting policyholders. In a competitive market, inefficient or unproductive firms are allowed to fail so that capital may find its way to more productive uses. In forming state guaranty funds, state regulators have considered the unique situation of an insurance policy being a future contract and the possible adverse effect on consumers.

Risks in insurance are different from bank risks for three reasons. First, insurers tend to be less leveraged than banks. This enables them to withstand financial stresses to a greater extent. In addition, strict rules on assets make insurers less vulnerable to declines in assets. Even in a situation that puts stress on policyholders and a line of business, it is unlikely that that strain will cascade to other areas of the economy.

Second, insurers tend to have liabilities that are different from those of banks. That is, the payment of the liabilities is generally independent of economic cycles. This makes a "run" on insurance companies unlikely compared to the situation with banks. Although annuity writers may experience a form of "run" by investors, it will likely be tempered by the existence of surrender fees. In an economic downturn, there will be some loss in demand for insurance policies, but in general, demand is relatively inelastic among insurers. That means cash flow is more likely to stay positive for insurance companies.

Third, and related to their unique liabilities, insurers tend to have a longer time horizon. They do not have to sell assets on a regular basis to meet short-term demands.

An insurance business having special interconnectedness to capital markets may be capable of generating systemic risk, however. The financial and mortgage guaranty lines have been stressed because of their coverage of mortgage-related securities. Those losses have negatively affected the availability of public sector and mortgage loan financing. The resulting situation has created a ripple effect where internal insurance losses resulting from a poor housing environment continue to further negatively impact the housing and mortgage sectors.

As has been well documented, large complex financial institutions with insurance operations have produced systemic risks within the economy. The insurance businesses in these holding companies have thus far been adequately protected by state insurance regulations. Nonetheless, the public may not differentiate between the instability in the holding companies and the relative stability of the insurance obligations, thus having the potential to create a flight by policyholders away from the insurance company.

Systemic risks originating in other parts of the overall economy, which in turn affect the insurance industry, are real. A collapse of the stock market (to a greater degree than what we have recently seen) or the bond market would have a dire effect on insurance companies and

could lead to insurance company failures. A collapse of the dollar and rampant inflation would increase claims costs for property and casualty insurers. A mixture of high inflation and a declining economy (stagflation) and low investment returns could create a perfect storm for all aspects of the economy. No system of regulation, no matter how good, can ensure that insolvencies will not occur in an extreme tail event. What it can do is protect consumers when that event occurs.

Promoting Financial Stability

State insurance regulators recognize that action is needed at the federal level to identify and manage systemic risk within the nation's financial marketplace. That shared objective calls for a collaborative approach to the regulation of financial enterprises that create true systemic risk. We caution, however, that our willingness to collaborate should not be misconstrued as simple acquiescence to federal preemption. Under our supervision, insurance companies have weathered these extraordinary economic times relatively well while coping with catastrophic storms and a challenging marketplace. Our conservative solvency standards and accounting guidance have been validated by these events, and the record of state insurance regulation proves that we have earned an equal seat at the table.

In addition to consideration of financial stability or systemic risk regulation, Congress should also consider regulatory safeguards and imposing greater transparency in the capital markets so that financial products or interactions that pose systemic risk can be identified. The magnitude of the credit default swap (CDS) market illustrates this reality.

Principles for Systemic Risk Regulation

State insurance regulators have been analyzing the potential for systemic risk within the insurance industry, particularly regarding the oversight of financial holding companies, and we look forward to contributing to the solutions being sought by Congress and the Administration. We have developed a series of principles for systemic risk regulation, as it relates to insurance, that we believe must be incorporated into any comprehensive systemic risk system. Our principles recognize that greater collaboration among financial services regulators is needed while securing and maintaining existing expertise through preservation of the principle of functional regulation.

1. Primary Role for States in Insurance Regulation

Any framework established to regulate financial stability must integrate, but not displace, the successful state-based system of insurance regulation. The nation's insurance markets represent an island of relative stability in an otherwise chaotic and troubled financial sea, and that is due to the strong solvency protections implemented and enforced by the states.

Consumer access to state-based, local regulatory officials must be maintained as part of any systemic risk regulatory system that is established. That local access, which exists in the current system of state insurance regulation, is the bulwark of consumer protection. State insurance regulators are on the front lines in resolving approximately three million consumer inquiries and complaints every year and that daily attention to the needs of individuals and businesses must be maintained in any reform effort. While state insurance regulators are concerned that insurers are profitable and provide a reasonable return for investors, the focus of insurance regulation is protection of policyholders and claimants. It is the forward-looking nature of insurance that compels regulators to make sure that sufficient funds are available to respond to consumers' needs when they arise.

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. This will ensure that all financial services regulators are on equal footing in access to needed information, and will help mitigate regulatory arbitrage.

2. Formalization of Regulatory Cooperation and Communication

Federal financial stability regulation should ensure effective coordination, collaboration and communication among the various and relevant state and federal financial regulators, and should ensure such coordination among all such regulators in the United States. Formal structures should be enhanced or introduced to provide a forum for all financial regulators to consult about emerging issues and trends, allowing early identification and action on issues potentially affecting the larger economy.

In consultation with functional regulators, any financial stability regulator should develop best practices for systemic 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 13,000 people working in state and territorial insurance departments.

3. Group Supervision of Holding Companies

Preemption of functional regulatory authority, if ever appropriate or necessary, should be limited to extraordinary circumstances that present a material risk to the continued solvency of the holding company (or "enterprise") or threaten the stability of a financial system. In considering the systemic risk posed by large institutions or holding company structures, the concept of "supervisory colleges" should be used 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.

Federal 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. Accordingly, they require the greatest care and expertise.

Where state insurance regulation is concerned specifically, preemption of state regulatory authority should take place, if at all, only under limited circumstances where there is material risk to the financial system, only to the extent necessary to meet obligations to policyholders and claimants, and only where state regulatory authority to act has been exhausted. Preemption should never occur for its own sake. There is great benefit to having multiple sets of eyes looking at an institution, such as exists with the current state-based insurance regulatory system. Preempting – and putting a single federal regulator in charge – would take away the crucial failsafe of allowing real and potential oversights by one regulator to be spotted and corrected by others.

Systemic Risk in Insurance

Insurance companies are more often the receivers or conduit of risk than the creators – the assumption of risk, after all, is their fundamental business. The same is true of systemic risk, which provides ample motivation for us to want to close regulatory gaps to encourage greater financial stability. Insurers' exposure to systemic risk typically flows from linkages to the capital markets. A classic example is AIG, where the unregulated credit default swap (CDS) transactions impaired the holding company, resulting in a downgrade which has 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. This activity resulted in a liquidity crunch when a massive deterioration in the value of traditionally conservative, fixed income securities resulted in AIG's counterparties all attempting to exit the marketplace at roughly the same time. No company or regulator operates so conservatively as to withstand such a "run on the bank" scenario, but financial stability regulation can ensure that such scenarios are identified and mitigated before they become systemic.

Insurance can also illustrate the difference between systemic risk and the risk of large failures. Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant. For example, if the largest auto insurer in the U.S. fails, its policyholders can be quickly absorbed by other insurers, and they are backed up further by the state guaranty fund system. This scenario does not pose systemic risk – as the impact is isolated, does not ripple to other financial sectors and does not require extraordinary intervention to mitigate. Any system of financial stability regulation should focus on truly systemic risk, and not create redundant mechanisms for dealing with isolated disruptions.

Conclusion

The NAIC is a full partner with Congress and the Administration in seeking ways to improve the financial regulatory system and promoting financial stability. The state-based insurance regulatory system is one of critical checks and balances, where the perils of a single point of failure and omnipotent decision making are eliminated. We have a long history of consumer protection, conservative solvency oversight, and market stability, so any system of financial stability regulation can, and must, build on this proven regime.

Thank you for the opportunity to testify, and I would be happy to answer your questions.