Testimony of the
National Association of Insurance Commissioners

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Government Sponsored Enterprises
Committee on Financial Services
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Michael T. McRaith
Director of Insurance
State of Illinois
On Behalf of the National Association of Insurance Commissioners

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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 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.