Property Casualty Insurers Association of America

Shaping the Future of American Insurance

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Chairman Dodd, Ranking Member Shelby, and other Members, PCI appreciates the invitation to provide testimony for the hearing on "Perspectives on Modernizing Insurance Regulation." PCI is the leading property-casualty trade association representing more than 1,000 insurers of all different lines and sizes.

Last fall, PCI formed a special board committee of 14 CEOs who spent a significant amount of time developing a responsive and responsible proposal to restore investor confidence and prevent another economic crisis from reoccurring. The details of this proposal have been previously provided but are further summarized below with some suggestions for additional legislative inquiry.

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. Simply stated – if the government has to step in to bail out a company to protect the larger economy, that is a systemic risk.

Traditional antitrust analysis focused on "Too Big to Fail," using the Herfindahl-Hirschman Index for market concentration. Recent government intervention decisions, however, have shifted towards "Too Interconnected to Fail" (TICTF). TICTF is measured by the degree a company's activities are leveraged throughout the economy such that its impairment would cause additional failures; and the extent to which its failure risk is correlated with other systemic downturns. For example, failure of a large auto insurer would not require significant deleveraging by hedge funds and other third parties and would not create a ripple effect of supply company failures. Its market share would be quickly absorbed by competitors, policyholders are protected by guaranty funds, and the number of auto accidents does not increase in a recession. Conversely, some small credit default swap and financial guaranty providers have highly leveraged counter-parties and their impairment can freeze related capital markets; recessions increase their likelihood of default, and their default or impairment further exacerbates the downward systemic cycle. Thus, the critical measure is not size, but rather the amount of interconnectedness with the larger economy that creates systemic risk.

The Gramm-Leach-Bliley Act made the Federal Reserve Board the systemic risk umbrella supervisor for financial holding companies. PCI proposes extending this existing oversight more broadly to all systemically risky financial entities. While PCI shares reservations with many Members of Congress about giving the Board too much authority or compromising its core mission, the Board has the greatest institutional expertise and oversight over market stability of any existing agency, and the independence necessary to minimize political pressures that might exacerbate systemic cycles. However, the Federal Reserve Board's systemic risk oversight should be completely separate from its other bank holding company responsibilities.

The Board's systemic risk powers should be flexible and include the authority to require the following:

1. Appropriate **transparency and disclosure** to the Board for all entities engaged in activities that create systemic risk beyond incidental or de minimus amounts to allow the Board to monitor marketplace movements;
2. Escalating **information sharing** about a holding company's financial statements and transactions among the Board, other U.S., and international overseers as the company's level of systemically risky activities increase;
3. Scalable **risk management standards** for specific entities whose financial activities present a significant systemic risk; and
4. **Coordinated resolution** of failed systemically risky entities, including resolution of holding company financial subsidiaries without a primary functional regulator.

However, systemic risk oversight powers would not include the following:

1. Solvency oversight for individual companies;
2. Business conduct oversight, such as licensing, market conduct, or product approval;
3. Duplicative disclosure or information requirements;
4. General federal compliance, such as privacy standards; and
5. Other elements of bank holding company oversight.

Risk management standards should increase with systemic risk, and should include:

1. Establishing standards for holding company capital and group risk management;
2. Monitoring of affiliate transactions and significant off-balance sheet obligations;
3. Collecting and sharing information related to group systemic risk and holding company solvency;
4. Requiring coordination of examinations and visits regarding systemic risk; and
5. Eliminating duplicative oversight of holding companies.

PCI proposes increasing coordination to detect financial fraud and improve early risk monitoring through enactment of the Financial Services Antifraud Network that passed the House in 2001. This legislation would also maintain confidentiality and privilege protections as company financial information is shared among regulators. PCI also proposes requiring the Presidential Working Group on Financial Markets to implement limited information sharing coordination and protocols with international overseers regarding potential threats to cross-border market stability.

This systemic risk oversight framework fills the current gaps and loopholes in existing law without necessitating the creation of new bureaucracies or radically changing the financial regulatory structure. Implementation would, however, help restore investor confidence in our marketplace, reduce the likelihood of this crisis reoccurring, and provide an orderly, predictable process for managing risk failures to minimize moral hazard and taxpayer exposures.

Detailed documents analyzing systemic risk are attached and can be found with supporting documentation on the PCI website at www.pciaa.net/reg-reform.

Additional Background on Systemic Risk

Health of the Property-Casualty Industry

Last year, there were no significant property-casualty insolvencies despite suffering the fourth most expensive hurricane in our history and the greatest market crash in half a century. The vast majority of industry credit ratings were stable last year, with AM Best actually announcing more property-casualty rating upgrades than downgrades and continuing to rate the industry as stable for 2009. The surplus that stands behind our policies remains at relatively strong and historically high levels and almost all segments of the property casualty marketplace remain stable and sound. Unlike the capital and credit markets, insurance operations have proceeded uninterrupted. The historical level of insolvencies in the p/c industry over the last several decades as a percentage of industry assets continues to be lower than that of the banks and far lower than that of the perennially troubled thrift industry. Property-casualty insurer failures are also relatively uncorrelated with larger economic downturns, unlike other financial segments. That is why PCI has reiterated publicly that our industry neither needs nor wants federal bailouts or assistance for insurance operations.

Our industry has suffered deeply from this crisis, however, in the same manner as any other American consumer – significant investment losses and decline in economic activity. Unlike many other financial providers, we invest our own money. While we do so very conservatively without excess leveraging, we have the same interest Congress does in stabilizing the market and fixing the systemic risk regulatory gaps.

The Need for Systemic Risk Oversight

According to the Commerce Department, last quarter our country's GDP fell 6.2%, exports fell 23.6%, business and residential investment fell 19 and 22%, and aggregate equity losses are now estimated to exceed 40 trillion dollars, exceeding 2/3rds of last year's global GDP. Individual pensions have been decimated, unemployment and foreclosures have skyrocketed, consumer confidence has fallen to an all time low and we are expected to suffer the longest and deepest global economic contraction since the Great Depression.

The Government Accountability Office released a report this January stating that:

Significant reforms to the U.S. regulatory system are critically and urgently needed…. Regulators have struggled, and often failed, to mitigate the systemic risks posed by large and interconnected financial conglomerates and to ensure they adequately manage their risks. The portion of firms operating as conglomerates that cross financial sectors of banking, securities, and insurance increased significantly in recent years, but none of the regulators is tasked with assessing the risks posed across the entire financial system…. The current system has important weaknesses that, if not addressed, will continue to expose the nation's financial system to serious risks.

Former Federal Reserve Board Chairman Greenspan admitted to Congress that the current crisis was caused in part by the failure of financial institutions to monitor and manage their capital and risk positions, and the failure of our existing regulatory system to limit such risks. Congress created systemic risk oversight in the Gramm-Leach-Bliley Act in 1999. According to Governor Laurence Meyer in a speech immediately following GLBA's enactment:

the Board will need to focus on "the systemic risks posed by large, complex, and diversified financial services companies [while having] to avoid imposing an excessive or duplicative regulatory burden and avoid creating a false impression that the benefits of the federal safety net extend to nonbank activities….We must be cautious, however, in assuming that the more diversified banking organizations will be inherently less risky and hence less likely to be a source of systemic risk. Past experience with consolidation in banking and geographic diversification suggests that banking organizations often use the benefit gained from diversification to increase the risk of individual components of their portfolios….What remains clear, however, is that appropriate disclosure and strong risk-management practices will become even more important in the years ahead, especially for larger banking organizations…. These challenges will require a new relationship between the Federal Reserve and the functional regulators of banks' insurance and securities affiliates. And they will place a premium on cooperation and appropriate information sharing [with] the Federal Reserve as umbrella supervisor…."

Ironically, ten years ago the Board described exactly what needed to be done and the course that led to our failure.

So what went wrong? The Board was given systemic risk oversight only over financial holding companies, not thrifts or thrift holding companies such as IndyMac, Countrywide, Merrill Lynch, and Washington Mutual; not investment bank holding companies such as Lehman Brothers or Bear Stearns; and not other entities such as derivatives firms not subject to GLBA systemic risk oversight. Not only did systemic risk oversight apply to a too-limited universe of entities, but the focus was on the risk of other affiliates to the bank and the systemic risk of the banks to the larger economy. We now understand that systemic risk is not solely bank-centric. Greenspan now admits that the risk models created were inadequate, particularly to guard against irrational systemic behaviors. And the need for institutionalized and systematic information sharing envisioned at the time was never adequately realized.

These are the precise gaps that need to be addressed, and that can be fixed with minimal unintended consequences using the existing regulatory structure, freeing Congress to then move onto the next phase of carefully and thoughtfully reviewing larger regulatory restructuring issues. The Federal Reserve Board already sets consolidated capital requirements, monitors affiliate transactions, and guards against systemic risks. As required under GLBA, it also relies on the primary regulators, such as the SEC and state insurance regulators, to oversee the solvency and business conduct of the individual subsidiaries and to pass along critical information. Solving the systemic risk crisis does not require a vast new bureaucracy or radical restructuring of our regulatory system. It does require plugging the loopholes and refocusing the existing system of holding company systemic risk regulation, that in hindsight was clearly too limited. Congress can ensure that a strengthened systemic risk overseer and information sharing system is neither duplicative nor optional, and works in tandem with the existing primary functional regulators.

Systemic Risk v Solvency

Solvency regulation plays a very separate and distinct role from systemic risk oversight, although the public discussion is sometimes blurred as part of a "Super-Size Us" regulatory agenda. Solvency regulation is intended to minimize failure by individual financial subsidiaries. It focuses on: (1) ensuring a financial company has enough capital to fulfill its promises and (2) limiting individual consumers' losses from failed financial companies. In insurance, it protects the policyholder; in banking, the deposit holder; and in the securities industry, the investor. Each financial industry has certain solvency requirements that reduce the likelihood a financial company will fail to fulfill its promise, and a consumer protection fund (GF, FDIC, SIPC) that limits certain consumer losses from such failures. Solvency regulation is currently conducted by the functional regulators separately in each marketplace.

Systemic risk regulation is macro oversight by the Federal Reserve Board to prevent a failure from contaminating other markets and the larger economy. It ensures that when failures do occur, the holding company has adequate risk management and capital to contain the failure and to allow resolution of the failure in an orderly and predictable manner without spreading to other industries and the global economy. Solvency regulation is conducted by the primary functional regulator for each subsidiary to avoid its failure. Systemic risk regulation is conducted by the consolidated umbrella supervisor to control the contagion affect of subsidiary failures when they occur.

This distinction was enshrined in current law by GLBA, with the Board overseeing systemic risk to a limited extent and relying on the primary/functional regulators to oversee solvency. The distinction is also recognized in the Treasury Blueprint's recommendation that Congress should separate systemic risk oversight and solvency into separate regulatory compartments. Confusion of these concepts led the debate back towards the "Super-Size Us" approach and the potential creation of omnibus regulators that are Too Big to Fail and too unwieldy not to fail.

Moral Hazard

Federal Reserve Board Vice Chairman Kohn testified at the end of your March 5th Committee hearing that "The US government is on record saying that it will not countenance, it will not allow, a disorderly failure of a systemically risk institution." The lack of a robust systemic risk oversight system to manage failures of companies that are Too Interconnected to Fail has created an enormous moral hazard that will continue to expose taxpayers to massive liabilities until corrected. Irrational exuberance and the attendant booms and busts of the economic cycle are inevitable and the government cannot and should not eliminate risk innovation and the ability to fail. Systemic risk oversight must allow failure, by creating an orderly resolution process with risk management protections imposed in advance that minimize the public costs. This will reduce any notion of an implicit government guaranty. PCI also proposes to allow companies to voluntarily submit to Board systemic risk oversight. This is critical not only for international equivalency regulation purposes, but also to avoid moral hazard should the marketplace place a greater benefit than cost on additional federal oversight. PCI has also suggested that systemic risk oversight be scalable, so that the standards become increasingly protective as a company's activities make it more systemically risky, such that the marketplace can balance the increased perceived risk level and regulatory costs with the increased oversight.

<u>Additional Research Needed</u>

PCI has spent the last several months working intensively on systemic risk and regulatory restructuring frameworks in order to be responsive to Congressional imperatives. However, there are several areas of inquiry we suggest your Committee may still wish to consider pursuing:

(1) Historical Systemic Risk Analysis: While the Board's systemic risk analysis needs to be flexible and principles based, there are several potential historical measurements that could provide the Committee with more insight in providing guidance. For example, the contraction of supply in the marketplace after a company fails may be a good indicator of interconnectedness for each of the industries – when a derivatives firm fails, how did that impact the supply of capital in other markets? When a bank fails, how did that affect the credit markets? The Committee may wish to consider and build upon the data that PCI has been developing on average failure rates in each industry and their failure correlation with economic downturns. For example, from 1934 (earliest available) through 1979, the FDIC reports bank failures (including those with assistance transactions) of $9.17 billion in assets. In the last 5 quarters alone, there have been 42 banking failures involving almost $1.7 trillion in assets. From 1980-2008, bank failures as an annual percentage of industry assets have averaged 0.65%, while thrift failures have averaged 3.19%. The failure rate of property-casualty companies during the first part of that period was only 0.27% according to CBO. Interestingly, the failure/assistance rate of property-casualty insurers during peak financial crisis in 1991 and 2008 is less than 0.1% of industry assets. This contrasts with comparable rates for banks and thrifts in 1991 of 1.8% and 8.67% and several times that level for banks and thrifts in 2008.

(2) Federal Reserve Board Authority: While the Board is currently a systemic risk regulator for financial holding companies, Vice Chairman Kohn admitted in his recent testimony that the Board was perhaps stretching its authority somewhat in some of its dedicated responses to the current crisis. GLBA's Fed-lite authority focuses on allowing the Board to identify bank related systemic risks and require corrective actions within 180 days or order a divestiture of the banking subsidiaries. The Board's powers with respect to other bank holding companies are broader and the Board has additional emergency authority in unusual and exigent circumstances. This Committee might consider delineating much more specifically the Board's corrective powers with respect to broader systemic risk oversight and to make it less bank-centric.

(3) Resolution coordination between the Board and the primary regulators: The boundaries between the Board and the primary functional regulators are somewhat unclear when

the government effectively owns or manages a company. The Committee may wish to consider carefully delineating the resolution authority of various regulators when a company fails, to address potential conflicts and ensure additionally that the systemic risk regulator has adequate authority to provide an orderly failure resolution for subsidiaries without a solvency regulator.

Timing of Reform

Regulatory adjustments in our financial system can have enormous unintended and dangerous consequences, as we recently learned with the changes of mark-to-market accounting rules. Congress needs to carefully plan the first phase of regulatory reform and perform the necessary due diligence to ensure any reforms are creating more certainty and result in more investor confidence rather than less. Congress will not have time or the resources to focus on all necessary reforms at once. The most critical reform that Congress can work towards, and the clear breakdown that allowed the current crisis to occur, is systemic risk oversight. This is also the area with broadest agreement where consensus is possible and it can be accomplished without necessitating a new bureaucracy or major transfer of power. PCI hopes that the Committee will focus first on this most critical phase of reform and gather the necessary information to carefully shape and complete this key foundational restructuring before building out the individual industry regulation rooms.

PCI's Commitment to Responsible Cooperation

PCI is committed to working with this Committee and the Congress on market stability reforms, and to be responsive and responsible in helping the Committee address its needs as this process evolves. We appreciate this opportunity to present testimony on our systemic risk framework to the Committee.

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Systemic Risk Oversight Proposal

Systemic Risk Definition (abbreviated)	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.
Overseer	The Federal Reserve Board should be the systemic risk overseer. It has the appropriate institutional culture, mission, and expertise. However, the FRB's systemic risk oversight should be completely separate from its other bank holding company oversight powers.
Oversight 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 oversight (e.g., typically for international equivalency treatment).
Oversight Powers	Authority to require: (1) Appropriate transparency and disclosure to overseers for all entities within the regulatory jurisdiction. (2) Coordination with other US and international overseers. (3) Risk management for systemic risk for specific entities whose financial activities present a significant systemic risk. Systemic risk oversight should not include: • Solvency oversight for individual companies. • Business conduct oversight (licensing, market conduct, product approval). • Duplicative disclosure or transparency information requirements. • General federal compliance (with privacy standards, etc.). • Other elements of bank holding company oversight.

Oversight of Risk Management	Systemic risk oversight standards might consist of: • Overseeing 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 oversight of holding companies.
Authority to coordinate with international oversight	Greater global financial harmonization is necessary to prevent global regulatory arbitrage. The FRB should coordinate systemic risk standards within its jurisdiction with international overseers after a full public review, including an examination of the effects on small companies. The overseer should not delegate oversight, and should retain the ability to provide exceptions or withdraw its deferral or mutual recognition as necessary.

For more information, please go to: www.pciaa.net/reg-reform.

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Regulatory Distinctions between Solvency and Systemic Risk Regulation

- Solvency measures whether a company has enough capital to meet its obligations. Solvency regulation is focused on (1) ensuring a financial company has enough capital to fulfill its promises and (2) limiting individual consumers' losses from failed financial companies. In insurance, it protects the policyholder; in banking, the deposit holder; and in securities, the investor. Each financial industry has certain solvency requirements that reduce the likelihood a financial company will fail to fulfill its promise, and a consumer protection fund (GF, FDIC, SIPC) that limits certain consumer losses from such failures. Solvency regulation is currently conducted by the functional regulators separately in each marketplace.

- Systemic risk measures the likelihood and the degree that a company's activities will negatively affect the larger economy, requiring federal intervention to mitigate the effects. Systemic risk regulation is focused on protecting the economy from major failures of mostly holding companies.

- While solvency regulation focuses on individual financial consumers within each marketplace (micro), systemic risk regulation focuses on limiting the spread of failure risks from one market segment to other industries and the global economy (macro). Solvency regulation is conducted by the primary functional regulator for each subsidiary. Systemic risk regulation is conducted by consolidated umbrella supervisors.

- The Gramm-Leach-Bliley Act (GLBA) created limited umbrella systemic risk regulation for financial holding companies (FHC). Insurance and securities activities can be conducted in the same holding company as banking only if the depository subsidiaries are well managed and capitalized and meet certain credit-rating thresholds. According to the Federal Reserve Board (FRB), which oversees FHC regulation, it supervises the consolidated organization, monitoring "the systemic risks posed by [FHCs]", while the OCC, FDIC, OTS, SEC, and state insurance regulators (the primary regulators) regulate each holding company subsidiary. The FRB oversees overall FHC risk-taking to judge how the parts and the whole may affect affiliated banks to avoid bank failures creating systemic risks to the economy.

- In theory, the FRB shares information with the primary regulators to protect against systemic risks while avoiding duplicative or excessive burdens. GLBA's "Fed-lite" provisions allow the FRB to examine and require reports from the FHC parent, but generally not the functionally regulated subsidiaries. FHCs that fail to meet FRB risk standards must enter into an agreement to correct the deficiencies. If not corrected within 180 days, FHCs may be required to divest all banking subsidiaries.

- There are several critical gaps in the current GLBA systemic risk oversight laws. GLBA focused FRB oversight on protecting banks from insurance/securities risks and resulting systemic risks from banks to the economy. However it did not address systemic risks flowing from non-bank subsidiaries to the economy, nor does GLBA allow FRB oversight of holding companies without banks (such as thrift, insurance, or investment bank holding companies). The FRB's risk management practices oversight may also need to be strengthened, to better account for broader market instability, liquidity risks, and enterprise risk-management.

- Solvency and systemic risk regulation are separate oversight regimes with distinct goals, standards, and remedies. Solvency regulation in each industry is being reexamined by functional regulators. However, the major vulnerability that allowed the current crisis and that needs to be quickly addressed to prevent its reoccurrence is a lack of broader systemic risk regulation beyond the limited GLBA/FRB/FHC construct. Fixing GLBA's systemic risk regulation deficiencies can be easily enacted and implemented, using current models, without requiring changes in solvency regulation or responsibilities.

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Information Sharing Proposal

<u>Needs</u>

- Increase oversight of holding companies by promoting cross-industry information sharing between and among various financial services overseers, both nationally and internationally, to detect potential problems earlier and help avoid another meltdown.
- Increase coordination of oversight efforts to prevent and detect financial fraud, both domestically and internationally.

<u>Holding Company Solvency Information Sharing</u>

- Require the Presidential Working Group (PWG) on financial markets to develop and implement a plan for information sharing coordination with international overseers regarding holding company solvency and potential threats to cross-border market stability 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 responsibilities, 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.
- Direct the overseers, pursuant to the PWG plan, to establish regular information sharing protocols and transfers with other domestic and foreign overseers, consistent with the above objectives, so that the lead overseer of a holding company collects and redistributes to the other relevant financial overseers appropriate information on the holding company's solvency.

<u>Antifraud Network Act</u> (summary of key provisions as passed the House in 2001)

- Require 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 overseer 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.

- Create a streamlined agent background check: requiring the FBI to do fingerprint background checks on insurance professionals and the NAIC to act as a clearing house that all states could rely on each record check for a year.

For more information, please go to www.pciaa.net/reg-reform.