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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of

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on behalf of the

National Association of Mutual Insurance Companies

to the

Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee

House Financial Services Committee

hearing on

Systemic Risk and Insurance

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

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

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

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

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

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

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

Systemic Risk

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

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

The current global financial crisis is a market-oriented crisis. The financial system broke down not because of a contagion that radiated from one or a few troubled institutions to a host of otherwise healthy entities. What happened instead is that market participants around the world independently speculated that a particular asset class—housing, in this case—would continue indefinitely to increase in value. As economist Scott Harrington of the Wharton School succinctly explained in his testimony before this subcommittee just last month, the crisis occurred because "many commercial banks, investment banks, thrifts, hedge funds, mortgage originators, sub-prime borrowers, and [the Financial Products unit of] AIG placed heavy bets on continued housing price appreciation and against any fall in prices. They gambled, and the losses have been both huge and widespread."

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

Systemic Risk in the Insurance Industry

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

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

- **Leverage**

  Very few property/casualty insurers use commercial paper, short-term debt or other leverage instruments in their capital structures, a fact that makes them less vulnerable than highly leveraged institutions when financial markets collapse. Because of their basic business model and strict capital requirements imposed by state regulators, property/casualty insurers are much more heavily capitalized, in terms of their asset-to-liabilities ratios, than banks and hedge funds. At the time that the financial crisis began to unfold, many large commercial and investment banks were operating at very high leverage ratios, often borrowing $15 to $25 for every $1 in capital they held. When the crisis struck, pools of available credit dried up and the cost of borrowing soared, destroying or severely impairing these firms' operating models. By contrast, property/casualty insurers neither borrow to make investments, nor borrow to pay claims. Thus, even when some of their investments perform poorly, the effect on property/casualty insurers is not magnified as it is when investments are highly leveraged. This explains why the property/casualty insurance industry is not suffering from a credit or liquidity crisis.

- **Liquidity**

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

- **Correlation**

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

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

- **Connectedness/Sensitivities/Concentration**

Property/casualty insurers manage concentrations of investments and have regulatory limitations on both the type and concentrations of the assets in which they invest. These limitations have the effect of reducing the property/casualty insurance industry's connectedness and sensitivity to the actions and conditions of other sectors of the financial services industry.

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

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

Unlike lightly regulated financial institutions such as investment banks and hedge funds, most of the obligations of property/casualty insurers are protected by the insurance guaranty fund system. This nationwide system, which is financed by the property/casualty insurers of each state, reduces the systemic impact of any failing property/casualty insurer by providing claimants assurance that the insurer's obligations will be satisfied on a timely basis.

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

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

Potential Consequences of Institution-Oriented Systemic Risk Regulation

Some commentators have suggested that systemic risk regulation should focus on particular financial institutions that are considered to be "systemically significant." Systemic risk regulation and oversight focused on particular institutions based on size, nature of business, or perceived significance may well miss market-oriented events and trends that are the true sources of systemic risk. While the criteria for determining which companies are systemically significant are unclear at this point, most proponents of this approach seem to have in mind companies that are thought to be “too big to fail” or “too interconnected to fail.”

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

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

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

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

Effective Systemic Risk Regulation

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

Attempting to define and regulate “systemically significant institutions” on the basis of size, business line, or legal classification – such as including all property/casualty insurers - would do little to prevent future financial crises. Indeed, a regime of systemic risk regulation that is institution-oriented rather than focused on specific financial products and services could divert attention and resources from where they are most needed, while at the same time producing distortions in property/casualty insurance markets that would be harmful to consumers.

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

Additional Reforms

The current crisis demands that Congress act, but Congress must act prudently and responsibly. NAMIC believes there are a number of finite and concrete reforms that Congress could undertake to strengthen our nation's financial regulatory system, including enhanced regulatory coordination, improved international information sharing, creation of an Office of Insurance Information, and adoption of selected national standards. All of these actions would complement a targeted, national focus on identifying, analyzing, and addressing systemic risk.

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

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

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

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

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

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

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

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

Conclusion

Appropriate regulation of financial markets serves the public interest by efficiently mitigating market failures. Any financial services regulatory reform should therefore demonstrate that the proposed regulatory interventions will efficiently address the specific market failure. Moreover, the benefits of regulation should outweigh its direct and indirect costs. This is particularly true as Congress continues to debate fundamental reform of the nation's financial services industry.

NAMIC supports regulatory measures designed to prevent future financial crises. However, we recognize that enacting new regulations and creating new regulatory structures could do more harm than good if they are not narrowly tailored to address the particular deficiencies in the existing regulatory system that have been revealed by the current crisis. This means Congress must avoid measures that would weaken or impair those regulatory systems that have functioned well throughout the crisis i.e. the state-based system of property/casualty insurance regulation. As it considers measures to curtail systemic risk, it is critical that Congress distinguish between those financial products and activities that propagate systemic risk and those that do not. Congress should recognize that no property/casualty insurer is “too big” or “too important” to fail. It would be a serious and potentially harmful mistake if Congress were to assume, despite abundant evidence to the contrary, that the property/casualty insurance industry creates systemic risk and should therefore be regulated as if it did.

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