Testimony of Robert A. DiMuccio
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On Behalf of the Property Casualty Insurers Association of America (PCI)
Before the Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
United States House of Representatives
Thursday, March 5, 2009

Chairman Kanjorski, Ranking Member Garrett, and other Members, thank you for this opportunity today to present specific solutions for addressing our systemic risk crisis. My name is Bob DiMuccio, and I am President and CEO of Amica Mutual Insurance Company. Amica is a hundred year old Rhode Island company that issues personal lines insurance products, such as auto home and excess liability, to consumers throughout the country. Amica stands as a leader in its financial security and is known for its world class customer service. I am appearing today on behalf of PCI, the leading property-casualty insurer trade association representing more than 1,000 insurers of all different lines and sizes.

I have 5 main points today:

(1) The property casualty industry is stable, did not cause this crisis and is not seeking federal assistance;

(2) As consumers, we are negatively impacted by ongoing market instability since as insurers, we invest our own money;

(3) Strengthened systemic risk oversight is the critical first priority for market stability that Congress needs to enact before considering comprehensive reform;

(4) There is an effective and politically achievable solution for overseeing and managing systemic risk; and

(5) PCI is committed to working responsively and constructively with your leadership.

First though, I would like to underscore that the property casualty industry did not cause the economic crisis and overall, is managed successfully for solvency at the state level. There were no property-casualty insolvencies last year, 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. The surplus that stands behind our policies remains at relatively strong levels and almost all segments of our marketplace remain stable and sound. Unlike the capital and credit markets, our insurance operations have proceeded uninterrupted. The historical level of insolvencies in the p/c and life industry over the last several decades as a percentage of industry assets have been much lower than that of the banks and far lower than that of the perennially troubled thrift industry. And, PCI has reiterated that our industry neither needs nor wants federal help.

Our industry has suffered deeply from this crisis, but, 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 share Congress's interest in stabilizing the market and fixing the systemic risk regulatory gaps.

Former Federal Reserve Board Chairman Alan Greenspan admitted to this Committee 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. Let me quote a Board 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 non-bank 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? Congress first tried to create systemic risk oversight in the GLBA by making the Federal Reserve Board an umbrella supervisor. But 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 immediately, and that can be fixed quickly using the existing regulatory structure. Then, if necessary to address the Congressional imperatives, larger regulatory reform and solvency oversight could be analyzed in a second phase.

PCI proposes beginning with the definition of systemic risk: which for financial institutions 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 put, if the government has to step in to bail out a company to protect the larger economy, that's a systemic risk.

The requisite threshold for a government rescue has to date not been fully articulated. Older metrics focused primarily on size, with the traditional antitrust analysis based on "Too Big to Fail." Recent government intervention decisions, however, have shifted away from a Too Big to Fail approach towards a more pertinent analysis that PCI and many others have termed "Too Interconnected to Fail."

There are two primary measurements for Too Interconnected to Fail: First: to what extent are a company's activities leveraged throughout the economy such that the company's impairment would cause additional impairments; Second: to what extent is a company's risk of failure correlated with other systemic waves or economic downturns. For example, even the failure of a very large auto insurer would not require significant deleveraging by hedge funds and other third parties or create a ripple effect of supply company failures; its market share would be quickly absorbed by competitors, and the number of auto accidents does not increase in a recession. Conversely, credit default swaps or payment risk insurance such as large scale mono-line financial guarantees, are often further leveraged by third parties, in a more concentrated marketplace, and an economic downturn increases the likelihood of payment default, with the company's impairment exacerbating the recession.

So, it is <u>not</u> a question simply of size or industry, but rather the systemic risk characteristics of a company's aggregate activities at issue. (See the attached Appendix – Systemic Risk Defined.) Few lines of property-casualty insurance, and few P/C insurance companies, pose significant systemic risk (See Appendix – Insurance Line Systemic Risk Grouping.) Among the few might be financial obligation insurance (e.g. mono-line financial guaranty and mortgage guaranty). (See Appendix – Financial Obligation Insurance: Systemic Risk Differences.)

To address the current economic crisis, restore investor confidence, and prevent another economic disaster from reoccurring, a systemic risk overseer should be created. The Federal Reserve Board should serve as the systemic risk overseer as it has the appropriate mission and expertise. However, the Federal Reserve Board's systemic risk oversight should be completely separate from other bank holding company oversight powers.

Incorporating Congressional imperatives, PCI recommends a three-tiered regulatory approach that is flexible and to match Federal Reserve Board umbrella oversight to the level of systemic risk. (See attached Appendix – Systemic Risk Oversight Proposal.)

1. Appropriate transparency and disclosure to overseers for all entities within the regulatory jurisdiction;
2. Escalating information sharing with other U.S. and international overseers as a company's systemically risky activities increase; and

3. Risk management for specific entities whose financial activities present a significant systemic risk.

Jurisdiction would include any institution engaged in financial activities that in aggregate presents a significant systemic risk. Also included, would be any institution engaged in financial activities that chooses to submit to federal systemic risk oversight, such as for international equivalency treatment.

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. <u>Duplicative</u> disclosure or transparency information requirements;
4. General federal compliance, such as privacy standards; and
5. Other elements of bank holding company oversight.

Regarding oversight of risk management, oversight standards could consist of:

1. Overseeing holding company capital standards 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.

Two other critical gaps in systemic risk regulation that need to be swiftly addressed are to increase coordination of oversight efforts to prevent and detect financial fraud, both domestically and internationally, and to promote sharing of existing financial holding company information among financial services regulators, both nationally and internationally, to improve early warning risk monitoring. Again, these gaps can be relatively easily addressed without imposing significant new burdens or requiring fundamental changes in our regulatory structure. In 2001 this Committee and the House passed nearly unanimously, with very broad industry and consumer support, the Anti-Fraud Network Act (H.R. 1408), institutionalizing regulator fraud information sharing – the type of system that the prosecutor in the Madoff scandal also recently testified was necessary. PCI also proposes requiring the Presidential Working Group on Financial Markets to develop and implement a plan for limited information sharing coordination with international overseers regarding holding company solvency and potential threats to cross-border market stability, focused on group level financial information related to solvency, such as capital levels and off-balance sheet or significant cross-affiliate obligations. (See Appendix – Information Sharing Proposal.)

These proposals are practical solutions that address systemic risk and holding company oversight concerns. 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 Securities Exchange Commission (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 addressing 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 works in tandem with the existing primary functional regulators.

Three final points:

(1) Consolidation of federal banking agencies, restructuring of the SEC, and regulation of derivatives are issues Congress needs to think through very carefully. But we need investor confidence in systemic risk oversight now; and focused systemic risk oversight can be accomplished quickly with minimum new bureaucracy and without unintended, negative consequences.

(2) Don't let outside groups try to confuse solvency with systemic risk regulation as part of a "Super-Size Us" regulatory agenda to collapse the multiple banking regulators into three cross-industry regulators for systemic risk, market conduct, and solvency. Solvency regulation is done by functional regulators to ensure that individual companies have sufficient capital to fulfill their promises. Systemic risk regulation is macro oversight by the Federal Reserve Board to prevent a holding company failure from contaminating other markets and the larger economy. This distinction was enshrined in current law by GLBA and more recently recognized by the Treasury Blueprint. Merging solvency regulation into systemic risk oversight will simply create a Too Big to Fail regulator where a mistake by the single agency head would jeopardize the entire financial marketplace. (See Appendix – Regulatory Distinctions Between Solvency and Systemic Risk Regulation.)

(3) My last point is that PCI is committed to working with this Subcommittee and Committee as the process evolves. We are in the unique position that we do not need federal help, but are dedicated to advancing appropriate solutions to stabilize the markets and prevent

another economic crisis from reoccurring. Addressing systemic risk is the best action to do so and we stand ready to assist in any way we can.

Thank you.

Property Casualty Insurers Association of America
Shaping the Future of American Insurance

Appendix to PCI Testimony
House Financial Services Committee – Capital Markets Subcommittee
March 5, 2009

Deal With Systemic Risk Now!
- Systemic Risk Defined
- Insurance Line Systemic Risk Grouping
- Financial Obligation Insurance: Systemic Risk Differences
- PCI Systemic Risk Oversight Proposal
- PCI Information Sharing Proposal

Deal With Systemic Risk First!
- Regulatory Distinctions Between Solvency and Systemic Risk Regulation

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

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Financial Obligation Insurance: Systemic Risk Differences

Financial obligation insurance can be thought of as the transfer of payment risk on a financial obligation from the creditor or investor to an insurer. Financial guaranty insurance, mortgage insurance, some types of credit insurance, credit default swaps, and similar payment risk transfers are all examples of financial obligation insurance (FOI). FOI products typically involve a transfer of risk from the banking (credit) marketplace or the securities (capital) marketplace to the insurance marketplace. FOI transfers only the risk of payment failure, as opposed to a traditional banking product involving lending or loan servicing or a securities product involving investment returns.

Financial obligation insurance products are similar to traditional property/casualty products in that they provide indemnification for losses in accordance with the specific requirements and conditions of an insurance contract. However, they are a different and distinct marketplace. Traditional property/casualty products indemnify a person or organization for losses that result from either the damaging, destruction or loss of use of their property; or the result of a claim of liability by someone seeking financial damages. Financial obligation insurance indemnifies losses arising from negative credit or payment events.

Many FOI products are not regulated as insurance, such as credit default swaps, even though they function in the financial marketplace in a manner similar to financial insurance. Even FOI products that are regulated by the states as insurance are often treated as a special class of risk. For example, many states prohibit financial guaranty and mortgage insurers from writing any other line of insurance business. In addition, most states exclude financial guaranty, mortgage guaranty and credit insurance from their state guarantee funds. It is interesting to note that while credit default swaps, total return swaps, some collateral debt obligation securities, and similar derivative structured finance risk transfers are functionally insurance products, they have no capital reserving requirements and are relatively unregulated and lack the equivalent statutorily mandated transparency.

PCI believes that it is appropriate for federal and state regulators to continue to recognize and treat separately the distinct systemic risk characteristics of financial obligation insurance from traditional property/casualty products. However, FOI products have varying degrees of systemic risk profile and many state regulated financial obligation insurance products have been protected by strict solvency standards and oversight, particularly in contrast to federally regulated or unregulated risk transfer equivalents. Furthermore, many small and large insurers offer financial obligations insurance products, including on an incidental basis, in amounts that do not generate significant amounts of systemic risk.

There are a number of mechanisms that can be used to transfer credit risk on a variety of financial instruments. The most commonly used are credit default swaps and financial insurance. Financial insurance includes financial guaranty insurance, mortgage guaranty insurance and credit insurance. All of these mechanisms present some degree of systemic risk. Credit default swaps and financial guaranty insurance present a high degree systemic risk potential, mortgage guaranty insurance has less systemic risk attributes and credit insurance poses low systemic risk.

Credit Default Swaps (CDS)

Although not currently regulated as an insurance product, the issuance of CDS was a significant growth area for most financial guaranty monoline insurers. The NAIC Financial Guaranty Insurance Model Act defines a CDS as an agreement using the credit derivative definitions of the International Swaps and Derivatives Association in which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event with respect to the issuer of a specified security or other obligation. In effect, the seller of a CDS will pay the buyer of that CDS any interest or principal payments defaulted on by the issuer of the covered debt security, because of an adverse credit event, during the time period covered by the CDS. Despite being equivalent to financial guaranty insurance (and generally perceived as insurance in the marketplace), credit default swaps are not regulated by state insurance departments or any other financial regulator and not covered by state guaranty funds. The total worldwide market for credit default swaps has been estimated at approximately $55 trillion in notional value at mid-year 2008. The notional value of a CDS is the face amount of the security that is used to calculate payments made on that instrument. The amount is called notional because it is not generally the amount that will change hands.

The extremely limited transparency of the unregulated CDS market creates a high degree of systemic risk by limiting the ability to monitor the CDS exposure among market participants or to quantify the impact of certain negative events (e.g., credit rating downgrades) on the sellers of CDS. This lack of transparency also limits the ability to establish standards for capital adequacy and liquidity to provide some measure of stability in the financial system.

The Securities and Exchange Commission (SEC) has discussed the need to create a credit default swap electronic exchange to increase liquidity, transparency, and pricing efficiency in the CDS marketplace. A CDS electronic exchange could also provide regulators with information to analyze and quantify the systemic impact of CDS and to develop other approaches to protect the integrity of the markets and its participants. Currently, two groups, IntercontinentalExchange and CME, have announced they have the technical ability to convert CDS into regulated exchange futures and to support their trading on an electronic platform. In addition, the SEC has asked for elimination of the “swap exclusion” in current law that prohibits it from regulating over-the-counter CDS.

Financial Guaranty Insurance

Financial guaranty insurance means a surety bond, or, when issued by an insurer, an indemnity contract under which a loss is paid upon proof that the financial loss has occurred as a result of any of the following events:

- Failure of any obligor on or issuer of any debt instrument or other monetary obligation to pay when due, principal, interest, premium, dividend or purchase price of or on, or other

amounts due or payable with respect to, the instrument or obligation, when the failure is the result of a financial default or insolvency.
- Changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products;
- Changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or
- Other events which an individual state's commissioner may determine are substantially similar to any of the above.

Although financial guarantees are insurance because they provide protection against specific identified losses, there are significant differences between financial guaranty insurance and other property and casualty coverages.

- Financial guaranty insurers generally cannot write other lines of insurance; because of this limitation they are called monolines.
- Financial guaranty insurance is covered under the property and casualty guaranty funds in only 14 states.
- Financial guaranty insurance has historically been written on a "no-loss" or "remote loss" underwriting standard, focused on insured municipal bonds, which have historically low loss rates.
- In recent years, many financial guaranty insurers sought to increase growth by insuring structured products such as collateralized debt obligations of various asset backed securities and by issuing credit default swaps, greatly increasing their systemic risk profile.
- The financial guaranty risks underwritten by monolines are much more correlated with economic conditions and other systemic vulnerabilities than the risks written by multiline property casualty insurers.
- In some instances financial guaranty monolines held invested assets that were directly correlated to the structured products they were insuring.
- Financial guaranty insurance issued by monoline financial guaranty insurance corporations is excluded from the definition of property and casualty insurance by the Terrorism Risk Insurance Act.

A few companies that are not monolines write very small amounts of financial guaranty insurance along with the rest of their business. These companies pose insignificant systemic risk, and should not be subject to systemic risk regulation.

Mortgage Guaranty Insurance

Mortgage guaranty insurance provides coverage for the mortgagee (usually a financial institution) in the event that a mortgage holder defaults on a loan. It is also called private mortgage insurance (PMI). Mortgage insurers, like financial guaranty insurers, also operate on a monoline basis. Mortgage insurers, under current regulation, are capitalized to handle catastrophic mortgage related claims, may not be associated with high risk non-traditional activities, and must invest in assets without correlation risk to residential mortgages. While significantly less at risk than financial guaranty insurers, mortgage guaranty insurers do present some lesser amount of systemic risk as the residential real estate markets continue to experience significant deleveraging. As home values drop below outstanding mortgage balances and general economic conditions deteriorate mortgage defaults continue to increase. Michigan is the only state that provides property and casualty insurance guaranty fund coverage for mortgage guaranty insurance. In addition, private mortgage insurance is excluded from the definition of property/casualty insurance by the Terrorism Risk Insurance Act.

Credit Insurance

Commercial credit insurance can be purchased by businesses or other providers of goods and services extending credit, for indemnification of losses or damages resulting from the nonpayment of amounts owed to them for goods and services provided in the normal course of their business. Personal credit insurance can also be purchased as either single interest or dual interest. Single interest credit insurance protects the creditor's interest in the collateral securing a debtor's credit transaction. Dual interest credit insurance protects both the creditor's and the debtor's interest in the collateral securing the debtor's credit transaction. Credit insurance, like mortgage guaranty insurance, has a significantly lower systemic risk exposure than financial guaranty insurance. However, like mortgage guaranty insurance, at least some systemic risk exposure may exist. Credit insurance is covered by state guaranty funds only in Illinois, Kansas, Maryland and Michigan.

Reinsurance

Any reinsurance put in place on financial obligation insurance coverages would assume similar systemic risk characteristics as the underlying coverages.

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

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Insurance Line Systemic Risk Grouping

***** excluding Life and Accident/Health insurance products

<u>High Systemic Risk</u>	
Financial Guaranty	An insurance policy, or an indemnity contract (when issued by an insurer), or similar guaranty types under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnitee as a result of failure to perform a financial obligation; a change in interest rates; a change in currency exchange rates; or, a change in the value of specific assets, commodities or financial indices. These contracts usually involve sophisticated insureds, and therefore rates may be exempt from general statutory standards.
<u>Less Systemic Risk</u>	
Mortgage Guaranty	Coverage for the mortgagee (usually a financial institution) in the event that a mortgage holder defaults on a loan; also called private mortgage insurance (PMI).
<u>Low Systemic Risk</u>	
Credit	Commercial – Various coverages purchased by manufacturers, merchants, educational institutions, or other providers of goods and services extending credit, for indemnification of losses or damages resulting from the nonpayment of debts owed to them for goods or services provided in the normal course of their business. Personal **-** Personal property credit may be either “single interest” or “dual interest”. Single interest means insurance that protects only the creditor’s interest in the collateral securing a debtor’s credit transaction. Dual interest (also commonly referred to as “limited dual interest”) means insurance that protects the creditor’s and the debtor’s interest in the collateral securing the debtor’s credit transaction. Examples include, but are not limited to, Placed Home, Placed Auto, Personal Property, Credit Involuntary Unemployment and Personal GAP Insurance.
Surety	A three-party agreement where the insurer agrees to pay a second party (the obligee) or make complete an obligation in response to the default, acts, or omissions of a third party (the principal or obligor). Contractors are often required to purchase surety bonds if they are working on public projects. The surety company becomes responsible for carrying out the work or paying for the loss up to the bond “penalty” if the contractor fails to perform.

No Significant Systemic Risk

Accident and Health	Coverage for accidental injury, accidental death, and related health expenses. Benefits will pay for preventative services, medical expenses and catastrophic care.
Aircraft	Coverage for aircraft (hull) and their contents; aircraft owners' and aircraft manufacturers' liability to passengers, airports and other third parties.
Allied Lines	Property insurance that is usually bought in conjunction with fire insurance; it includes wind, water damage and vandalism coverage.
Boiler and Machinery	Coverage for the failure of boilers, machinery and other electrical equipment (e.g., air conditioners, heating, electrical, telephone and computer systems). Benefits include (i) property of the insured, which has been directly damaged by the accident; (ii) costs of temporary repairs and expediting expenses; and (iii) liability for damage to the property of others. Coverage also includes inspection of the equipment.
Burglary and Theft	Coverage for property taken or destroyed by break-in and entering the insured's premises (commercial or personal); burglary or theft; forgery or counterfeiting; fraud; and off-premises exposure. Includes Fidelity and Surety coverage written as part of a Crime and Fidelity program.
Commercial Auto	Coverage for motor vehicles owned by a business engaged in commerce that protects the insured against financial loss because of legal liability for motor vehicle related injuries, or damage to the property of others caused by accidents arising out of the ownership, maintenance, use, or care-custody & control of a motor vehicle. Examples include business auto (Auto Liability, PIP, MP, UM/UIM, Specified Causes of Loss, Comprehensive, and Collision); garage policies (Garage Liability, Garagekeepers Legal Liability, PIP, MP, UM/UIM, Specified Causes of Loss, Comprehensive, and Collision) and truckers policies (coverage for persons or organizations engaged in the business of transporting property by auto for hire, including coverage of the specialized liability exposure created by trailer interchange agreements).
Commercial Multiple Peril	The policy packages two or more insurance coverages protecting an enterprise from various property and liability risk exposures. Frequently includes fire, allied lines, various other coverages (e.g., difference in conditions) and liability coverage. Such coverages would be included in other annual statement lines, if written individually. Examples of CMP policies include builders risk, business owners (BOP), e-commerce, and commercial farm and ranch.
Crop	Coverage protecting the insured against loss or damage to crops from a variety of perils, including but not limited to fire, lightening, loss of revenue, tornado, windstorm, hail, flood, rain, or damage by insects.
Earthquake	Coverage for building and contents losses resulting from a sudden trembling or shaking of the earth, including that caused by volcanic eruption. A special policy or endorsement is available because earthquakes are not covered by standard homeowners or most business policies.

Farmowners	Farmowners insurance sold for personal, family or household purposes. This package policy is similar to a homeowners policy, in that it has been developed for farms and ranches and includes both property and liability coverage for personal and business losses. Coverage includes farm dwellings and their contents, barns, stables, other farm structures and farm inland marine, such as mobile equipment and livestock.
Fidelity	A bond or policy covering an employer's loss resulting from an employee's dishonest act (e.g., loss of cash, securities, valuables, etc.)
Fire	Coverage protecting property against losses caused by a fire or lightning that is usually included in homeowners or commercial multiple peril policies.
Flood	Basic flood insurance is provided by the federal government (the NFIP) and sold through private companies and agents. Private insurers also provide excess flood policies and may cover flood damage under the comprehensive portion of an auto insurance policy.
Homeowners	The typical homeowners insurance policy covers the house, the garage and other structures on the property, as well as personal possessions inside the house such as furniture, appliances and clothing, against a wide variety of perils including windstorms, fire and theft. Homeowners insurance also covers additional living expenses which reimburses the policyholder for the extra cost of living elsewhere while the house is being restored after a disaster. The liability portion of the policy covers the homeowner for accidental injuries caused to third parties and/or their property. Coverage for flood and earthquake damage is excluded and may be purchased separately. This applies similarly to condos, renters/tenants and mobile homes at a fixed location.
Inland Marine	Coverage for property that may be in transit by all forms of land and air transportation, held by a bailee, at a fixed location, or movable goods that are often at different locations (e.g., off-road construction equipment), or scheduled property (e.g., Homeowners Personal Property Floater). These lines also include instrumentalities of transportation and communication, such as bridges, tunnels, piers, wharves, docks, pipelines, power and phone lines, and radio and television towers. Also includes policies for electronic data processing equipment/software, pet insurance, animal mortality, event cancellation and travel coverage.
Medical Malpractice	Insurance coverage protecting a licensed health care provider or health care facility against legal liability resulting from the death or injury of any person due to the insured's misconduct, negligence, or incompetence, in rendering or failure to render professional services.
Ocean Marine	Coverage for ocean and inland water transportation exposures; goods or cargoes, ships or hulls, earnings, piracy, the jettisoning of cargo to save the property of others, and liability.
Other Liability	Coverage protecting the insured against legal liability resulting from negligence, carelessness, or a failure to act resulting in property damage or personal injury to others. Examples include liability coverage for commercial general liability, completed operations, contractual liability, day care centers, D&O, E&O, elevator/escalator, employers liability, liquor liability, municipal liability, environmental pollution liability, Internet liability, etc.

Other Lines of Business	Coverage not described under previous lines of insurance, such as service contracts and title insurance.
Personal Auto	Coverage for privately owned motor vehicles and trailers for use on public roads not owned or used for commercial purposes including the following, singularly or in any combination: Auto Liability, Personal Injury Protection (PIP), Medical Payments (MP), Uninsured/Underinsured (UM/UIM); Specified Causes of Loss, Comprehensive, and Collision. Also includes motorcycle and recreational vehicles (RV).
Products Liability	Coverage for losses or injuries caused by defect or malfunction of the product.
Surplus Lines	Property/casualty insurance coverage that isn't available from state-licensed/admitted insurers must be purchased from a non-admitted carrier (surplus lines insurer). Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies.
Workers' Compensation	Insurance that covers an employer's liability for injuries, disability or death to persons in their employment, without regard to fault, as prescribed by state or federal workers' compensation laws and other statutes. Coverage may include payments for medical care, physical rehabilitation, and lost wages.

Reinsurance – The systemic risk exposure generally follows the level associated with the line of coverage generating the risk being ceded. This can change based upon the allocated capital driven-underwriting capacity of the respective reinsurance market.

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

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Information Sharing Proposal

Needs

- 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.

Holding Company Solvency Information Sharing

- 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.

Antifraud Network Act (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.

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Regulatory Distinctions between Solvency and Systemic Risk Regulation

- <u>Solvency</u> 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.

- <u>Systemic risk</u> 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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PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

Systemic Risk Defined

"Systemic risk" refers to the likelihood and degree of negative consequences to the larger body.

With respect to federal financial regulation, 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.

How to Measure Systemic Risk

Too Big to Fail: The traditional analysis for assessing the risk of required government intervention is the "Too Big to Fail" Test (TBTF). TBTF can be measured in terms of an institution's size relative to the national and international marketplace, market share concentration (using the Herfindahl-Hirschman Index for example), and competitive barriers to entry or how easily a product can be substituted. While there are large companies in most financial marketplace segments, the national insurance marketplace is spread among thousands of companies, and the barriers to entry in a business where capital is the primary input are relatively minor. The policies of one homeowners' insurer can be relatively easily substituted for another or picked up by a state residual market provider, with limits on the underwriting fluidity primarily stemming from state-by-state regulatory impediments, such as limits on pricing and capital mobility. There are arguably either no or extremely few insurers that are TBTF in the U.S. marketplace.

Too Interconnected to Fail: A more useful systemic risk measure than a traditional TBTF test is a "Too Interconnected to Fail" (TICTF) assessment. An intuitive TICTF analysis has been at the heart of most recent federal financial emergency relief decisions. TICTF is a 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.

Property/casualty (P/C) insurance companies, other than in a few specialized segments noted below, present relatively low systemic risk because they generate relatively little counterparty risk and their liabilities are generally independent of economic cycles or other potential systemic failures. With respect to liabilities, P/C products tend to be mandatory with inelastic demand, so revenues are less affected by other systemic risks. Recessions or 3rd party failures do not significantly increase workers' injuries, auto accidents, or house fires. Insurance contracts are not typically subject to further hedging or risk arbitrage (unlike mortgage underwriting or financial guarantees that may be subjected to numerous cycles of securitization and further third party financial guarantees or risk betting). While some portions of primary risks are passed on to reinsurers, the risks are not further multiplied or leveraged, and the primary company almost always remains obliged on and retains a portion of the underlying risk. With respect to assets, p/c insurers don't hold other people's money, so there is no vulnerability to a "run on the bank," and they only underwrite based on their own assets (unlike depository institutions, investment funds, or retirement accounts) with less leveraging statutorily allowed than for other insurance or financial companies. Ultimately, while the economy is highly dependent on the p/c industry, the industry's risks are independent and relatively walled off from other systemic impairments.

Examples: Even a very large auto insurer poses very little systemic risk to the larger economy. Few commercial third parties rely on a specific auto insurer's policies that would suffer immediate economic losses or decline, other than the insurer's direct investors. Policyholders would be largely protected by existing state guaranty funds, third party accident claimants would be similarly protected through such funds (as well as under their uninsured motorist coverage), and new business could be switched relatively easily to other providers or a state residual market provider. The insurer's contracts with its agents and other suppliers would migrate quickly to new underwriters, and the beneficiaries of its investments would similarly migrate over a relatively short period of time. The insurer's failure would be relatively independent from a larger economic cycle or downturn – its investment portfolio is required to be relatively conservative and unleveraged, and its auto losses would be relatively uncorrelated with any economic cycles or systemic risk waves. Unlike banks and securities firms, a property-casualty insurer failure would not cause a run on the industry since the products are essentially mandatory and overall demand is relatively inelastic. While the failure of a large auto insurer would be undesirable, and perhaps even cause a short period of transitory disruption in a local auto insurance marketplace, the negative economic consequences to the larger economy would be relatively limited – primarily transition costs and any net losses of the specific company.

Exceptions: A small number of p/c insurance market segments present a different systemic risk vulnerability. For example, the credit downgrading of a small number of bond insurers (and unregulated investment companies offering equivalent financial guarantee products) last year played a role in the trillions of dollars of third party credit default swaps that are still being unwound. That deleveraging process has triggered a domino affect of other negative economic consequences throughout the globe, including freezing numerous capital markets that have limited general consumer and commercial financing. A few very large state owned/run insurance funds may also present slightly higher systemic risk, particularly for natural catastrophe exposure, since they tend to be severely underpriced, underfunded, and most likely to require additional capital after events that would cause competing state budgetary impairments and needs. Mortgage insurance is more correlated with economic cycles and susceptible to further 3rd party leveraging, although the companies are still subject to strict leveraging and investment limits, rely on their own capital, and sell a product that is essentially mandatory and thus less elastic in demand. Surety insurance can also be susceptible to economic cycles, although it has not presented a systemic risk in the current economic cycle. Reinsurance has a slightly different risk profile than primary insurance, but is similarly uncorrelated to other systemic risks and the negative effects of reinsurance failures are mostly confined to the insurance industry.

AIG

It should be noted that AIG was not "Too Big to Fail", but ultimately received unusual federal assistance because it was "Too Interconnected to Fail". AIG's *insurance* units were mostly engaged in underwriting coverages that other insurers would be able to assume over a relatively short period of time. Almost all of AIG's subsidiaries have continued to successfully operate except for AIGFP, an *unregulated* entity engaged in financial guarantees and derivatives activities. AIGFP, however, was involved in hundreds of billions of dollars of risk swaps that were relied upon and further highly leveraged by numerous 2nd and 3rd parties. The credit downgrading of AIG because of the liabilities of AIGFP, and its inability to raise sufficient additional offsetting capital, set off a series of 2nd and 3rd party adjustments that continued to ripple through the economy with deleterious consequences until the federal government stepped in with an additional backstop. This made AIGFP, and thus the AIG thrift holding company as a whole, TICTF. While AIG's insurance operations are large, they did not generate the same level of systemic risk. The economy, after a short period of market transition, would be better able to adjust to a severe impairment of AIG's insurance subsidiaries than its non-insurance operations. AIG did suffer write downs from its securities lending business, which involved borrowed assets from its life (but not property-casualty) insurance subsidiaries, but these losses were much less in scope than the AIGFP exposure.

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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.

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