“How Should the Federal Government Oversee Insurance?”

Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
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Chairman Kanjorski, Ranking Member Garrett and members of the subcommittee, it is an honor to testify on behalf of Towers Perrin. I appreciate this opportunity to offer my firm’s perspective on the important issue of insurance industry oversight.

Towers Perrin is a global professional services firm that helps organizations improve performance through effective people, risk and financial management. In the area of risk and financial management, our services include risk and capital management, insurance and reinsurance intermediary services and actuarial consulting. The insurance industry is an area of particular focus for our firm.

With the notable exception of AIG, the insurance industry in general has not felt the impact of the financial crisis to the degree experienced by the banking industry. However, the crisis has exposed certain issues – such as systemic risk – that raise valid questions about regulatory oversight. As I will explain in more detail, any new federal oversight role should take into account certain distinctive features of the insurance industry and its stakeholders and leverage the existing regulatory framework.

Insurers have been impacted by the economic crisis

Without a doubt, the financial crisis has had a significant adverse impact on insurer balance sheets and profitability.

For life insurers, 2008 was among the poorest on record for operating performance, largely because of significant realized and unrealized losses on investment portfolios, large reserve increases to support product guarantees, higher costs of capital and a declining revenue base.

The property/casualty industry experienced its worst financial performance since 2001.[1] P/C insurers reported an annualized statutory rate of return on average

[1] 2008 – Year End Results, Insurance Information Institute, 2009.

surplus of 0.5% in 2008, down from the 12.4% return in 2007. Net investment gains fell 47%. The mortgage and financial guaranty segments reported a collective underwriting loss of $15.1 billion.[2]

Insurers Have a Significant Impact on the Economy

The insurance industry, a comparatively small part of the financial services industry, has a disproportionately large impact on the general economy. Think of your own experience. The businesses you rely on couldn't open their doors without liability insurance. You can't drive a car or get a mortgage without appropriate insurance.

Insurance companies also are huge investors, with pools of capital that are vital for the U.S. financial markets. In 2007, on the eve of the economic crisis, life companies held cash and invested assets of $3 trillion, while P/C companies held cash and invested assets of another $1.3 trillion. P/C companies are among the largest holders of municipal bonds.

The financial crisis has highlighted one of the industry's less commonly known roles in the economy – as the provider of financial guaranty insurance to enhance the credit quality of a wide range of structured securities.

Although Current Regulation Is Generally Effective, There Are Gaps

The fact that U.S. insurers, in general, are weathering the financial crisis in a stronger position than the banking industry can be explained by a number of factors. They include:

- Effective risk management with an emphasis on an appropriate spreading of risks, especially among P/C companies.
- An existing regulatory framework that concentrates primarily on solvency and policyholder protection.

Any new federal-level role in insurance regulation should build on these two very positive features of the current regulatory environment while addressing new challenges presented by systemic risk and the complexities of a financial services sector in which the lines are increasingly blurred between insurers and other financial services players.

The AIG situation is instructive. AIG's most significant problems were primarily at the holding company level and within the Financial Products unit. Those problems sparked policyholder concerns about the insurance operations. Few regulators could have anticipated problems of this nature and, in any case, neither state nor federal regulators had the oversight authority to regulate or monitor effectively the relationship between the insurance and non-insurance operations.

[2] A.M. Best Co., 2009

With the current regulatory structure, which is based primarily on legal entity by legal entity oversight, no state insurance department is in a position to exercise comprehensive oversight of a diversified, multinational financial services company that includes insurance operations. The current state regulatory system, with its focus on policyholder protection for each legal entity, dates back to a time when insurers were smaller and less complex, typically with only one or a very small number of separate legal entities. Many insurers were mutuals, a model that lent itself to state regulation. The landscape changed with the growth of huge, non-insurance holding companies, cross-sector multiline insurance companies and multinational insurers.

In addition to these limitations, the current system can in certain circumstances inadvertently encourage regulatory and capital arbitrage, the notion that products gravitate to the financial services sector that requires the least regulatory capital. This is an unintended consequence of our current system, with different regulators overseeing banks, securities firms, asset managers and insurance companies. Some sectors, such as hedge funds, have little regulatory oversight.

Credit risk, for example, can be transferred using either a financial guaranty insurer or through a credit default swap (CDS), each of which has very different capital regulatory requirements. The insurer is obliged to allocate capital to the transaction but there is no uniform requirement for a credit default swap writer to do the same. The result is that financial guaranty insurers are still generally solvent while the CDS market has been severely impaired.

Systemic Risk Oversight Should Consider Distinctive Features of Insurers

The unfolding financial crisis has revealed that the current regulatory structure does not adequately anticipate or address financial “contagion” or systemic risk. Risks that were once thought to be independent turned out to be linked in unanticipated ways and have had far-reaching consequences for the U.S. and global economy. More coherent oversight is needed by a single regulator or unified group of regulators with clear lines of authority and responsibility.

A more holistic regulatory framework should include economic capital requirements based on enterprise-wide stress testing. Such requirements would improve transparency into the ability of the consolidated enterprise to withstand extreme loss scenarios.

State regulators already have resolution authority for insurers under their jurisdiction. Any new federal-level resolution authority should be designed to address multi-jurisdictional and multi-entity conglomerates, in coordination with state authorities.

Implementing Federal Regulatory Oversight Needs To Be Done Cautiously

While there may be advantages to the federal government taking a more active role in regulating insurance solvency, simply extending a regulatory regimen designed for banks would not work well for insurers.

The insurance industry has many distinctive features and market practices. The federal government should build a knowledge base about the insurance industry by collecting information and by leveraging the collective knowledge and expertise of state regulators and industry associations.

Regulation at the federal level needs to be carefully structured and designed to supplement and improve the existing regulatory framework, not replace it. A strong argument can be made for including insurance in a broad financial services regulatory framework that might include commercial banks, investment banks and hedge funds. There are models for comprehensive financial services regulation in the United Kingdom, Australia, Canada and elsewhere. This path presents issues that will require careful attention:

1. There are significant risks to simply imposing a whole new regulatory structure on top of the existing system. Any reforms should avoid duplication and complexity while preserving state regulatory powers that have proven to be effective.

2. Reform should recognize that there is a great body of expertise in the state regulatory system that should be retained and leveraged. A company's size, complexity and global reach could be determining factors in decisions concerning federal vs. state regulatory responsibilities. Insurers should be given the option of selecting a charter from a federal regulator.

3. In regulatory terms, the Subcommittee may want to look at solvency and market conduct differently. While solvency and policyholder security might be best handled on a federal level, an argument can be made that market conduct is best regulated at the state level, closer to the customer.

4. Direct federal participation in the insurance markets should not be necessary except in unusual circumstances that present systemic risks. For example, while natural catastrophe risk can be extreme, the insurance markets have developed effective pricing mechanisms. Terrorism risk that led to the enactment of TRIA, on the other hand, was an appropriate intervention because the risk was seen as systemic and normal insurance market characteristics did not apply.

5. Because banking is many times the size of the insurance industry, there is a danger that all regulatory talent on the federal level will come from the

banking industry, and banking-oriented regulators might attempt to impose an unworkable banking model on the insurance industry.

6. U.S. regulatory reform should be coordinated with reform at the global level. Systemic risks in the current crisis have had global implications. In addition, effective oversight of multinational insurers requires cooperation on a global scale. A federal regulatory structure would benefit from close relationships with global insurance regulatory organizations such as the International Association of Insurance Supervisors.

Any regulatory structure will require appropriate insurance knowledge and expertise, including both solid grounding in traditional insurance regulatory theory and practice and an appreciation for the interaction of insurance and other financial services that may contribute to systemic risk. Perhaps there should be a distinct insurance department in an overarching regulatory structure with specific attention paid to the industry. There are certain insurance concepts and principles that are not present in the banking industry. The very essence of insurance is to provide protection against unknown future risks -- sometimes providing guarantees far into the future.

Complement Regulatory Oversight with Strong Professional Standards

The current financial crisis has demonstrated that systemic risk can arise from the failure to understand and evaluate risks and properly value complex financial instruments.

Current state insurance regulations require appropriately credentialed professionals, i. e. actuaries, to value certain insurance liabilities that, by their very nature, are complex financial obligations. Towers Perrin provides actuarial consulting services and is one of the world’s largest employers of actuaries. In our experience, actuaries have the skills, objectivity, credentials and professional standards to understand and value complex risks for both internal management purposes and for financial reporting.

These same skills qualify actuaries to examine and value complex and risky financial instruments. When the market for an asset is active, the market typically sets the asset value. When a market is thin and illiquid, alternative means of asset valuation are necessary to approximate as closely as possible the value an active market would produce. This valuation challenge is acute for mortgage-backed securities, CDOs and other hard-to-value assets.

Whether it is to analyze the risks associated with complex financial obligations or to generate alternative market-consistent value in the absence of liquid markets, financial institutions generally are relying on internally generated models and a range of outside advisors. There are no established guidelines for how such valuations are to be done, and no particular credentials required of those performing the valuations.

Drawing on their deep resources, insurance companies are increasing the involvement of actuaries in the analysis and valuation of complex financial obligations and assets. A potential benefit of federal involvement in the regulation of insurers and other financial institutions could be to require actuarial valuation of all complex financial obligations and hard-to-value assets.

Conclusions

- There are specific regulatory issues that can best be resolved at the federal level. They include, for example, eliminating regulatory arbitrage, addressing systemic risk and developing a comprehensive approach to the risk management landscape for financial services institutions.

- But a new regulatory regime should retain and leverage the strengths and best practices that have been proven over time by state regulators.

- While it might make sense to regulate banks and insurers under a single administrative framework, it is important that such a framework recognize the distinctive needs and attributes of the insurance business.

- The financial performance of insurers during the financial crisis may hold lessons for other financial services institutions, particularly as they relate to the integration of risk and capital management and the spreading of risk. Any regulatory regime should be structured to encourage the transfer of best practices from one industry segment to another.

- Complex risks are best evaluated and managed by risk management professionals, including actuaries, who have the requisite skills and objectivity and who conduct their work consistent with a well-developed body of professional standards.

Thank you for this opportunity to express Towers Perrin's views.

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