Testimony of the National Association of Insurance Commissioners before the

House Committee on Financial Services

"Systemic Regulation, Prudential Matters, Resolution Authority and Securitization"

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Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify at this afternoon's hearing. My name is Thomas Sullivan, and I am the Insurance Commissioner of the State of Connecticut. I am also a member of the National Association of Insurance Commissioners, serving as chair of its Life Insurance and Annuities Committee. Today I am representing the views of my fellow regulators on behalf of the NAIC.

The National Association of Insurance Commissioners continues to welcome federal efforts to reform financial regulation in response to the economic turmoil of the past year. However, we continue to stress that state regulation of insurance has protected insurance consumers and companies from the worst of the financial crisis, and therefore should be preserved in any reform efforts. The insurance sector is critically important, but the business of insurance has not created the kinds of unrestrained and unregulated systemic risks that reform efforts seek to manage or prevent. Prudential oversight of insurers by the states works – our solvency and capital standards have ensured that policyholder commitments are met and that companies remain stable. Our system of supervision is compatible with the structure and goals of financial reform efforts, and we urge that our expertise and experience be embraced, not undermined, by any changes to the U.S. financial regulatory structure.

Insurance is a Unique Product, and State Insurance Regulation Provides Necessarily Unique Protection

Americans purchase personal or commercial insurance for a very specific reason: to protect themselves, their dependents, and the items they value from unknown risk. The guarantee received by consumers in return for this purchase distinguishes insurance from other financial products currently under review, such as a home loan or a security. The economic well-being of every insurance consumer is affected by the strength and effectiveness of insurance regulation, and consumers clearly have an enormous financial and personal stake in making sure that insurers keep the promises that they make. Insurance products require policyholders to pay premiums in exchange for a legal promise of protection against risk. Effective insurance regulation must reflect the laws, values and unique risks of each state and region of the nation. This reality calls for maintaining the national system of state-based insurance regulation that has grown and evolved to meet the needs of consumers for over 150 years.

As the insurance market has become increasingly national and global in scope, state regulation has evolved and adapted, utilizing technology and other uniformity tools to streamline oversight where appropriate, while preserving local, accountable oversight. For example, the NAIC developed several important solvency initiatives including: risk-based minimum capital requirements that are geared toward an insurer's exposure to certain risks; codified statutory accounting principles and a uniform statutory annual statement for disclosure of financial results; and analysis and examination handbooks and procedures for state insurance regulators to ensure proper solvency assessment of insurers. The NAIC Accreditation Program is in force in all 50 states and ensures that all jurisdictions use the same baseline solvency standards.

Let me assure you, though, that in the wake of the financial crisis, we are not satisfied and we are not standing still. Last year, we have launched the Solvency Modernization Initiative, to review our entire solvency system to seek areas for improvement. The SMI includes study of other financial supervisory modernization initiatives and solvency proposals in place or under development in other jurisdictions, including Australia, Canada, Switzerland and the EU, and ultimately will result in compiled principles for any needed reforms. The principles will facilitate dialogue with other jurisdictions and institutions and bring about a constructive reconciliation of U.S. solvency principles with solvency regimes in other countries, where appropriate. The consolidated principles would also provide a foundation for the NAIC to establish clear goals, priorities and long-term modernization plans that will result in a solvency assessment framework consistent with regulatory best practices. The initiative places emphasis on five key focus areas: capital requirements, international accounting, insurance valuation, reinsurance, and group solvency. We are fully committed to ensuring that our prudential oversight of insurers is effective and efficient, and ready to meet the challenges ahead.

Our rigorous oversight has resulted in high regulatory compliance, enabling our sector to avoid the level of insolvencies and market meltdowns that we have seen in other sectors of the financial community. Indeed, our national solvency system has protected the ability of companies to pay claims while remaining competitive and profitable. But while state insurance regulators are concerned that insurers remain profitable and provide a reasonable return for investors, the true focus of our regulation is the protection of policyholders and claimants. It is the forward-looking nature of insurance that compels regulators to make sure that sufficient funds are available to respond to consumers' needs.

Systemic Risk, Resolution Authority, and the Insurance Sector

In the view of state insurance regulators, an entity poses systemic risk when its status and activities have the ability to ripple into the broader financial system and initiate problems for counterparties, requiring extraordinary mitigation efforts. The insurance industry in general does not pose a systemic risk to the nation's financial markets to the extent we have seen in the banking and securities sectors; rather, insurance companies are more often the recipients or conduit of risk. Mortgage and title insurers, for example, do not generate systemic risk; rather, they facilitate the underlying loan transaction. The quality of the underlying banking transaction, and related underwriting, determines whether proliferation of such transactions increases systemic risk. Insurance tends to be far less leveraged than other sectors, and many of the risks assumed by insurers (mortality, property damage, etc) tend to be uncorrelated to other risks in the financial sector.

Exposure to systemic risk in the insurance sector, as opposed to the generation of systemic risk, typically flows from assets linked to the capital markets. As such, state regulators have placed appropriate restrictions on the investments held by insurers, and we are continuing to review those standards in light of losses in the capital markets. We are also assessing our reliance on private financial rating agencies, to determine their impact on insurer liquidity and investments.

Regardless of changes to our supervision of insurers, no regulatory system is so constraining as to eliminate the possibility of company failure, and indeed the threat of failure serves as a critical component of risk management for insurers. If a life insurer or property insurer were to fail, regardless of size, state-based guarantee funds would protect existing policyholders and pay claims, and state insurance statutes prioritize policyholders over other creditors. As history has demonstrated, competition and capacity from over 7000 U.S. insurers fill marketplace voids left by the failed insurer.

State insurance commissioners have broad receivership authority over insurance companies. In the case of insurance subsidiaries, this receivership authority walls insurance company holdings off from the broader holding company. The insurer's assets cannot be used to satisfy the debts of its owner, thus ensuring the continued protection of policyholders. This "walling off" is a critical protection that should not be lost or compromised by federal efforts.

Proposals for Systemic Risk and Resolution Authority Reform

In the months since the Obama Administration's proposal for financial regulatory reform was unveiled, members and staff of the National Association of Insurance Commissioners have consistently delivered the same, overarching message to Congress: That a coordinated, national system of state-based insurance supervision has met, and will continue to meet, the needs of the modern financial marketplace while effectively protecting individual and commercial policyholders. We believe that any regime change that results in redundant, overlapping responsibilities will result in policyholder confusion, market uncertainty, regulatory arbitrage, and a host of other unintended consequences that will harm individuals, families, and businesses that rely on insurance for protection against the risks of everyday life. A federal regulator is not a prerequisite for systemic risk supervision that includes review of the insurance sector – such a structure can overlay the existing state regulatory system without displacing it.

To that end, the NAIC has worked to communicate the following principles for systemic risk regulation to this Committee, the broader Congress, and the Administration:

First, we believe that any new system must incorporate, but not displace, the state-based system of insurance regulation. State insurance regulators are on the front lines in resolving approximately three million consumer inquiries and complaints each year, and that daily attention to the needs of individuals and businesses must remain a cornerstone after any reform effort. Our national solvency system has proven resilient during the financial crisis, so if supervision of systemically significant holding companies requires group capital standards, such requirements should be in addition to existing solvency requirements of the functional regulators.

Second, federal legislation should ensure effective coordination, collaboration and communication among all relevant state and federal financial regulators in the United States. Preservation of "functional regulation" should be a fundamental goal. In particular, financial stability regulation, as it relates to insurance, can only be stronger with the added expertise of the 13,000 people who currently work in our nation's state and territorial insurance departments. We can bring expertise and information on the condition of the insurance industry to bear in any systemic risk review. As such, state insurance regulators must have a meaningful seat at the table of the proposed Financial Services Oversight Council. In order to provide a complete view of the financial system, regulators at the state and federal level must also have appropriate authority to share information.

Third, group supervision of complex holding companies that includes functional regulators is necessary, but preemption of state insurance regulators, if ever necessary, should result only after our efforts have been exhausted. Group supervision through "supervisory colleges" preserves functional regulation and provides a complete view of the activities within a complex holding company. There is a great benefit to having multiple sets of eyes looking at an institution, such as what exists with the current state-based insurance regulatory system. Preemption – and putting a single federal regulator in charge – would take away the crucial failsafe of allowing real and potential oversights by one regulator to be spotted and corrected by another. State insurance regulation is not without its challenges, but it allows for a system of checks and balances that mitigates regulatory capture and typically detects problems before they become systemic in nature.

Additionally, we would also stress that systemic supervision should consider the unique expectations of consumers, and the different regulatory structures for different entities within a holding company. For example, an AIG insurance policyholder is paying for a promise backed up by a solvency regime tailored to that promise. On the other hand, the counterparty to an AIG credit default swap may be merely speculating with no guaranty of success and with no underlying promise of protection. Systemic risk supervision of holding companies needs to recognize this reality so that the health of a well regulated entity within a holding company is not sacrificed to preserve an unregulated operation within that same holding company.

These principles are focused on review of systemic risk, but they are equally critical in developing any federal mechanism to resolve large, complex financial institutions. A resolution mechanism responsible for "unwinding" problems in complex financial institutions that threaten economic stability (presumably when bankruptcy proves to be the more costly alternative), must work in tandem with the existing state-based receivership and guaranty fund regime for insurance companies. As previously noted, state insurance commissioners have broad authority and a long history of working through insolvencies in the marketplace. This experience and structure should be leveraged, and systemic resolution authority must continue to allow state regulators to protect the assets of the sound insurance entities from predation by unsound, poorly-regulated subsidiaries or the broader holding company. State receivership authority prioritizes policyholders as creditors of failed insurers, and we stress that federal resolution authority should respect this system so that assets of insurers can not be pulled from policyholders to pay off failings at the holding company level. One need look no further than AIG – where the insurance subsidiaries remained solvent while the holding company spiraled into failure – for illustration of this critical issue. We have experience in coordinating multi-state receiverships, as well as insolvencies of insurers within holding companies. Again, this proven system and expertise must be preserved.

The Congress is appropriately reviewing the scope and strength of financial supervision, and we welcome that attention. The proposals on the table, from expanding the Federal Reserve's authority to making significant changes to the scope of the Bank Holding Company Act, are far reaching and will impact insurance consumers. Better consolidated supervision of complex firms is needed, but we urge caution in pursuing any proposals that could impact our ability to adequately regulate the insurance market and protect insurance consumers, and ask that our perspective be considered by this Committee in the critical days and weeks ahead.

Mr. Chairman, thank you again for the opportunity to testify at today's hearing and I look forward to your questions.