

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Regarding:
“American International Group’s Impact on the Global
Economy: Before, During and After Federal Intervention”

Wednesday, March 18, 2009

Joel Ario
Insurance Commissioner
Pennsylvania Insurance Department

**Testimony of Joel Ario
Insurance Commissioner
Pennsylvania Insurance Department**

I would like to thank Chairman Paul Kanjorski, Ranking Member Scott Garrett and the members of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises for inviting me to testify today at this hearing on the “American International Group’s Impact on the Global Economy: Before, During, and After Federal Intervention.”

My name is Joel Ario and I am the Insurance Commissioner for the Commonwealth of Pennsylvania. I am appearing here today on behalf of the National Association of Insurance Commissioners (NAIC).

I very much appreciate the Subcommittee holding this hearing so that we can discuss what has happened at AIG and how to improve financial services regulation in the future.

Only AIG’s Domestic Insurance Companies are Subject to State Insurance Regulation

I would like to start by clearing up some confusion. AIG is typically described as the world’s largest insurance company, which reinforces the misconception that AIG is entirely the province of state insurance regulation. In fact, AIG is a huge, global financial services conglomerate that does business in 130 countries. AIG includes 71 U.S. insurance companies, but it also has 176 other financial services companies, including significant non-U.S. insurers.

State insurance regulatory authority is limited to the 71 U.S.-based insurance companies. Under the nationally-coordinated system of state-based insurance regulation, state insurance departments have primary authority for those insurance companies domiciled in their state. In Pennsylvania’s case, we are the domestic regulator for 11 of AIG’s 71 U.S. insurance companies.

These 71 insurance companies are primarily involved in three lines of insurance: life and annuities, commercial lines (e.g., workers compensation and other business insurance), and personal lines (e.g., auto). AIG pools its business in each of these three lines and there are lead regulatory states for each

line, starting with the state in which the lead AIG company in each pool is domiciled: Pennsylvania for commercial lines, New York for personal lines, and Texas for life and annuities.

Six of the Pennsylvania companies are members of AIG's commercial lines pool, including the lead commercial lines company, National Union Fire Insurance Company of Pittsburgh, PA. The other commercial lines companies are AIG Casualty Insurance Company, Insurance Company of the State of Pennsylvania, New Hampshire Insurance Company, American International South Insurance Company and Granite State Insurance Company.

The other five Pennsylvania domestics are personal lines companies: AIG Centennial Insurance Company, AIG Indemnity Insurance Company, AIG Preferred Insurance Company, AIG Premier Insurance Company and New Hampshire Indemnity Company.

AIG does not have any life insurance companies domiciled in Pennsylvania.

One of the checks and balances inherent in the state-based regulatory system is that multiple states look at each AIG line of business. Our critics may question the efficiency of having multiple eyes on a complex enterprise such as AIG, but the reality is that these multiple eyes have served policyholders well by protecting the solvency of the AIG insurance companies despite turmoil at the AIG holding company level.

Efficiency is important, and through the NAIC, state regulators have developed tools and technologies to improve efficiency and coordination. But effectiveness is more important, and one reason our state-based system has worked well to identify and limit damage from the inevitable mistakes that come with any regulatory system is that we are careful not to trade minor gains in efficiency for our effectiveness in protecting solvency and policyholder interests.

The core principle of our nationally-coordinated financial accreditation system is the requirement that insurers hold conservative reserves to ensure that they can honor their obligations to policyholders and claimants. The concept sounds simple enough -- companies must practice sound risk management by setting aside funds to pay obligations down the road -- but it is a concept that other segments of the financial sector have failed to enforce. One clear lesson of the current crisis is the importance of having plenty of capital and not having too much leverage.

AIG Financial Products was the Problem, Not the AIG Insurance Companies

Federal Reserve Chairman Ben Bernanke recently described the source of AIG's troubles as coming from "a hedge fund, basically, that was attached to a large and stable insurance company." He was right on both counts. The "hedge fund" is the AIG Financial Products unit, which, according to Chairman Bernanke, "made huge numbers of irresponsible bets" and "took huge losses." The "large and stable insurance company" is the 71 state regulated insurance companies.

Let me be more specific. When the credit rating agencies announced potential rating downgrades for AIG on September 12, 2008, the primary focus of concern was AIG Financial Products and the \$440 billion in credit default swaps it had outstanding at that time, many of which included subprime housing loans. As it became clear that Financial Products had bet more than twice the market value of AIG in these credit default swaps, and failed to hedge or otherwise protect itself against collateral calls, the situation turned dire.

Faced with ratings downgrades over that fateful September weekend, AIG Financial Products and AIG holding company were staring at tens of billions of dollars of demands for cash collateral on the credit default swaps written by Financial Products and guaranteed by the holding company. To make matters worse, the counterparties to those credit default swaps included many of the world's largest financial institutions, all of which had hedged their own involvement in the risky credit default swap business through Financial Products. To quote Chairman Bernanke again, Financial Products "took all these large bets where they were effectively, quote, 'insuring' the credit positions of many, many banks and other financial institutions."

In summary, the reason the federal government decided to rescue AIG was not because of the insurance companies, which were stable and well capitalized. Rather it was because of the systemic risk created by Financial Products. I will address the future role of insurance regulation in avoiding systemic risk later in my testimony, but it is important to understand that the systemic risk created and still ongoing at AIG came from the Financial Products operation. Also important is the fact that the federal government acted more to protect the counterparties rather than AIG itself.

In Chairman Bernanke's words: "We're not doing this to bail out AIG or their shareholders, certainly. We're doing this to protect our financial system and to avoid a much more severe crisis in our global economy. We know that the failure of major financial firms in a financial crisis can be disastrous for the economy. We really had no choice."

Put simply, AIG Financial Products' reach was so broad and so interconnected with the world's largest financial institutions that it has become the poster child for systemic risk.

AIG Financial Products and Holding Company Are Federally Regulated

By purchasing a savings and loan in 1999, AIG was able to select as its primary regulator the federal Office of Thrift Supervision (OTS), the federal agency that is charged with overseeing savings and loan banks and thrift associations.

AIG Financial Products is not a licensed insurance company and is not regulated by the states. Financial Products is an investment unit based chiefly in London. It was able to evade regulation under the British Financial Services Authority because the AIG holding company was registered with an "equivalent regulator," the OTS.

Although OTS has acknowledged its role as the holding company supervisor, it is worth noting that credit default swaps were exempted from regulation under the Commodities Futures Modernization Act of 2000, which prevented both the C.F.T.C. and the states from regulating these instruments.

AIG and its Insurance Competitors Continue to Engage in Vigorous Competition

AIG's insurance companies continue to perform well in a troubled economic times, well enough that allegations have been raised by their competitors as to whether the AIG companies are using their current situation to unfair advantage in the marketplace. The allegations are most prominent in the highly competitive commercial property and casualty markets, where some of the nation's largest insurers routinely bid against each other on multi-million dollar accounts for the privilege of insuring the nation's largest businesses.

AIG's competitors have argued that AIG is deliberately under pricing its insurance in a desperate attempt to maintain premium volume at a time when policyholders might otherwise move their business to a safer competitor given AIG's uncertain future. Not surprisingly, AIG has fired back that its competitors are targeting AIG business by making disparaging comments about AIG and selectively under pricing their products in an unfair bid to take business away from a vulnerable competitor.

Each of these allegations has some plausibility, and state regulators have spent considerable time listening to such allegations, asking for specific facts, and following up as appropriate. When AIG complained of disparagement by competitors in the aftermath of the federal government's September actions, Pennsylvania and other states issued notices reminding everyone that disparaging a competitor violates state insurance laws. Later, when AIG did the same thing by making unfair comparisons between its investments and those of competitors on its website, Pennsylvania and New York required them to focus on their own strengths and delete the offending material.

The latest round of allegations have involved specific cases where the charge is that a particular account was deliberately under priced in a manner that would present a solvency risk if done systematically. Such disputes are common in highly competitive markets and typically reflect insurers trying to protect profit margins. However, there is a point at which low prices for policyholders can threaten long term stability, especially considering that the effects of under pricing may not show up for years given the time lapse between collecting premium and paying claims.

The Pennsylvania department has devoted special attention to the current allegations because both AIG and its competitors may have distorted incentives to put their competitive engines into overdrive – to preserve business on one side and to deliver a knock out blow on the other side. With the caveat that these issues are very complex, we have not seen any clear evidence of under-pricing to date, though we continue to look both at individual cases and at aggregate numbers on both renewals and new business at AIG.

State Insurance Regulation Has Performed Well

Some have rather disingenuously tried to use AIG's problems as an argument for an optional federal charter for insurance companies. There are some lessons to be learned from the AIG situation, but

shifting the primary locus of insurance regulation to the federal level is the wrong lesson to learn from AIG for two reasons.

First, when you permit companies to pick their regulator, you create the opportunity for regulatory arbitrage. The whole purpose of financial services regulation is to appropriately control risk. But when you allow regulatory arbitrage, you increase risk, because you create the opportunity for a financial institution to select its regulator based on who might be more lenient, who might have less strict rules, who might demand less capital.

Second, what happened at AIG demonstrates the strength and efficacy of state insurance regulation. Indeed, the federal rescue of AIG would have been an even tougher call were it not for the well-capitalized insurance companies that provide the possibility that the federal government and taxpayers will be paid back. AIG's insurance companies remain strong, in part because state regulation continues to wall them off from the high risk activities engaged in by AIG Financial Products.

In most industries, the parent company can reach down and use the assets of its subsidiaries. With insurance, that activity is greatly restricted. Insurance is a promise to pay, often many years, even decades, down the line. Companies must be well capitalized to ensure that they can pay claims. That is why state regulators require insurance companies to maintain healthy reserves backed by investments that cannot be used for any other purpose. As New York Superintendent Eric Dinallo says, "the insurance companies are the bars of gold" within the AIG conglomerate.

State Insurance Regulation Must Continue to Improve, Including Securities Lending

There are certainly activities that the states need to modernize, such as producer licensing, product review, and market regulation. State regulators are making progress in each of these areas, often by applying the lessons we learned in developing our financial accreditation program. That program has a strong and solid history of safeguarding the most important consumer protection: a solvent insurer to honor its promises and pay claims. At a time when many financial firms are in trouble because they do not have adequate capital and are too highly leveraged, insurance companies remain relatively strong.

This is not to say that the state financial regulation system is perfect. There are always improvements to be made and new challenges to address. The current economic crisis has exposed new clouds on the horizon, particularly within the life insurance sector, and there will be some serious challenges if the economy continues to deteriorate at current rates. But that is true of virtually every sector of our economy, and only reinforces the need to be wary of changing a part of our regulatory system that has proven effective.

That brings me to the question of securities lending, because this is one area where the AIG situation has exposed some problems and improvements are underway. Before addressing those issues, however, let me again emphasize that securities lending did not pose unmanageable systemic risk and was not the reason for federal intervention. AIG Financial Products was the source of federal intervention.

If there had been no Financial Products unit and only the securities lending program, as it was, we would not be here today. There would have been no federal rescue of AIG. Financial Products, which wrote \$440 billion in credit default swaps, as well as other derivatives and futures, with a total notional value of about \$2.7 trillion dollars as of September 2008, created systemic risk. Securities lending, with a \$58 billion balance in the U.S. life insurer portion of the pool outstanding in September 2008, did not create systemic risk. If not for the run on the bank caused by Financial Products, the securities lending pool would likely have continued to decline at a manageable pace, as it had been doing under state regulator supervision for the year before the Financial Products crisis.

It is also important to understand that securities lending is an activity that has been going on for decades without serious problems. Many, if not most, large financial institutions, including commercial banks, investment banks and pension funds, participate in securities lending.

Securities lending involves financial institution X lending a stock or bond it owns to financial institution Y. X still owns the security and will benefit from any growth in its value. In return, Y gives X collateral, usually cash, to secure the borrowing. Generally, the cash collateral provided is about 102 percent of the value of the security it is borrowing. X then invests the cash to gain an additional amount of return. These contracts typically mature in 30 to 90 days, with an option to “rollover” and continue the contract for an additional term.

Problems can occur if Y decides it wants to return the security it borrowed from X rather than allowing the contract to rollover. X is then required to sell the investments it purchased with the cash collateral in order to obtain the cash it owes Y. Generally, in a big securities lending program, X will have some portion of the collateral investments in liquid assets it can easily sell. But if borrowers choose to terminate contracts more frequently than planned for, then X may not be able to sell enough assets quickly enough to obtain the cash it needs. If collateral investments have declined in value, X may be required to sell assets for less than what is owed to Y. If the number of borrowers choosing to terminate contracts grows large enough, X may not have enough assets with enough value to provide the cash it must return to the borrowers. This is the proverbial “run on the bank” scenario.

In the case of AIG, it was the crisis at Financial Products that caused such a run, which exacerbated a securities lending problem that state regulators were otherwise on the way to resolving. Furthermore, even with the collateral damage caused by the Financial Products crisis, it must be noted that the securities lending problems at AIG have been defined, contained and fixed, meaning that securities lending is not any part of the ongoing challenges at AIG.

AIG securities lending was consolidated by the holding company at a special unit it set up and controlled, totaling about \$76 billion in the U.S. life insurer portion of the pool at its height. This special unit was not a licensed insurance company, but directed the securities lending program for a variety of AIG affiliates, including the twelve U.S. life insurers.

Traditionally securities lending pools operated by insurers primarily invest in conservative, highly liquid investments, such as treasuries and short-term paper, and include cash set aside to offset some liquidity risk with these transactions. The AIG securities lending program initially operated in this more traditional manner; however, as with some other holding company activities, the special unit changed course and became more aggressive in its management and collateral investment practices to generate additional revenue for AIG.

This change in philosophy was not disclosed by AIG and only came to light in 2006 under questioning by state insurance regulators. By then, many of the collateral investments were already facing some liquidity and market value stress. State insurance regulators immediately began working with the companies to deal with those issues. While most of the AIG securities lending collateral

investments were top-rated assets, about 60% of these assets were mortgage-backed securities, including almost 29% in subprime. Today, with the perfect clarity of hindsight, we all know that those ratings were not aligned with the market value of many mortgage-backed securities.

State insurance regulators were making steady progress in reducing the securities lending program, but were thwarted by the Financial Products crisis in September 2008. From its peak of about \$76 billion, the securities lending pool had declined by \$18 billion, or about 24 percent, to about \$58 billion by September 12, 2008. At that point, the crisis caused by Financial Products caused a run on the AIG securities lending program. Borrowers that had reliably rolled over their positions from period to period for months began returning the borrowed securities and demanding their cash collateral. From September 12 to September 30, borrowers demanded the return of about \$24 billion in cash.

To avoid massive losses from sudden forced sales, the federal government, as part of its rescue, provided liquidity to the securities lending program. In the early weeks of the rescue, the holding company used federal rescue funds to meet the collateral needs of the program. In November 2008, the Federal Reserve Bank of New York created Maiden Lane II, a special purpose vehicle that used about \$20 billion in federal funds to purchase the remaining securities lending collateral at market value. The federal government still holds that collateral, which has held its market value in the \$20 billion range since November.

State insurance regulators have closely monitored the securities lending programs operated within other insurance entities, most of which have not posed problems. AIG's property and casualty companies had securities lending programs, but they were phased out without problems by August 2008. State insurance regulators have also acted to increase disclosure requirements for these programs through the NAIC Statutory Accounting Principles Working Group.

Going forward, state insurance regulators are considering changes to regulations involving holding company groups, as well as investments held by insurers. The issues that impacted the U.S. life insurers due to the securities lending program operated by the AIG holding company will be key considerations in these discussions.

Financial Regulation can be Improved With a Coordinated Approach to Systemic Risk

State insurance regulators recognize that action is needed at the federal level to identify and manage systemic risk within the nation's financial marketplace. That shared objective calls for a collaborative approach to the regulation of financial enterprises that create true systemic risk, such as AIG Financial Products.

We caution, however, that collaboration does not mean federal preemption. Under our supervision, AIG and other insurance companies have weathered the current economic crisis relatively well, and our conservative solvency standards have been validated. State insurance regulation should be integrated into the framework for managing systemic risk.

In addition to consideration of financial stability or systemic risk regulation, Congress should also consider imposing greater transparency in the capital markets so that financial products or interactions that cause systemic risk can be more readily identified. The magnitude of the credit default swaps market illustrates the need for this reform.

State insurance regulators have been analyzing the potential for systemic risk within the insurance industry, particularly regarding the oversight of financial holding companies, and we look forward to contributing to the solutions being sought by Congress and the Administration.

Dr. Terri Vaughan, the new CEO of the NAIC, recently testified on behalf of state insurance commissioners before this Subcommittee on the topic of systemic risk. She outlined the nature of systemic risk within the insurance industry and proposed three principles supported by the state insurance commissioners for achieving greater collaboration among financial service regulators while securing and maintaining existing expertise through the principle of functional regulation:

- Primary role for states in insurance regulation. The framework should preserve the current flexibility to address state needs at the state level and ensure consumer access to state-based regulatory officials. The framework should include information sharing and confidentiality protocols that give state insurance regulators access to the information they need to fulfill their consumer protection responsibilities.

- Formalization of regulatory cooperation and communication. Formal structures should be enhanced to provide a forum for all financial service regulators to consult about emerging trends and issues and develop best practices for systemic risk management.
- Group supervision of holding companies. The concept of “supervisory colleges” should be used to involve all financial regulators in understanding the risks within holding companies deemed to pose systemic risk. This form of collaboration should operate in a transparent and accountable manner that defers to the functional regulator and does not compromise one company within the holding company structure simply for the benefit of another company. Preemption of state insurance regulation should take place, if at all, only under the very limited circumstances where necessary to address a material risk to the financial system and only to the extent that obligations to policyholders and claimants are met and state regulatory authority has been exhausted.

We look forward to continuing to work with Congress and the Administration on fleshing out these principles and developing an effective approach to systemic risk that preserves the proven strength of state-based insurance regulation.

Consumer Protection Must Remain Job One for Insurance Regulators

The primary goal of state insurance regulators throughout the AIG ordeal has been to protect insurance company policyholders and stabilize the insurance marketplace. I believe we share this goal with the federal government and with AIG officials, if only because all parties recognize that the insurance companies are AIG’s most valuable assets and the key to preserving that value is the continued confidence of policyholders. As efforts to resolve the ongoing problems at AIG Financial Products continue, it is imperative that whatever actions are taken are guided by doing what is best for policyholders. I can assure you that state insurance regulators will continue to evaluate any transactions involving AIG insurance companies on that basis.

Thank you and I would be happy to answer your questions.