Testimony of J Eric Smith
House Financial Services Committee
Subcommittee on Insurance, Housing and Community Opportunity
July 28, 2011

Chairman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee, on behalf of the Reinsurance Association of America (RAA) and my company, Swiss Re, thank you for the opportunity to testify at today's hearing on the impact of insurance-related public policy on U.S. consumers, businesses and jobs. My name is Eric Smith, and I am president and CEO of Swiss Re Americas. Swiss Re is a global reinsurance company with a highly-skilled workforce of several thousand U.S. employees, and we transact U.S. business through U.S. tax-paying companies. The RAA is a U.S. national trade association representing the interests of reinsurers doing business in the United States and other parts of the world. My testimony today will focus on key public policies stemming from the Dodd-Frank Act that affect reinsurers.

We applaud your leadership in creating the Federal Insurance Office (FIO). Chairman Biggert, you must be particularly proud that the first FIO director comes from the great state of Illinois. The FIO has a fundamental role to play here at home and in the international insurance regulatory arena, and the importance of its role as expert advisor to the Financial Stability Oversight Council (FSOC) cannot be overstated. FIO Director Michael McRaith's background as a state insurance regulator, and his experience supervising global insurance groups and working on international issues, will be a real compliment to the U.S. government. We look forward to working with him and the entire team at the FIO and Treasury as they carry out the agency's new and important insurance-related functions.

The Subcommittee has come to know that reinsurance is an important part of the insurance mechanism. It is an efficient risk management tool that assists insurance companies and governments in improving their insurance capacity and enhancing financial security. You and I as consumers manage our own personal risks by purchasing protections including life, auto and home insurance, and businesses manage their risks by purchasing a variety of insurance products. Insurance companies and governments also protect their interests by purchasing reinsurance. For example, insurers and state-run property insurance programs use reinsurance in managing the cost of natural catastrophe risks, such as flood, wind and earthquake. In fact, reinsurers have helped the United States recover from every major catastrophe over the past century. To provide a sense of what this means, here are a few facts. Sixty percent of the insured losses related to the events of September 11, 2001, were absorbed by the global reinsurance industry. In 2005, sixty-one percent of Hurricanes Katrina, Rita and Wilma insured losses were ultimately borne by reinsurers, and in 2008, approximately one-third of insured losses from Hurricane Ike and Gustav were reinsured. Swiss Re has helped Americans rebuild from every major U.S. catastrophe since the 1906 earthquake.

Reinsurance is a global business and reinsurers are global companies. Without global scale, reinsurers would not be able to absorb peak risks. Diversification is achieved by spreading risks across different geographical regions and lines of business in order to increase the number of mutually independent risks. As a result, loss events within particular product lines or local markets can be absorbed by the return on other policies not affected by those events. These global diversification concepts provide efficient and effective protection to reinsurance purchasers.

Information Gathering and Knowledge Sharing

We understand there is lingering concern about some elements of the Dodd-Frank Act. The FIO is not one of those elements and we offer our strong support for its establishment. For the first time, there is a federal agency responsible for understanding the insurance and reinsurance industry. We believe the FIO is a step in the right direction. We urge Congress and the Administration to provide sufficient resources to the FIO to ensure that it meets its responsibilities, which are indeed essential functions.

The FIO was given data collection authority in order to fill a gap in federal level knowledge of the industry, and in evaluating systemic risk. In carrying out these functions, we believe the FIO should coordinate closely with the Office of Financial Research, the National Association of Insurance Commissioners and other existing regulatory and non-regulatory sources. In this way, the FIO can utilize credible, available data and avoid duplicative reporting requests, which can be a drain on business resources. Since the FIO serves as one of the few but very important insurance-focused members on the FSOC, we believe the FIO's data collection, analysis, and advice are essential to the FSOC's deliberations and determinations on insurance sector risk. The RAA has for many years collected data and provided analysis on the reinsurance sector to regulators and public policy makers, and we hope to share that information with the FIO as a constructive resource not readily available from traditional regulatory filings. Similarly Swiss Re is one of the world's leading risk experts with a research time horizon of 50 to 100 years. We believe we have a responsibility to share our risk research with governments around the world. It is important that the relevant confidentiality provisions of the Dodd-Frank Act are fully effectuated to ensure that confidential company information can be safely shared

The Dodd-Frank Act requires the FIO to produce and deliver certain reports to Congress, including one on improving U.S. insurance regulation and another on the breadth and scope of the global reinsurance market. We believe these reports should include specific discussion of states' implementation of section 531 of the Act and related state-based collateral reform efforts, and section 532 of the Act. By including these provisions, we believe Congress was clear that it expects specific outcomes in the regulation of insurers and reinsurers, and that the FIO will monitor and report on these specific aspects of the U.S. insurance regulatory

system. We hope there will be room for relevant industry input and objective analysis in these reports.

U.S. Engagement Internationally on Insurance

We fully support the FIO taking an active and meaningful role internationally on insurance regulatory matters. There are many international forums where important insurance-related issues are being addressed, and it is clear from the Dodd-Frank Act that Congress intends for the United States to act and speak with one voice in these forums going forward. Whether it is at the International Association of Insurance Supervisors, working with the G-20 and Financial Stability Board, the OECD, WTO or elsewhere, the FIO has the power to be the clear and consistent voice of the United States, reflecting the interests of U.S. policyholders, insurers, reinsurers, and the U.S. insurance regulatory community. One of the most important powers that Dodd Frank granted to the FIO is the authority to enter into and enforce international agreements with foreign regulators on prudential insurance regulatory measures. We believe this authority should be used to ensure equitable treatment for domestic and foreign insurers and reinsurers alike, and to promote job creation and foster innovation and economic growth in the United States.

Financial Services Oversight Council and Systemic Risk

This Subcommittee knows that the Dodd-Frank Act empowers the FSOC to create criteria for evaluating and designating non-bank financial institutions as "systemically relevant", and to subject those companies to heightened regulatory scrutiny. It is an important reminder for all of us that Congress set the statutory bar for systemic risk designation very high. In order for a U.S. or foreign non-bank financial company to be subjected to heightened prudential regulation and Federal Reserve Board supervision, the FSOC must find that the material financial stress, or the ongoing activities of the company, could pose a threat to the financial stability of the United States. This high standard was established by Congress in order to mitigate unintended consequences that could result from uninformed systemic risk designations, which could have lasting effects on a company, its employees and shareowners and the United States economy.

In order to understand the unique nature of the insurance and reinsurance industry, we urge the FSOC to rely heavily on the expertise of its three insurance-focused members when considering the sector. We urge the FSOC to de-link all considerations for designating insurance companies from those used for banking institutions. The business models and roles in society of insurance companies and banks are distinct and should be considered separately.

There are important lessons learned from the financial crisis. First, the significant gap in U.S. supervision of company groups must be closed in insurance regulation. A single regulator must be responsible for understanding and regulating a group. Second, systemic risk

regulators must consider activities first—rather than entities first—if they hope to effectively identify potential systemically important non-bank financial institutions. The RAA has undertaken extensive quantitative systemic risk analysis using non-bank criteria proposed by systemic risk regulators as the basis for the work. The results of this effort indicate that reinsurers and reinsurance are not the source of systemic risk. The RAA findings are attached to this statement for the record and shown as Appendix A.

On behalf of the Reinsurance Association of America and my company, Swiss Re, thank you for the opportunity to appear before the Subcommittee. We are gratified that Congress continues to remain engaged in insurance-related matters.

Appendix A

EVALUATING SYSTEMIC RISK

Property & Casualty Reinsurance

Reinsurance Association of America
Washington, DC
July 2011

Definitions of Systemic Risk

Financial Stability Board

- "The risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy."

- "Fundamental to this definition is the notion that systemic risk is associated with negative externalities and/or market failure and that a financial institution's failure or malfunction may impair the operation of the financial system and/or the real economy. "

Definitions of Systemic Risk

Federal Reserve Chairman Ben Bernanke

"The possibility that the failure of a large interconnected firm could lead to a breakdown in the wider financial system; systemic risks threaten the stability of the financial system as a whole and consequently the broader economy, not just that of one or two institutions."

(Re)insurance Business Model

The (re)insurance business model is not a source of systemic risk.

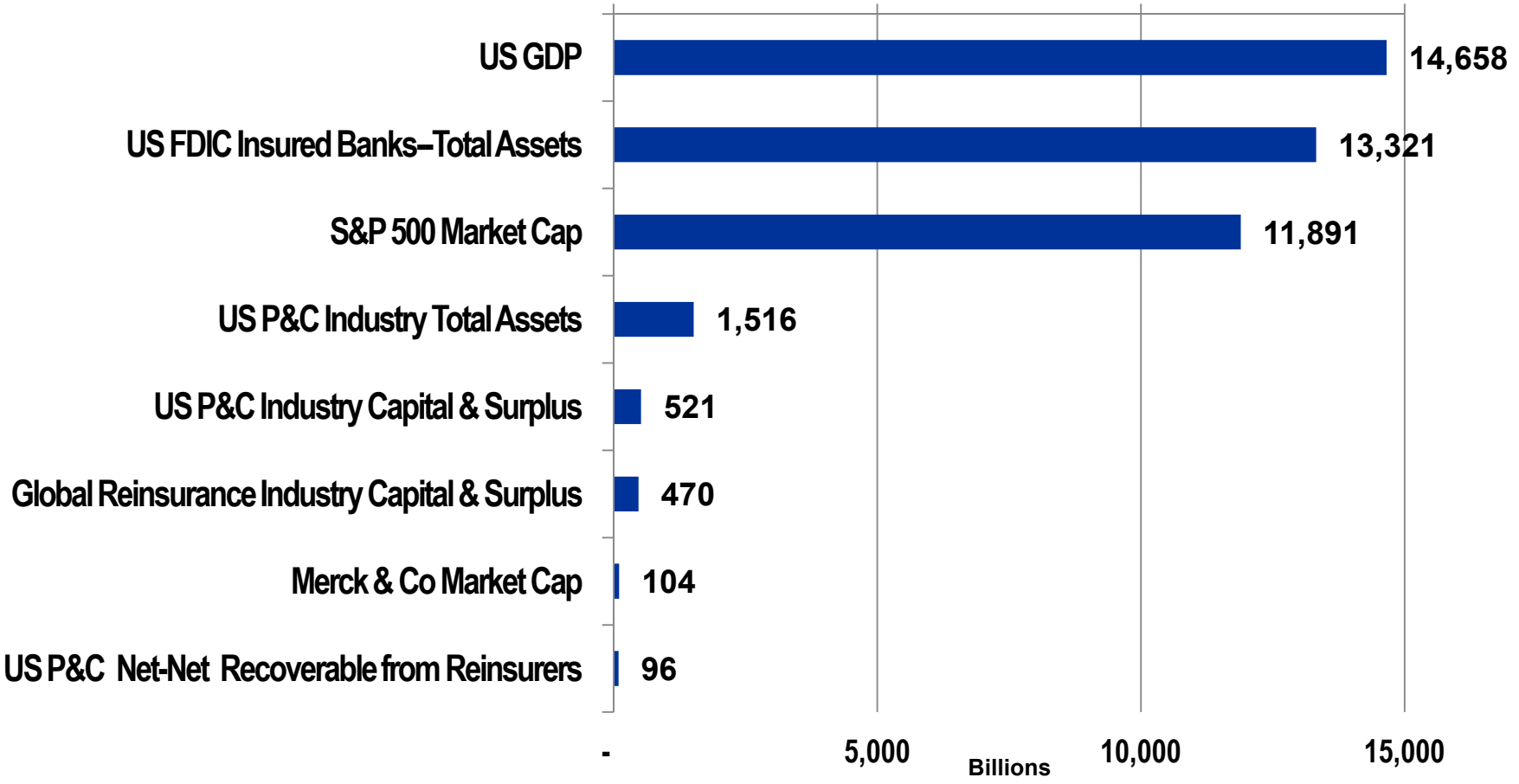
- It is fundamentally different from other financial institutions.
- Inverted production cycle: obligations are pre-funded at the inception of the policyholder relationship.
- Lack of leverage limits interconnectedness.
- (Re)insurance obligations are not callable. Cash outflows may only be triggered by an external insured event.
- Insured loss events are not correlated with financial crises or economic cycles.

FSB Systemic Risk Attributes

The FSB has identified four primary attributes for the evaluation of systemic risk

- Size
- Interconnectedness
- Substitutability
- Time / Liquidity

Size - Reinsurance recoverables are not systemic risk amounts relative to U.S. financial markets or economy.



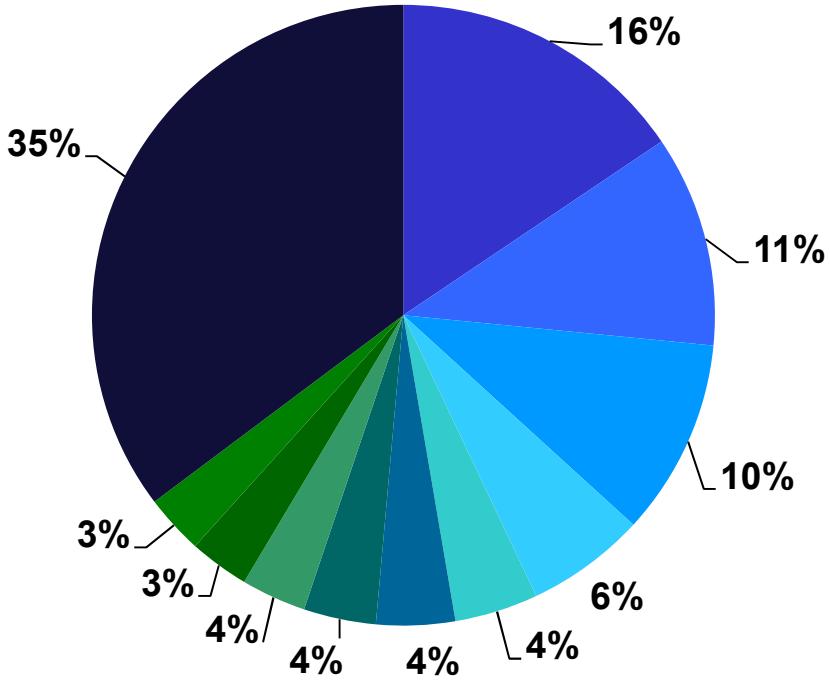
Size – Small relative size / reinsurance credit risk is further reduced by offsetting amounts.

U.S. P&C Industry Exposure to Reinsurance Recoverables

2009 Results	**$ Millions**
Total Assets	1,515,926
Reinsurance Recoverables on Paid Losses	14,444
Policyholders' Surplus	520,600
Net Recoverables (Paid, Case & IBNR, net of amounts owed to reinsurer)	233,816
Less Funds Held	23,502
Less LOCs, Trust Funds, & Other Collateral	114,654
Equals Net Net Recoverable	95,661
Recoverables Analysis	
Net Net Recoverable as % of PHS	18.4%
Net Net Recoverable as % of Total Assets	6.3%
Recoverable on Paid Loss as % of PHS	2.8%
Recoverable on Paid Loss as % of Total Assets	1.0%

Interconnectedness – Insurance risk is spread broadly and globally. Reinsurance is a net credit enhancement for many cedents.

Top US P&C Groups
3rd Party Reinsurance Net-Net Recoverables Concentration

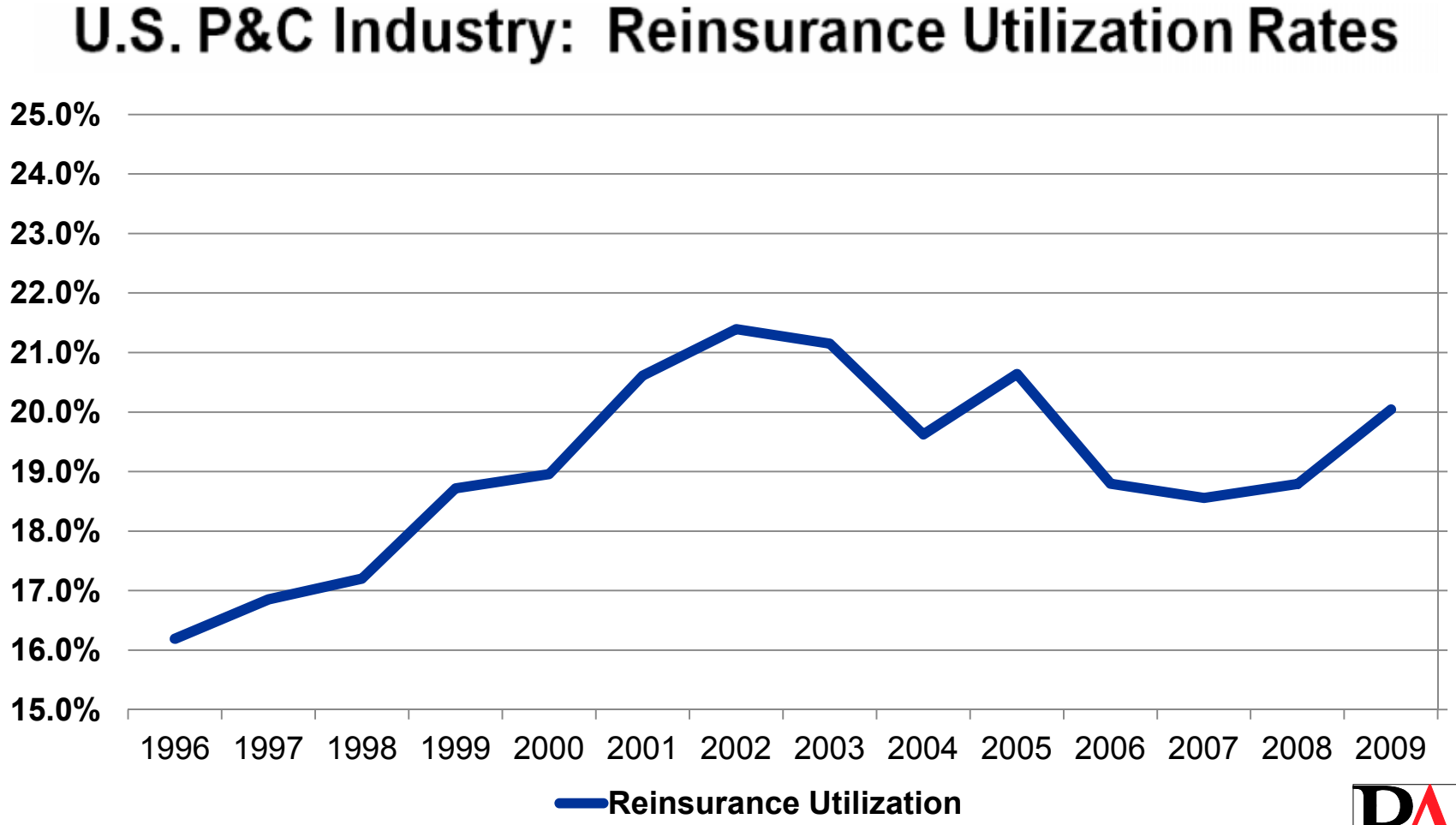


Swiss Re	A+
Berkshire Hathaway	AA+
Munich Re	AA-
Lloyd's of London	A+
Nationwide	BBB*
Everest Re	A+
Transatlantic Re	A+
Hannover Re	AA-
XL Group plc	A
Fairfax	A-
All Other Reinsurers	

*Note: Nationwide's AM Best Rating = A+. Approximately 90% of this net-net recoverable is due from Nationwide Indemnity Co., an entity used to run off asbestos and environmental obligations.

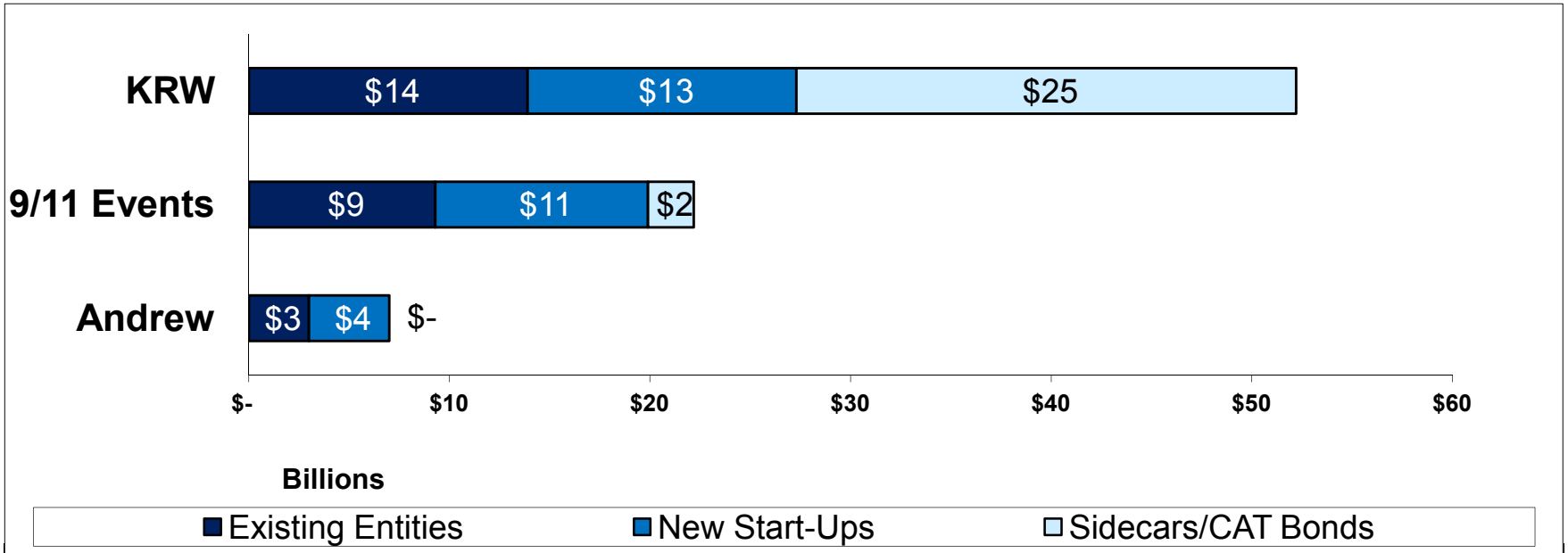
Interconnectedness & Substitutability

P&C industry cessions to the global reinsurance market are only 20% of gross premium.



Substitutability – Capital is quickly replaced following significant events. Alternative forms of capital have become more prevalent.

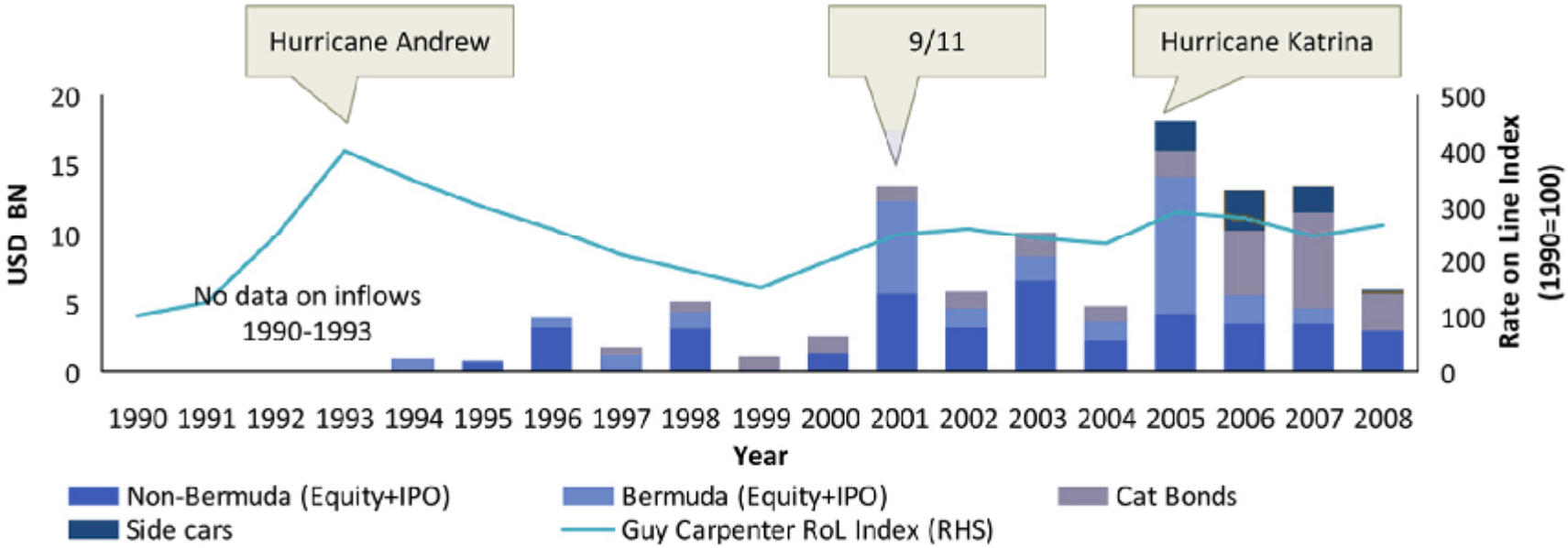
Post CAT-Event Capital Raised



	KRW	9/11 Events	Andrew
New Capital Raised	$52.2 B	$22.2 B	$7.0 B
Est. Loss Industry Wide	$65.0 B	$41.0 B	$15.5 B
New Capital % of Est. Loss	80.3%	54.1%	45.2%

New capital inflow into reinsurance shows high substitutability

New capital flows into nat cat reinsurance industry and nat cat reinsurance rates

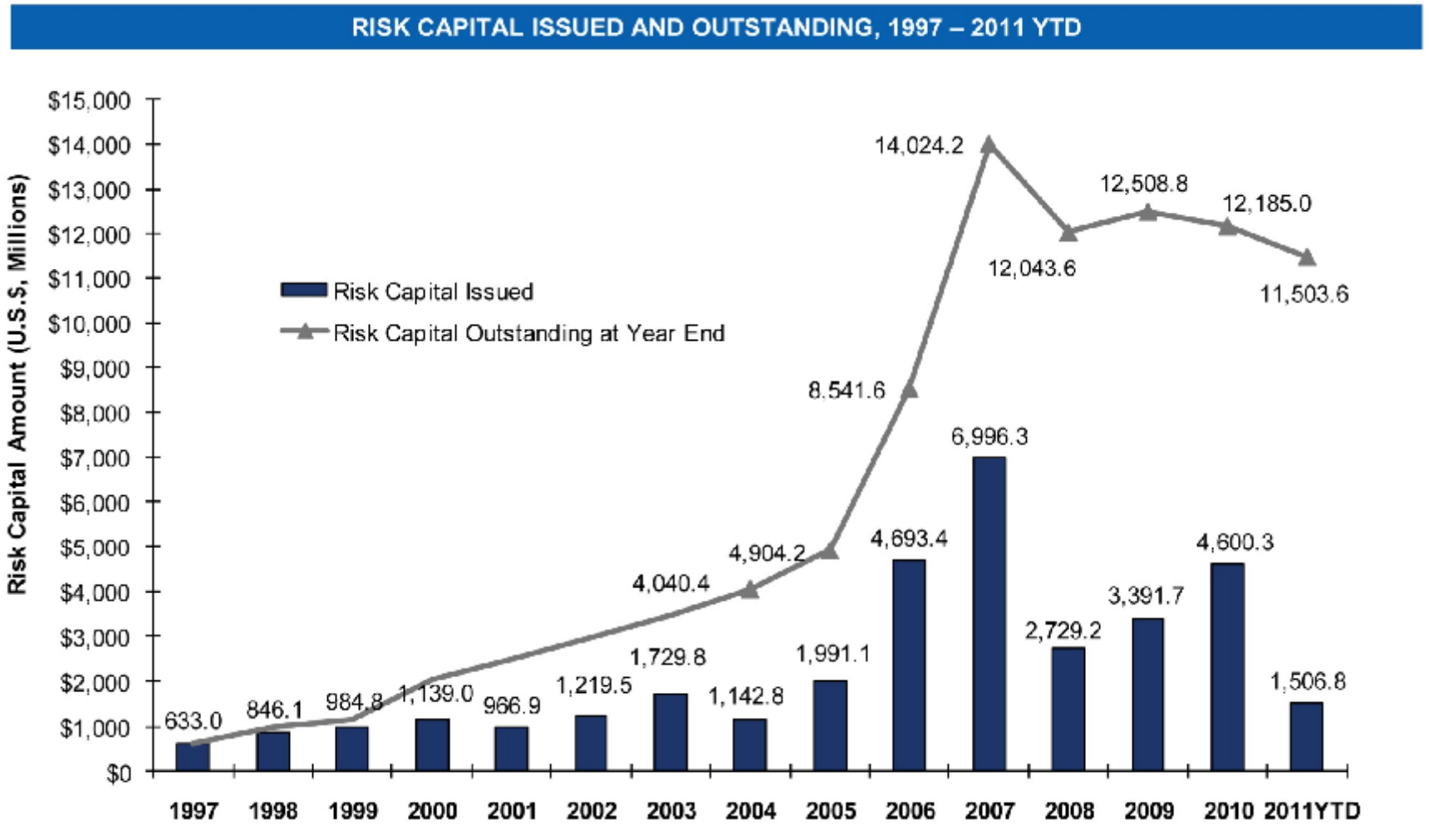


- Reinsurance rates increase for years following big catastrophes
- This attracts steady inflow of capital in the industry through new entrants or capital increases of existing reinsurers (including side cars and cat bonds)
- In addition, capital base of reinsurers is also progressively rebuilt after large natural catastrophes through the higher reinsurance rates

Reinsurance capacity has always increased after natural catastrophes – insurance capacity is highly substitutable

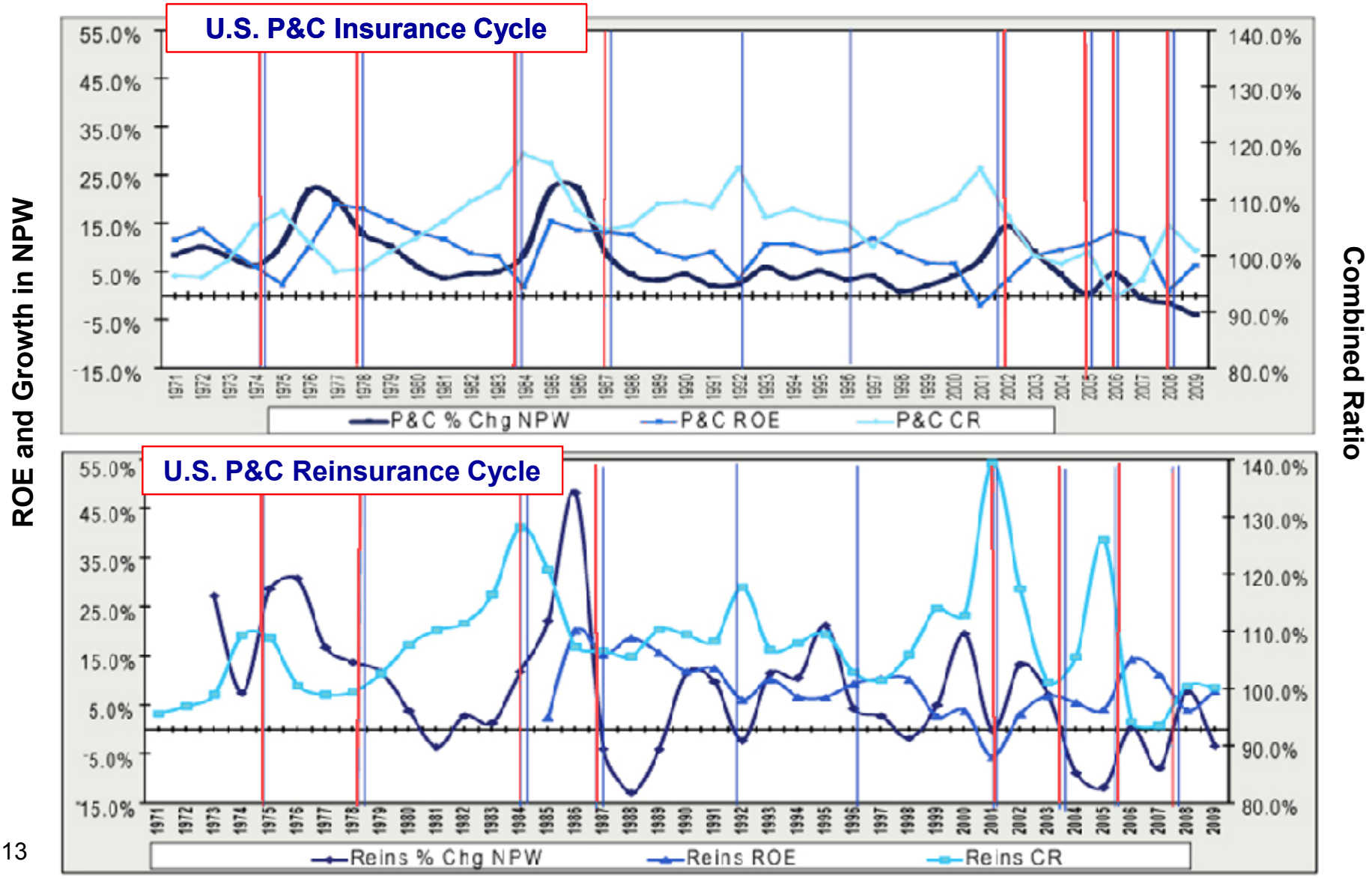
Source: Thomson, Guy Carpenter, AON Benfield, Dealogic, Oliver Wyman analysis

Substitutability – Catastrophe Bond Market Growth Continues



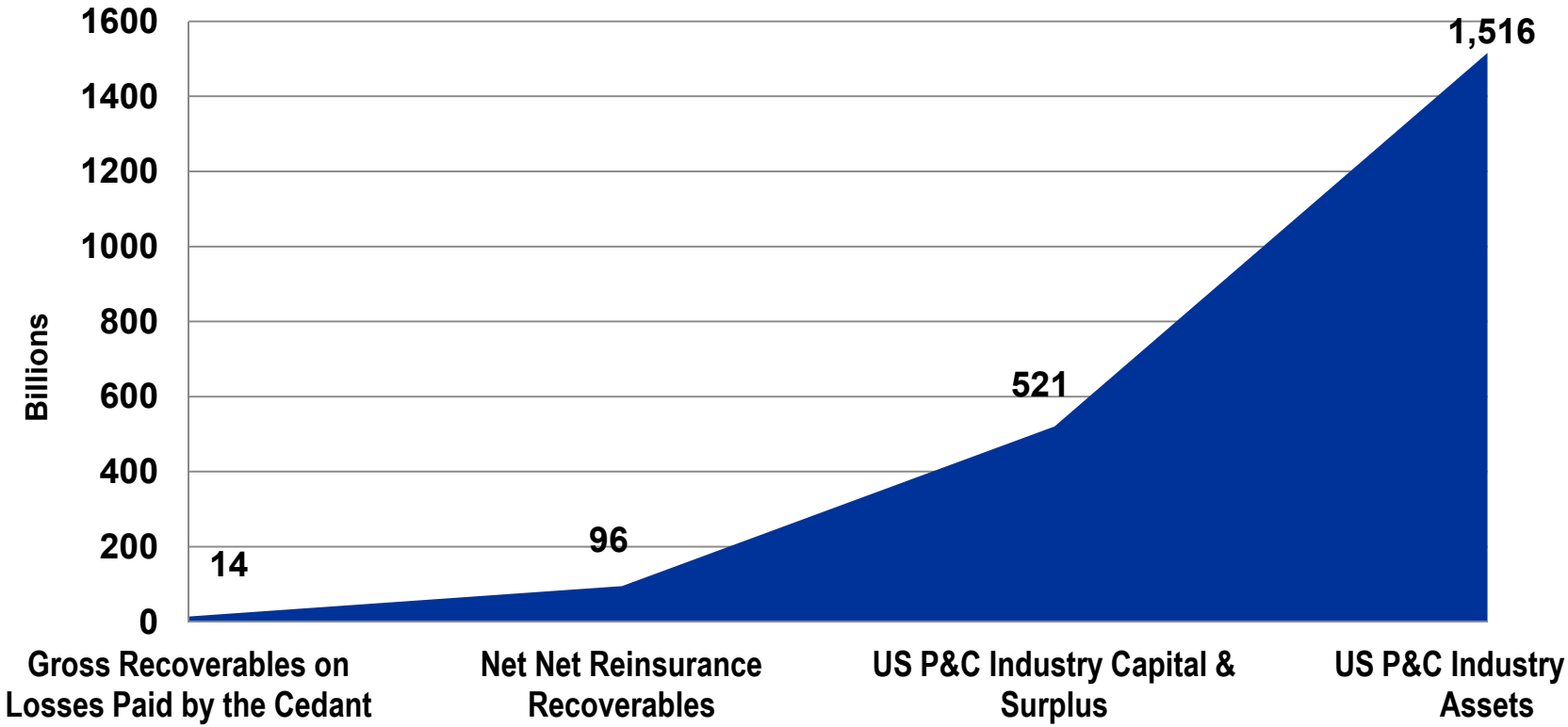
Source: GC Securities *As of May 31, 2011*

Substitutability – Capital flows follow the reinsurance cycle. Reinsurance absorbs insurance industry volatility and adds stability.



Time/Liquidity – (Re)insurance obligations are not callable, significantly limiting the systemic risk potential.

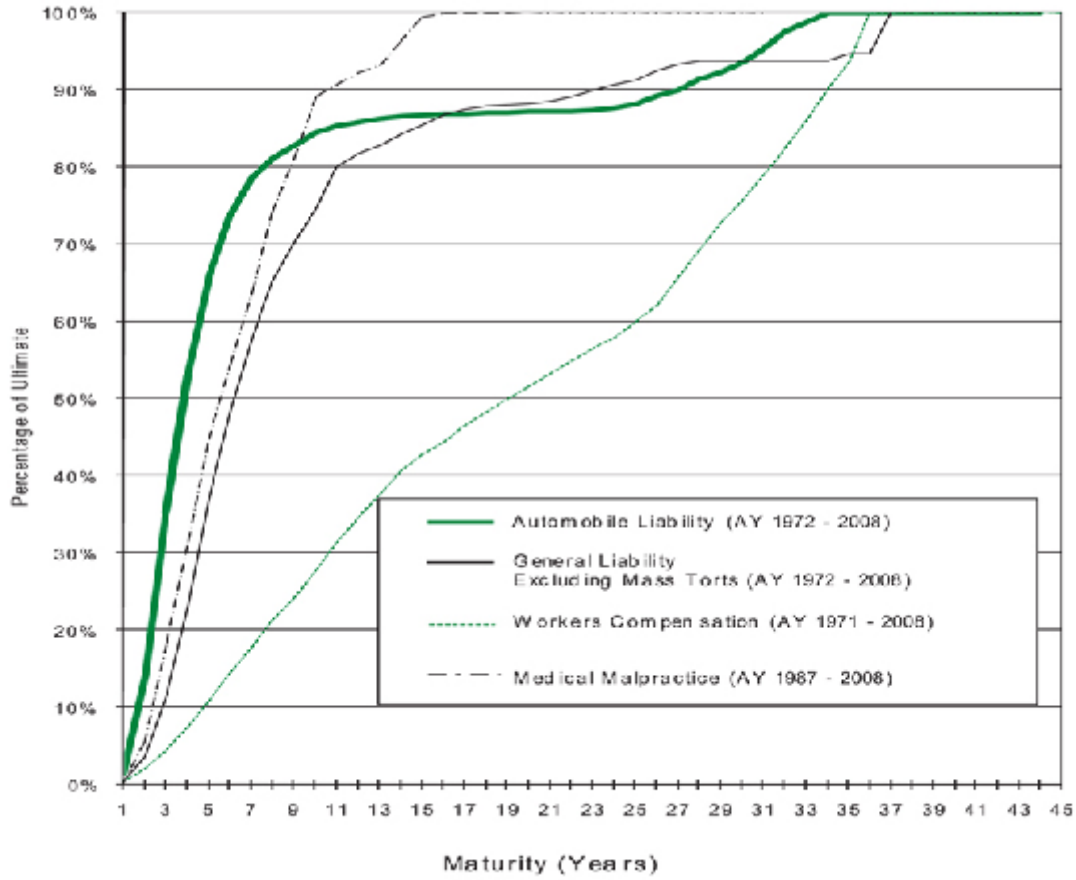
US P&C Recoverables on Paid Losses Compared to Surplus and Assets



$14 Billion Reinsurance Recoverable on Paid Losses are the only amounts currently due. Reflects the illiquid nature of insurance and reinsurance obligations.

Time/Liquidity - Liability reinsurance losses emerge over many years.

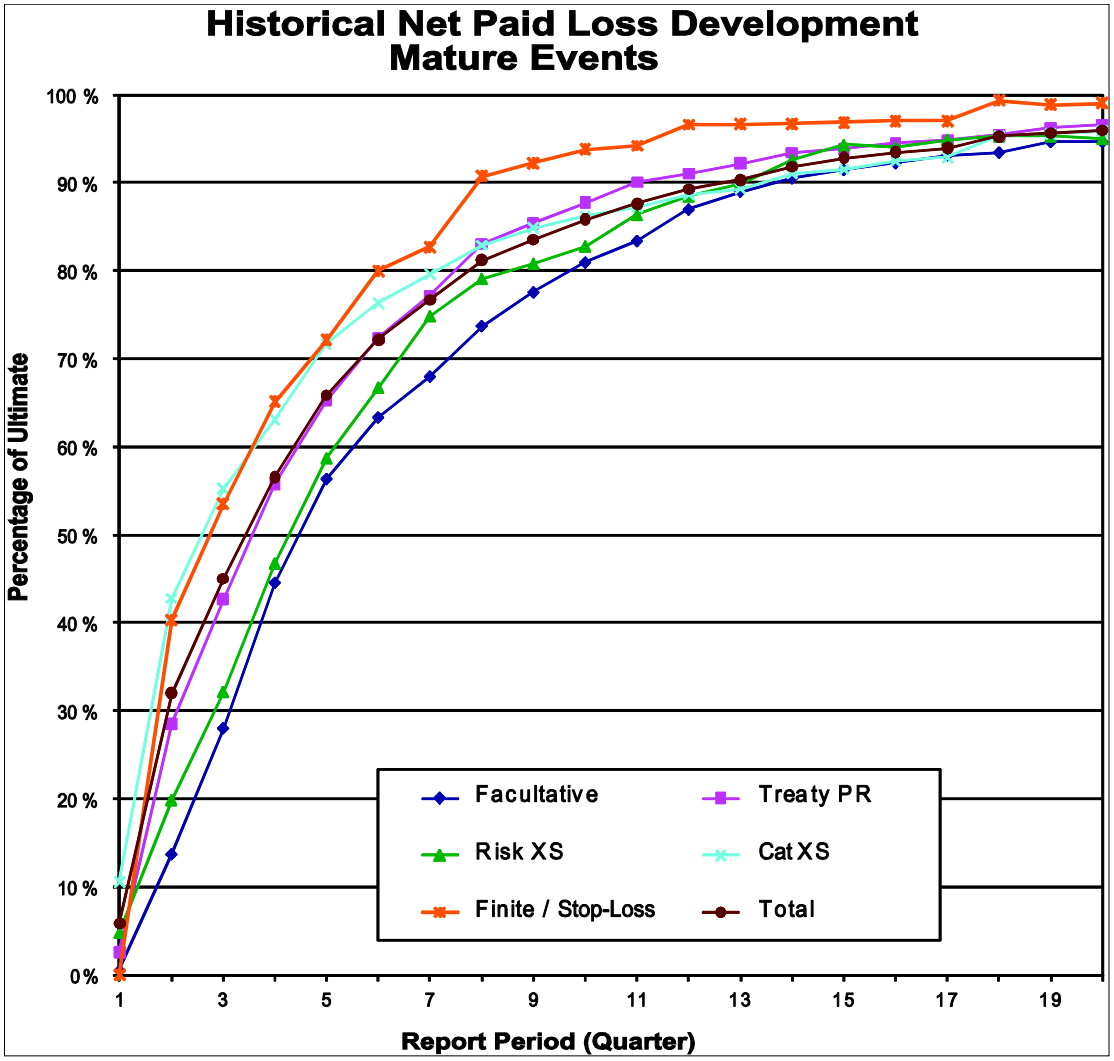
Historical Loss Development Paid Losses Excess Reinsurance



RAA Historical Loss Development Study, 2009 Edition

Time / Liquidity

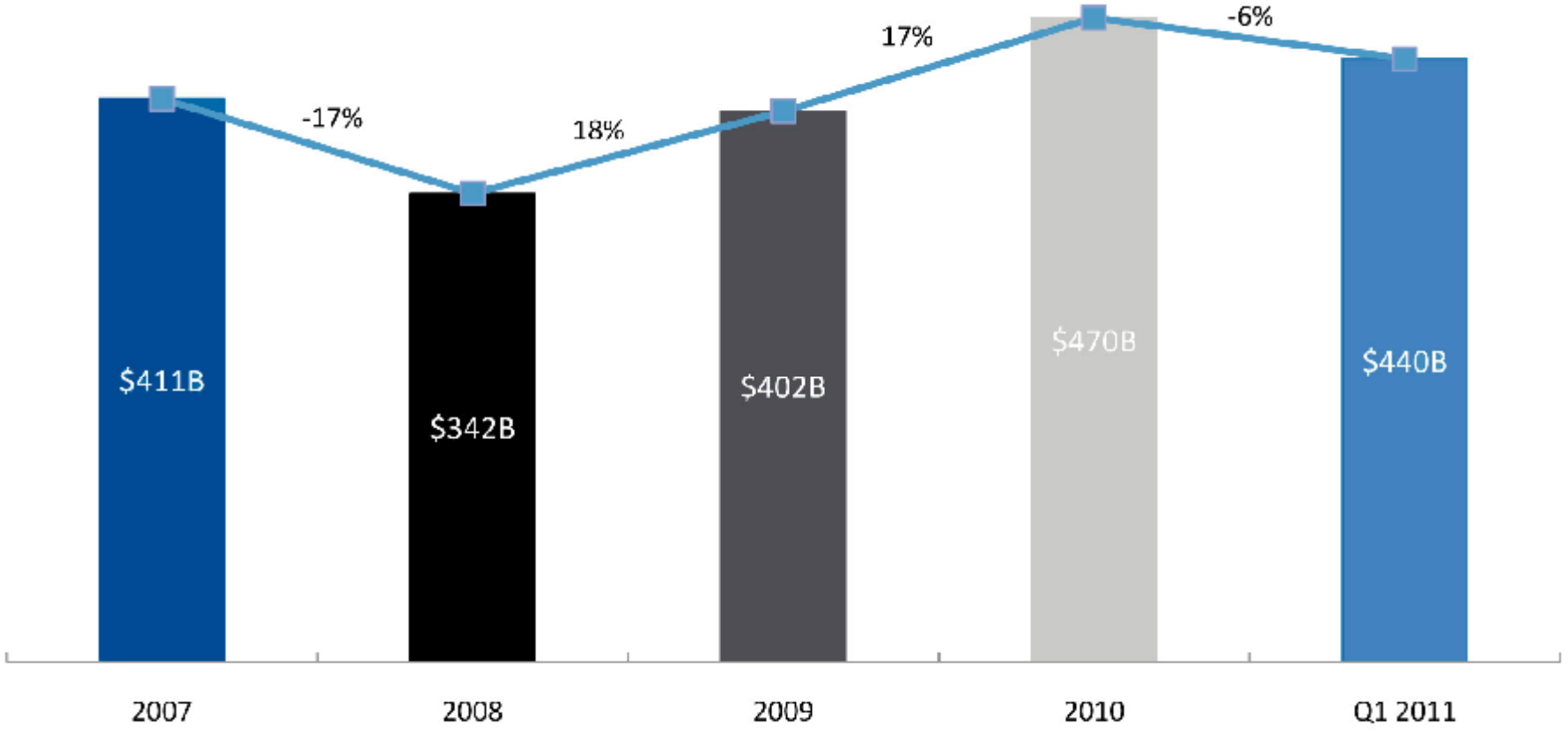
Reinsured property catastrophe losses also emerge more slowly than might be expected.



Assumptions Underlying A Global Reinsurance Stress Test Scenario

Reinsurer capital was minimally impacted by the financial crisis. It recovered quickly and remains adequate for demand.

Change in Reinsurer Capital



Source: Individual Company Reports, Aon Benfield Analytics

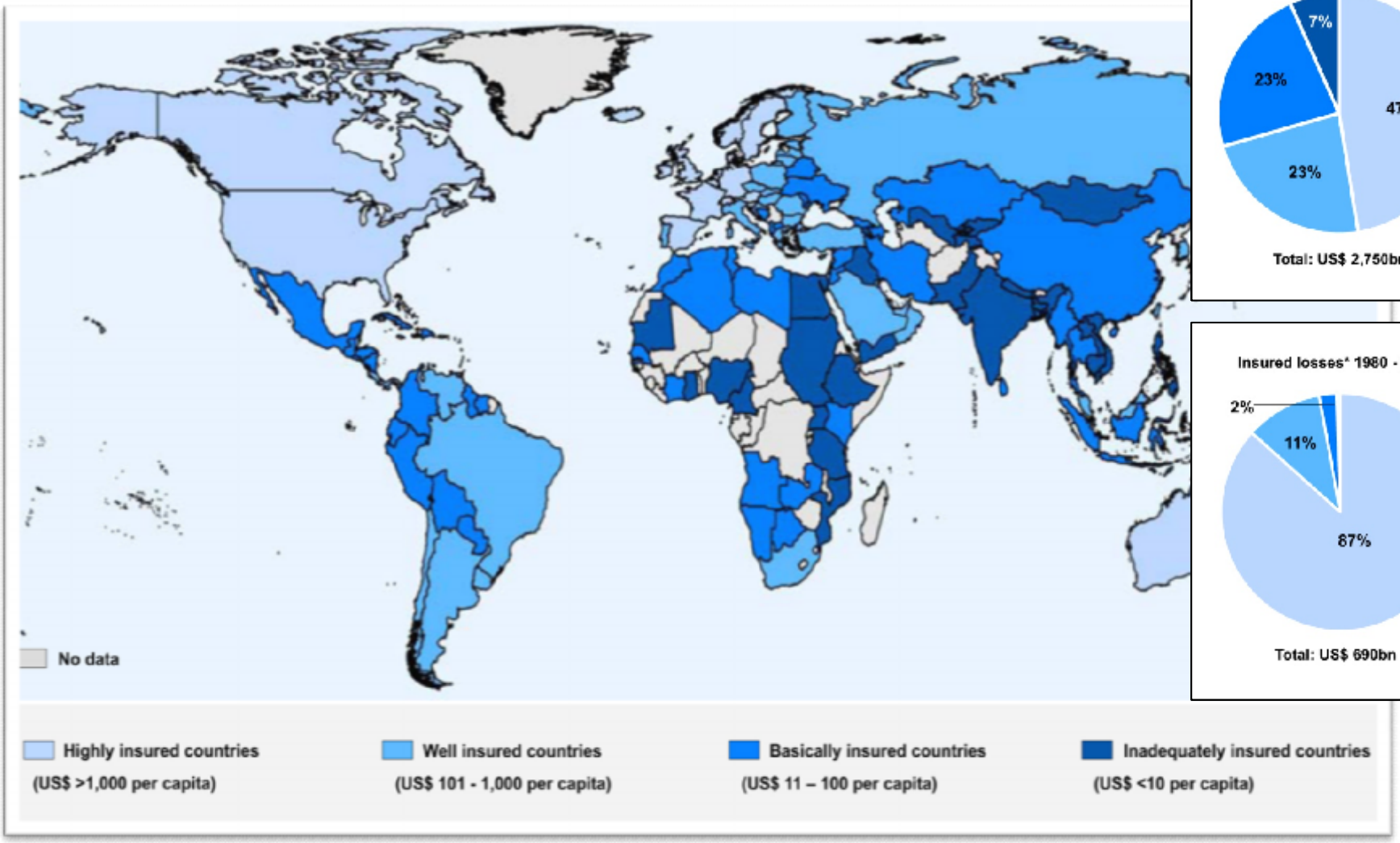
Economic losses are 5 to 20 times greater than reinsured losses.

The Range can be impacted by:

- type of reinsurance (XOL v. QS)
- type of peril (take-up rate/exclusions)
  - e.g. Earthquake/Flood
- location (insurance penetration)
  - e.g. developed v. developing economies
- level of government participation in the reinsurance market

Natural Catastrophes in differently insured countries

Classification of the world by property insurance premium (non-life including health) per capita

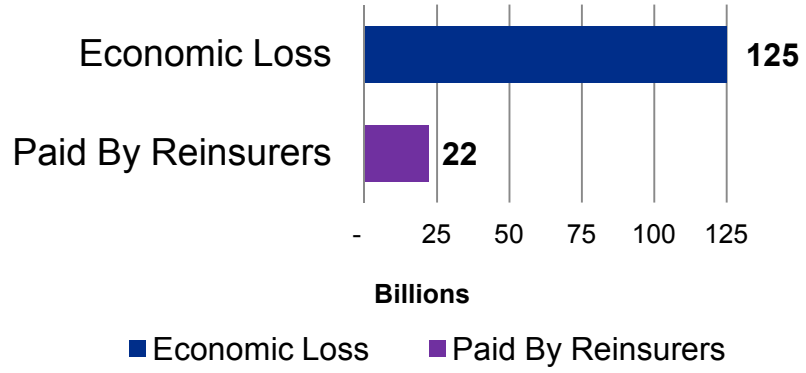


Source: MR NatCat*SERVICE* as at July 2010

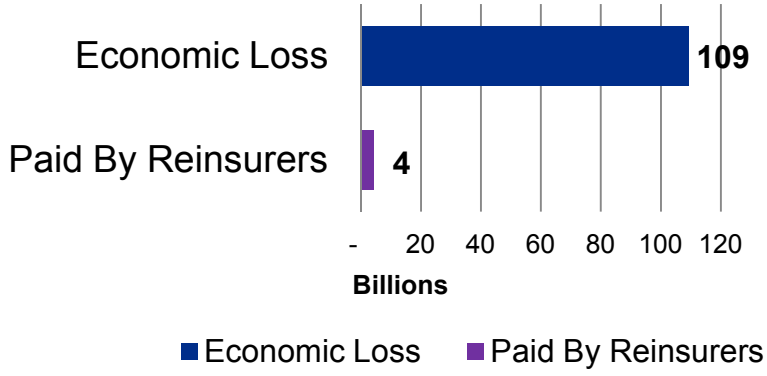
Economic Losses are 5 to 20 Times Greater than Reinsured Losses

Reinsurance is not nearly as significant a source of risk compared to uninsured loss.

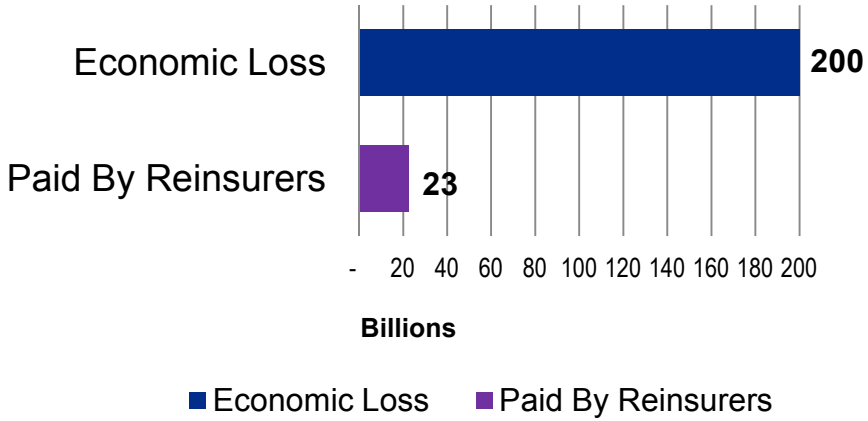
Hurricane Katrina



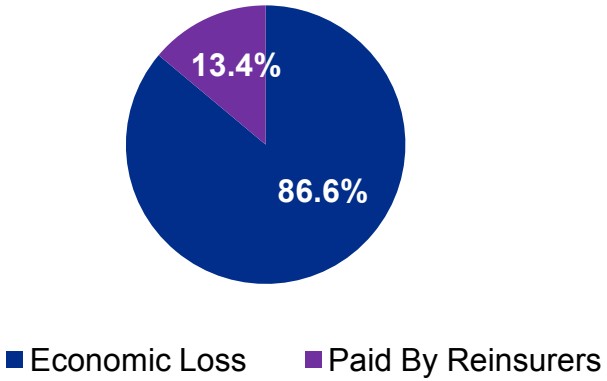
U.S. 1-in-250 Yr EQE



9/11/2001 Terrorist Attack



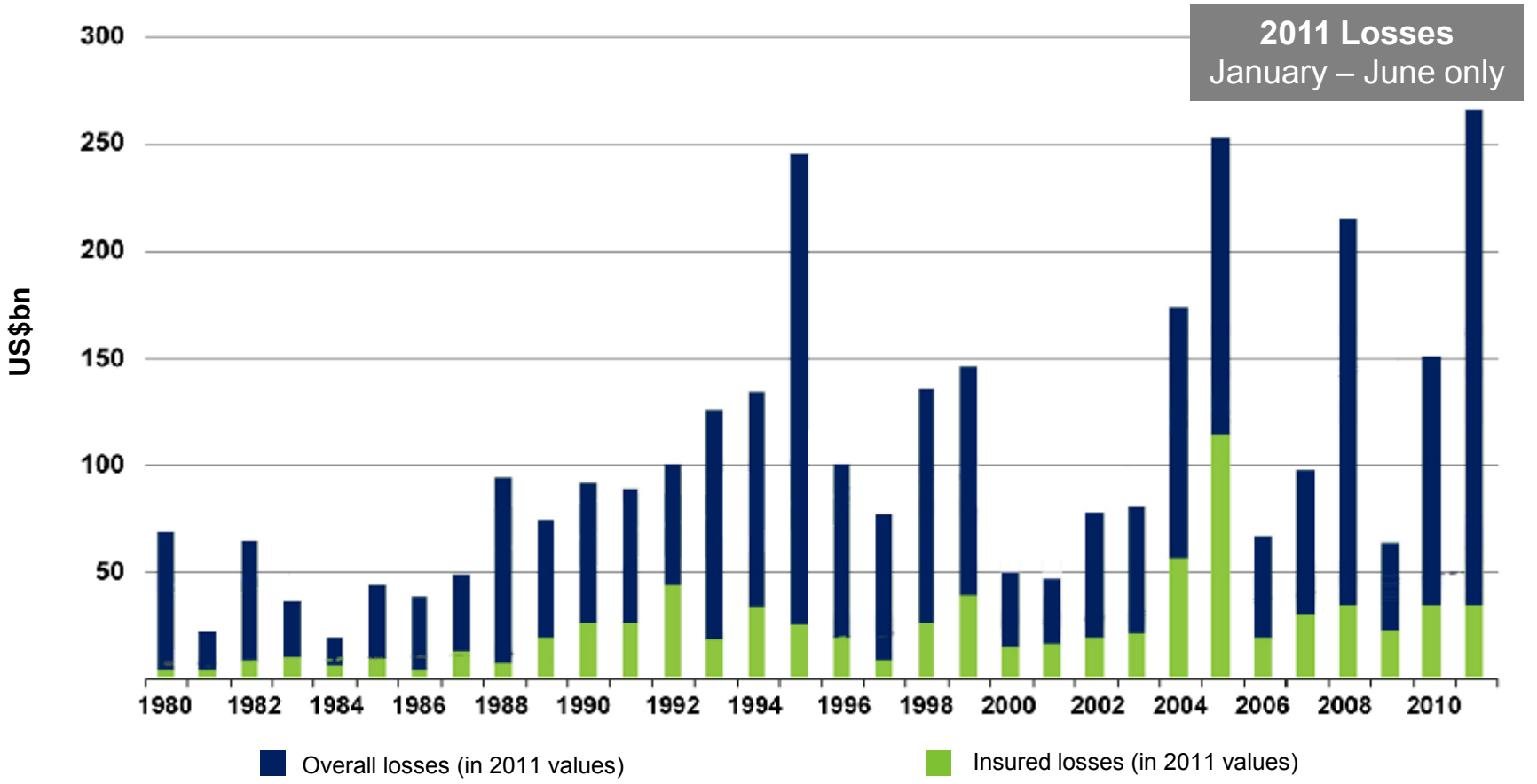
Average of Significant Historical Events



Worldwide Natural Disasters 1980 – 2011

Overall Economic versus Insured Losses

Insured losses are a small portion of economic losses: Reinsurance loss is an even smaller portion.



Source: MR NatCat*SERVICE*

Stress Test Scenario: 100% Solvency Ratio

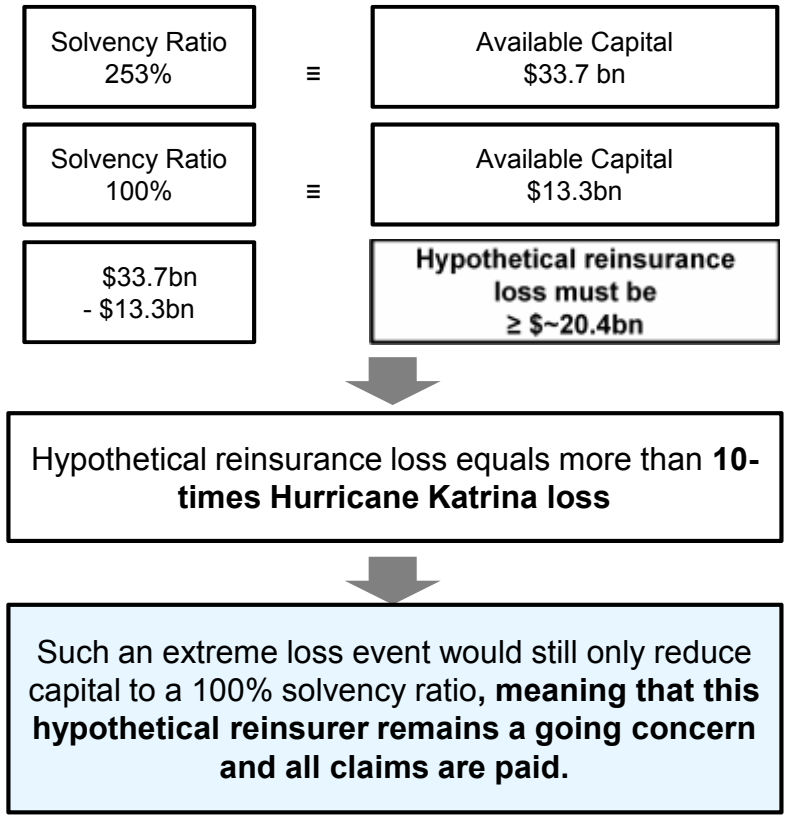
Creating an extreme scenario: What would it take to bring down a major reinsurer?

- To start with: let's focus on a leading global reinsurer to see **what amount of losses would be needed to reduce its capital base to 100% of the solvency ratio.** Let's use published data for Munich Re and Swiss Re (the global TOP2) and think of this **hypothetical reinsurer as a simple average of the two market leaders** (thus all numbers used in this example will be based on a simple average of the respective Munich Re and Swiss Re number).

- Taking into account an average 2009 solvency ratio of 253% for this hypothetical reinsurer and available capital of $33.7 bn., a fall to the 100% solvency ratio level (capital at $13.3 bn.) would imply a cumulated loss event in the magnitude of $~20.4 bn.

- This would imply a loss more than ten times the loss from Hurricane Katrina (~$1.9bn. for Munich Re and Swiss Re on average), the by far largest (re)insured loss event in history.

- Thus, it would take such an extremely large loss event (or equivalently, a series of very large loss events taking place within a short period of time) just to bring the level of capital to 100% of the solvency margin. One should therefore extend this stress scenario to the entire industry to see what level of economic loss would cause the whole reinsurance industry's capital to fall to a 100% solvency ratio level.

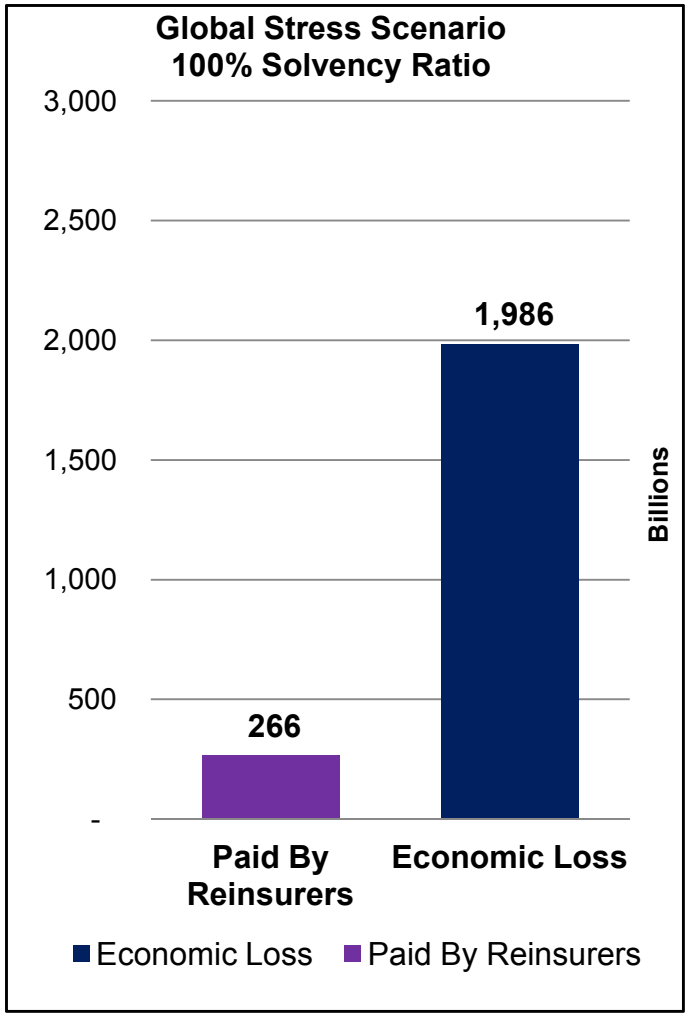


Source: Munich Re, Swiss Re

Extreme scenario at 100% solvency ratio shows: Respective economic loss would by far exceed the reinsurance industry loss.

- Assuming similar solvency ratios[1] for the rest of the industry and using numbers on total industry capital[2], it would take a loss to the reinsurance industry of $~266.1 bn. to create such a scenario that reduces industry capital to a 100% solvency ratio level.
- In contrast to these already very large numbers, the estimated **total economic loss** from such a series of extreme events is likely to be close to $**1,986 bn.** (for comparison again: the economic loss from Hurricane Katrina was $~125 bn.).
- **All of the Great Natural Catastrophes that have occurred World-wide from 1950 – 2010 amount to $2,100 bn.** (adjusted to 2010 values), which is about the size of loss from a series of events occuring in a single year that would be needed to bring industry capital down to a100% solvency ratio

- **The respective total economic loss of this extreme scenario would by far exceed the reinsurance industry loss. Moreover at a 100% solvency ratio, the reinsurance industry would not see widespread default as the existing capital base and reserves would be sufficient to pay the claims.**

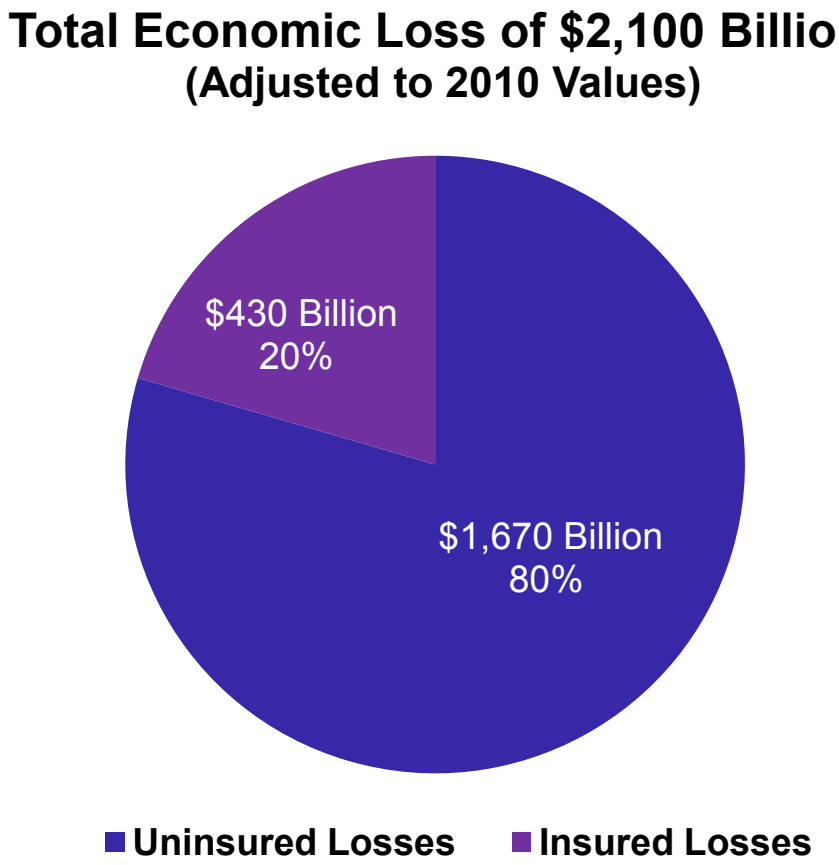


1) clearly a simplifying assumption, as solvency ratios differ between reinsurers; 2) taken from Aon Benfield's estimate that global reinsurance capital is $440 bn.

Source: RAA Analysis Based on Underlying Assumptions Provided by a Munich Re and Swiss Re Analysis

Great natural catastrophes worldwide 1950-2010

The total economic losses used in the global stress test are greater than all of the great natural catastrophes worldwide between 1950-2010.



Source: Munich Re Nat Cat SERVICE, As of January 2011

Stress Test Scenario: 40% Solvency Ratio

Extreme Stress Test Scenario Analysis

	Swiss Re / Munich Re Combined	Global Industry
	$ in Billions	
Solvency Ratio 253%	33.7	440.0
Solvency Ratio 100%	13.3	173.9
Solvency Ratio 40%	5.3	69.6
Implied Cuml. Loss @ 100%	20.4	266.1
Implied Cuml. Loss @ 40%	28.4	370.4

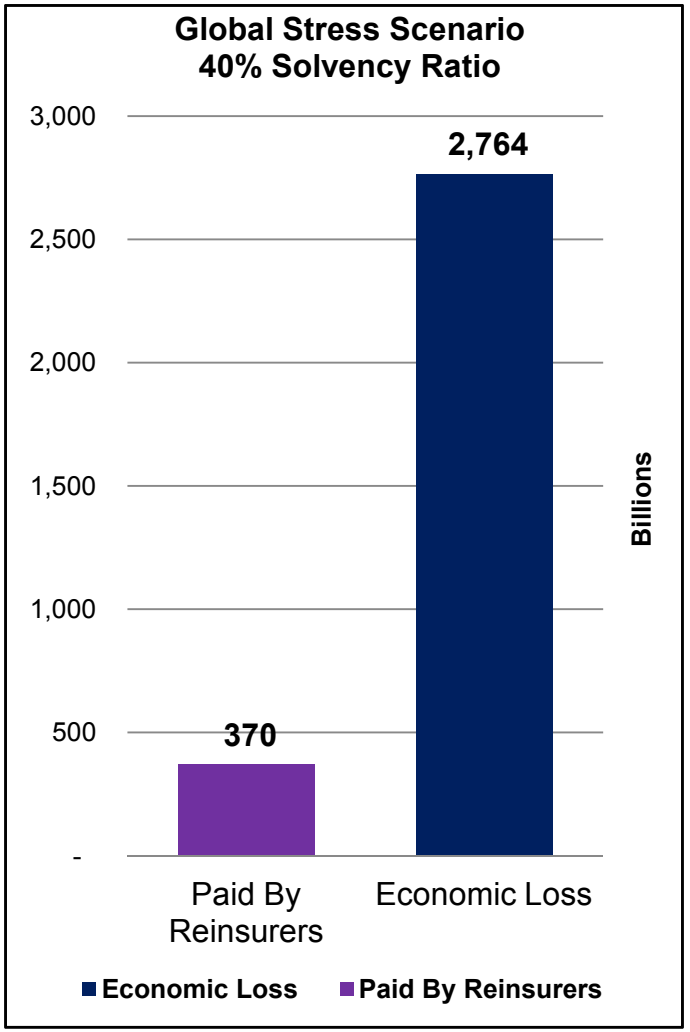
Economic Loss Scenarios Needed to Reduce Industry Capital to 100% of Solvency Ratio	Global Re Loss	Global Economic Loss	Example Type of Events
Reins Loss = 20% of Economic Loss	102.0	1,330.4	Hurricanes (U.S. /Developed Economies)
Reins Loss = 13.4% of Economic Loss	152.2	1,985.7	Mix of Global Events
Reins Loss = 5.5% of Economic Loss	370.8	4,837.9	Earthquake/Flood w/low take-up rate

Economic Loss Scenarios Needed to Reduce Industry Capital to 40% of Solvency Ratio			Example Type of Events
Reins Loss = 20% of Economic Loss	142.0	1,852.2	Hurricanes (U.S. /Developed Economies)
Reins Loss = 13.4% of Economic Loss	211.9	2,764.4	Mix of Global Events
Reins Loss = 5.5% of Economic Loss	516.2	6,735.2	Earthquake/Flood w/low take-up rate

Extreme scenario at 40% solvency ratio shows: Respective economic loss would by far exceed the reinsurance industry loss.

- Assuming similar solvency ratios[1] for the rest of the industry and using numbers on total industry capital[2], it would take a loss to the reinsurance industry of $~370.4 bn.) to create such a scenario.
- In contrast to these already very large numbers, the estimated **total economic loss** from such a series of extreme events is likely to be close to $**2,764 bn.**
- For comparison, a loss of $2,800 bn. equates to nearly twice the amount of economic losses from all hurricanes and earthquakes that occurred in the U.S. between 1900 and 2005 based on normalized loss statistics as published in studies by Dr. Roger Pielke—University of Colorado.

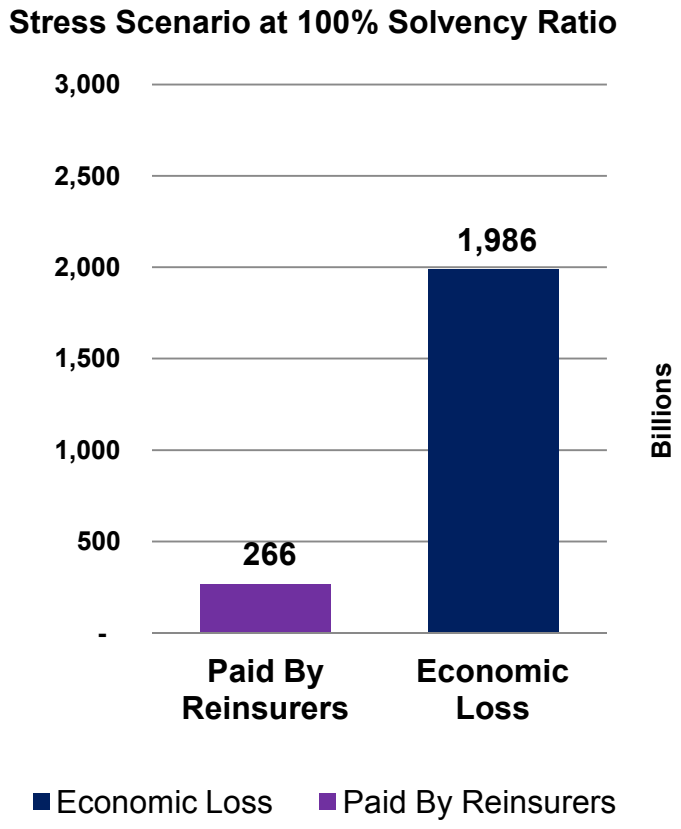
- **The respective total economic loss of this extreme scenario would by far exceed the reinsurance industry loss. Moreover the reinsurance industry's loss would largely be paid given their present $440 bn. in capital.**

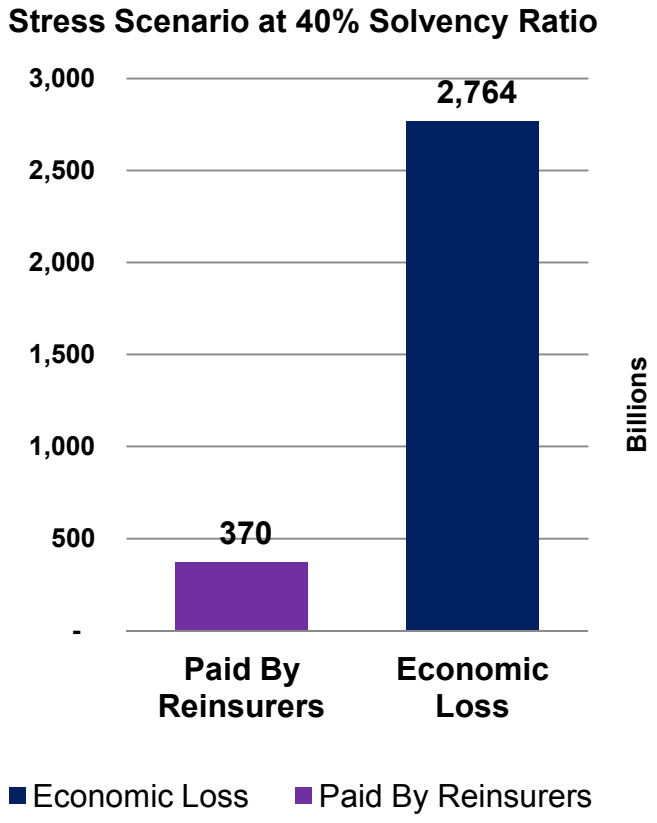


1) clearly a simplifying assumption, as solvency ratios differ between reinsurers; 2) taken from Aon Benfield's estimate that global reinsurance capital is $440 bn.

Source: RAA Analysis Based on Underlying Assumptions Provided by a Munich Re and Swiss Re Analysis

Economic losses (not reinsurance losses) are the true source of systemic risk following extreme loss events.

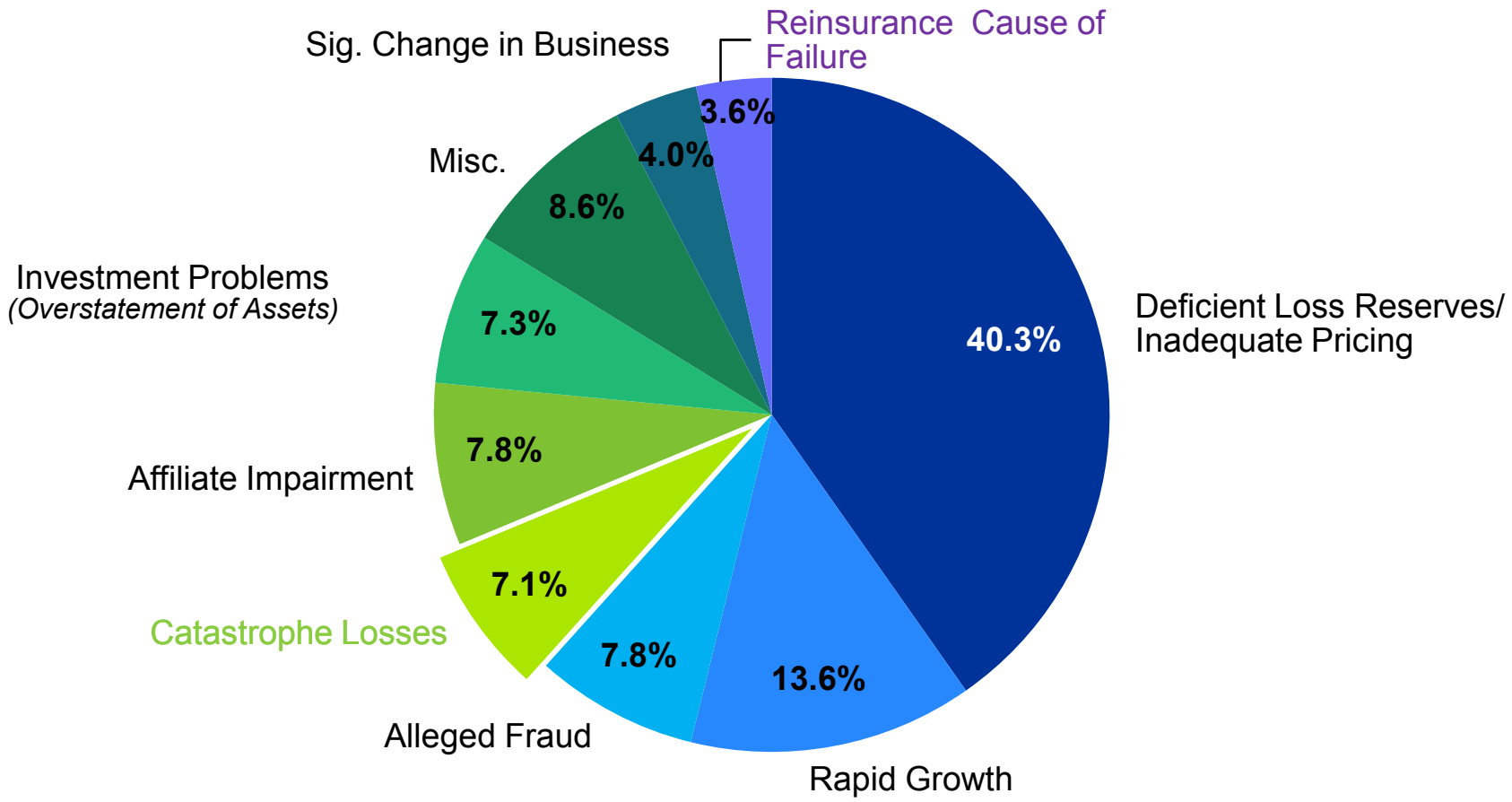




U.S. Financial Institutions Impairment History and Implications for P&C Reinsurance Systemic Risk

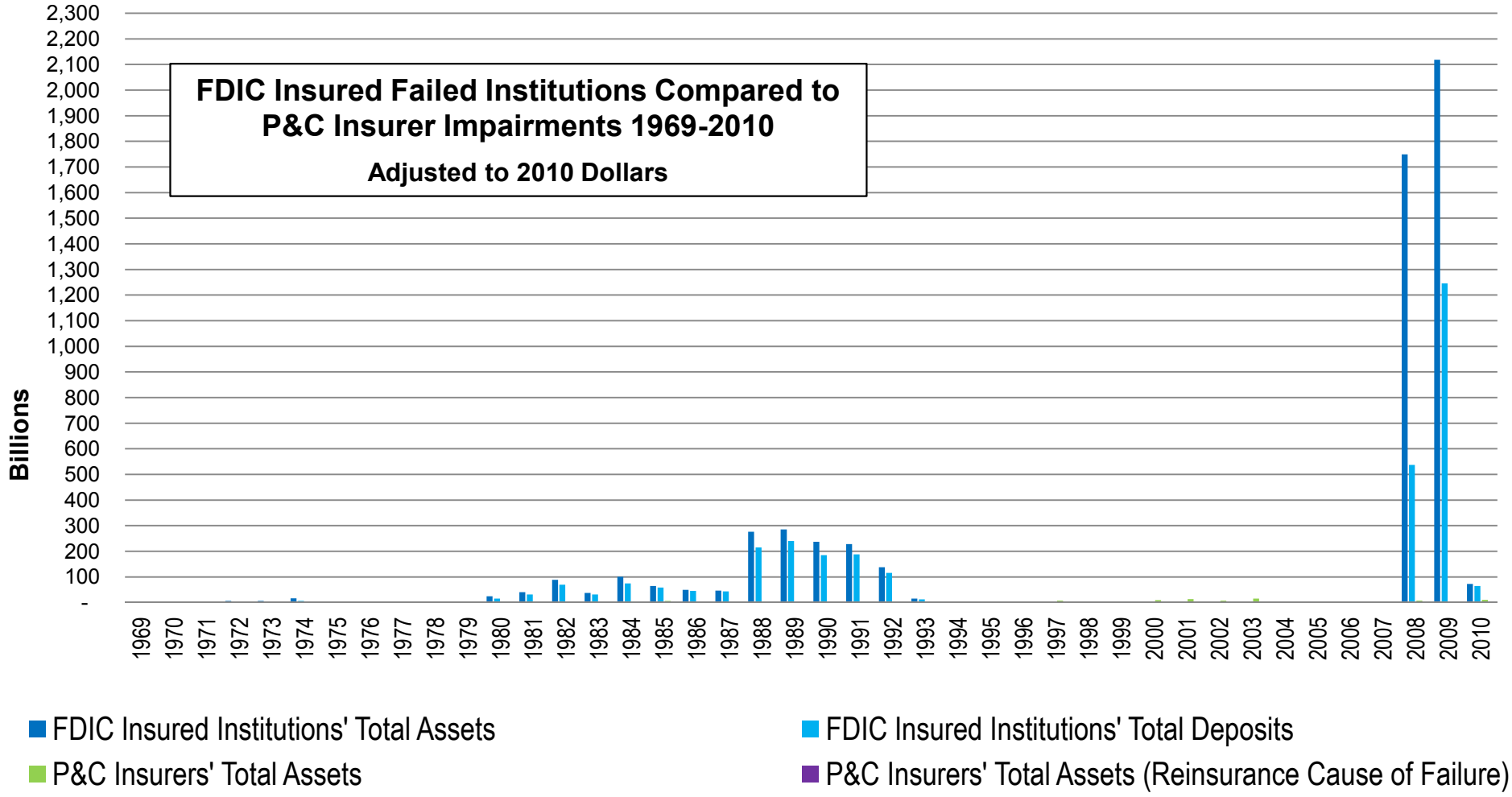
Insurance impairments attributed to reinsurance as the cause of failure are historically insignificant.

Reasons for US P/C Insurer Impairments, 1969–2010



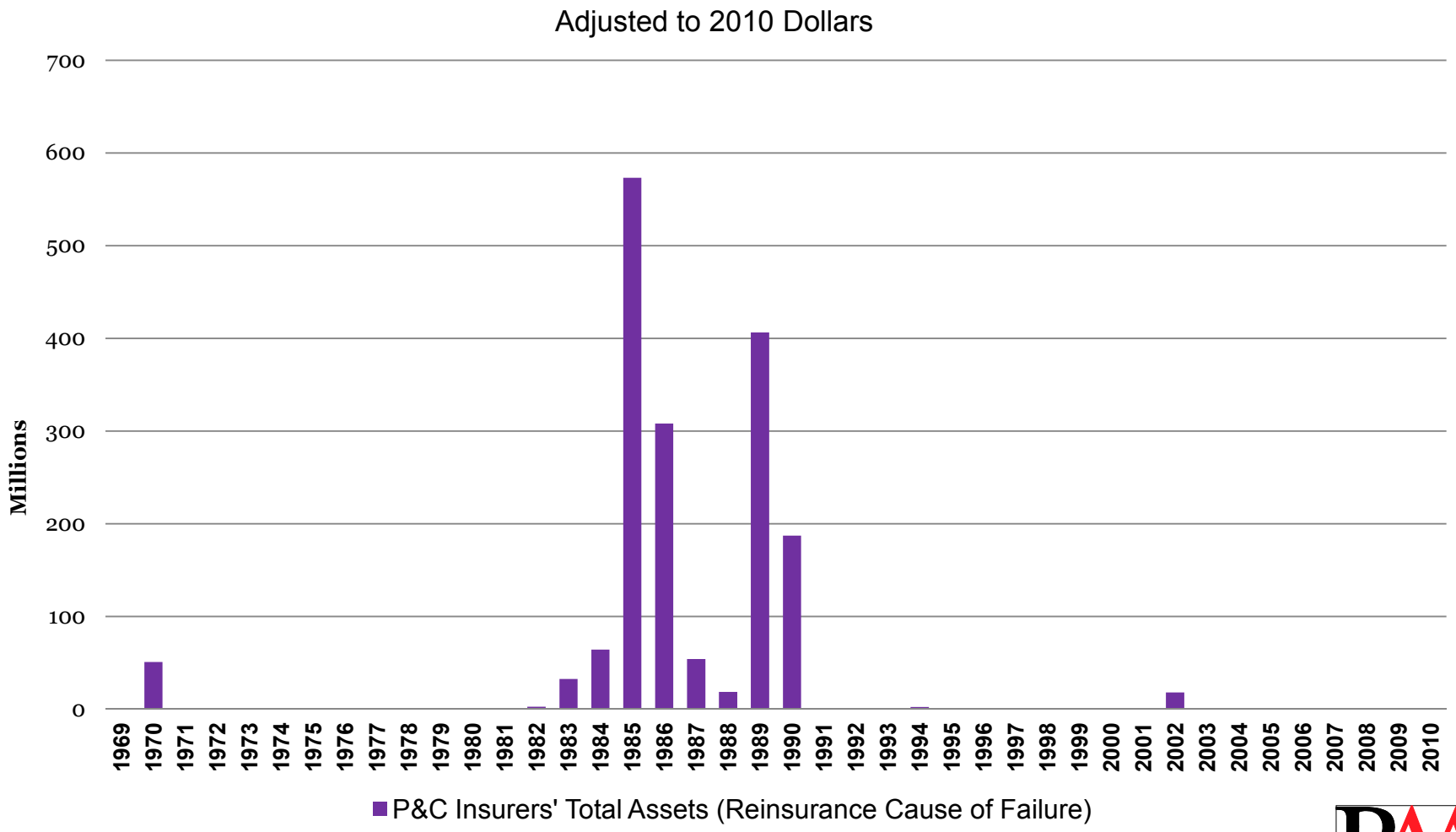
Source: A.M. Best: *1969-2010 Impairment Review*, Special Report, April 2011.

Insurance impairments are insignificant compared to bank impairments in past crises and over several economic cycles.



Source: A.M. Best: *1969-2010 Impairment Review*, Special Report, April 2011; FDIC.

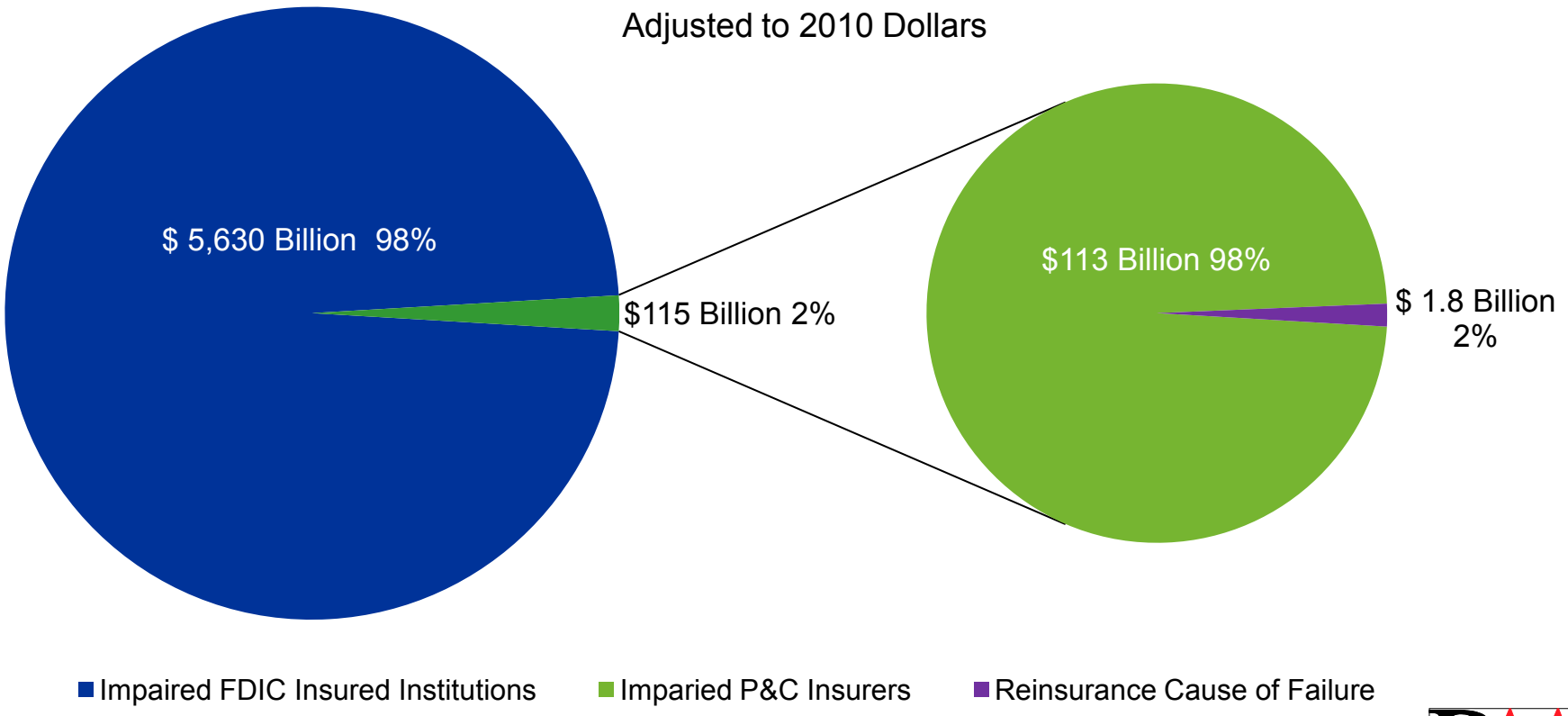
Insurance impairments attributed to reinsurance failure are insignificant over the same period.



Source: A.M. Best: *1969-2010 Impairment Review*, Special Report, April 2011.

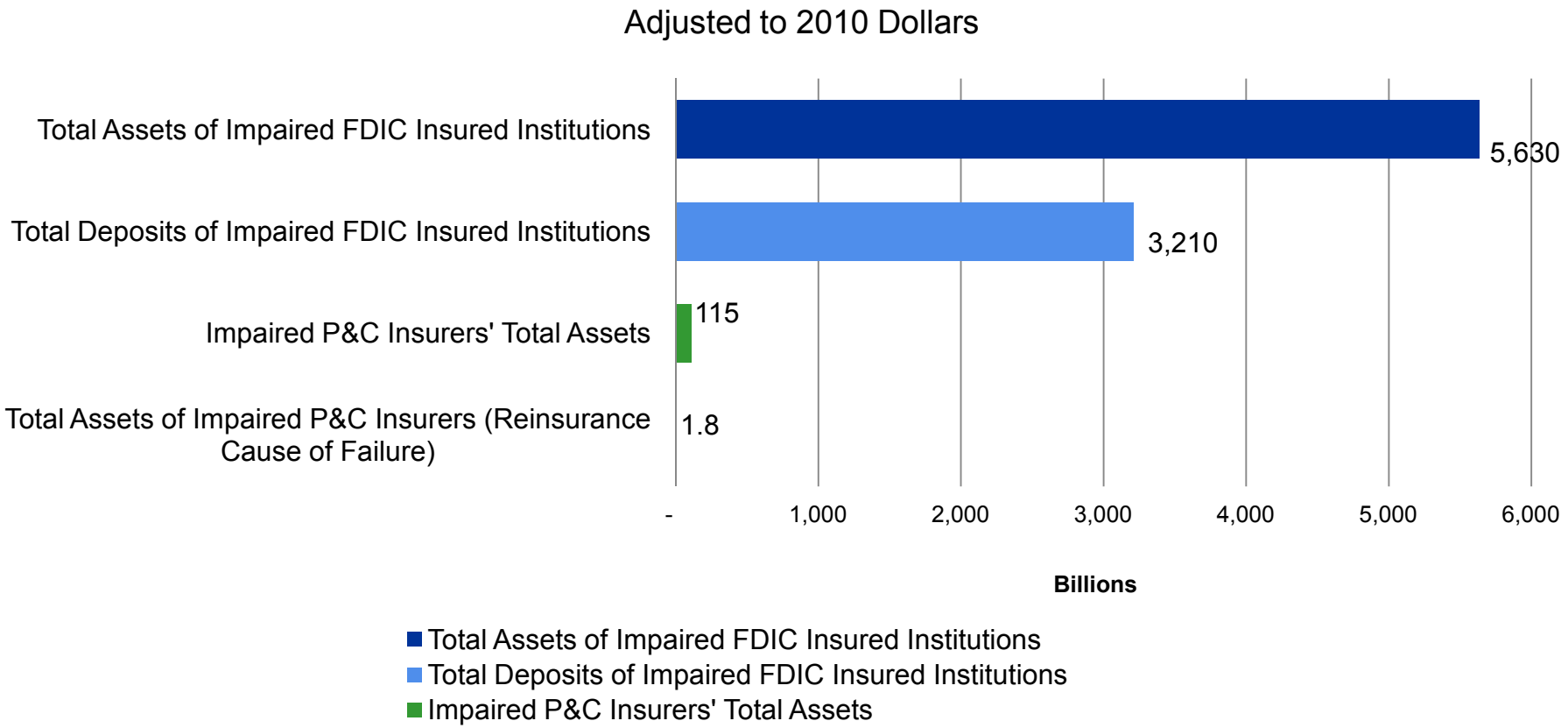
Reinsurance failure is not a significant cause of insurance impairment and pales in comparison to the systemic risk in the banking industry. – View 1

Total Assets of FDIC Insured Failed Institutions Compared to P&C Insurer Impairments 1969-2010



Reinsurance failure is not a significant cause of insurance impairment and pales in comparison to the systemic risk in the banking industry. – View 2

FDIC Insured Failed Institutions Compared to P&C Insurer Impairments 1969-2010



Reinsurance failure is not a significant cause of insurance impairment and pales in comparison to the systemic risk in the banking industry. – View 3

Total Assets of FDIC Insured Failed Institutions Compared to P&C Insurer Impairments 1969-2010

Adjusted to 2010 Dollars

$5,630 Billion

$115 Billion

$1.8 Billion

- Impaired FDIC Insured Institutions
- Impaired P&C Insurers
- Reinsurance Cause of Failure

Reinsurance Association of America

www.reinsurance.org

For questions on the information contained herein, please contact:

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United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
ERIC SMITH	Swiss Re Reinsurance Assn of America (RAA)

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.