Statement of

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Regarding

Systemic Risk and Insurance

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Chairman Kanjorski, Ranking Member Garrett, and Subcommittee Members, thank you for the opportunity to testify before you today on systemic risk and insurance. My name is Ken Spence, and I am Executive Vice President and General Counsel of Travelers. The Travelers family of companies offers a wide variety of property casualty insurance products, surety and risk management services to numerous business, organizations and individuals in the U.S. and abroad. Our products are distributed primarily through independent insurance agents and brokers and the company is a member of the American Insurance Association.

We welcome the opportunity to speak to you today on the issues of systemic risk and insurance regulation. The decisions you make in the next several months will determine the course of financial services oversight for years to come. We appreciate your consideration of

Travelers' views on these issues, which are so critical to the well-being of our company, our industry and our Nation.

I. Introduction

The current financial crisis has demonstrated the need for significant improvements to the financial regulatory system that must be addressed to mitigate and to potentially avoid financial disruptions in the future. There is a need for government and the private sector to work together to develop mechanisms to understand and address these systemic problems. Any thoughtful and effective response will be comprehensive and have significant long-term consequences to the health of the U.S. and global economies.

Insurance must be a central part of this effort. Recent problems have revealed gaps in insurance regulation that demonstrate that the current insurance regulatory structure is unable to adequately oversee the diverse industry that insurance has become and the sophisticated players that are involved in the insurance marketplace at the highest levels. Moreover, the absence of a federal presence in insurance regulation results in a lack of "big picture" oversight for the insurance sector and leaves the federal government with no expertise to address insurance issues as they arise.

II. The Need For Federal Insurance Expertise

At Travelers, we have first-hand experience with the lack of insurance knowledge at the federal level. For a number of years, Travelers was part of a financial holding company and, as such, was directly regulated by the Federal Reserve – one of two insurance entities subject to such oversight. The lack of insurance expertise within the agency, however, and the inability of agency personnel to be able to access non-existent federal insurance expertise through any other resource created difficult challenges for both the regulator and the company.

We have seen the lack of federal insurance expertise affect other issues, as well. With no "federal presence" in insurance regulation, you and other policymakers in Washington have had no resident insurance experts upon whom to rely for counsel on policy matters that affect the insurance industry and insurance policyholders, nor do you have anyone to turn to for insurance expertise during times of crisis. This deficiency is readily apparent in the current financial crisis, and is evident in the debate over terrorism insurance coverage after 9/11 and in the on-going debate over natural catastrophe insurance. These are national problems that demand national solutions – but with no national expertise in the federal government, there is a huge gap in our ability to address them properly.

Thus, at a minimum, it is critical that this void of federal expertise be addressed as you move forward with financial services regulatory reform. There is an emerging consensus that there will be some form of systemic risk regulation at the federal level. We have specific suggestions with respect to systemic risk that I will discuss in Part III of my testimony below but, for any systemic-level oversight to be meaningful across financial services sectors, there must be an insurance regulatory presence at the federal level to ensure that the appropriate information is provided and analyzed and to ensure that any systemic-level directives are effectively implemented.

To that end, the creation of an Office of Insurance Information, as the Chairman has proposed in his legislation, would bolster the federal government's presence in and understanding of the insurance sector. The OII would bring needed information about the insurance marketplace to Washington, and would give the United States a single voice with which to speak on international insurance policy and trade matters. Presumably, an OII could work in conjunction with a systemic regulator to provide and exchange information and ensure that the resources of both agencies are fully utilized.

We believe that a comprehensive approach to federal financial services modernization will not be complete unless it includes a broader federal insurance presence that encompasses federal chartering for insurers. Such federal insurance regulation is critical to ensure robust regulatory oversight, strong consumer protections, and a healthy insurance industry. A single federal regulator also will bring efficiencies to regulation that will benefit all stakeholders. We support federal regulation because insurance is a sophisticated and diverse international business involving large national and multinational conglomerates, and as such demands strong oversight. We believe the federal government is the only entity with the resources to provide adequate oversight for such an important sector of the economy. In light of the current crises engulfing the financial sector, it is critical that consumers and other market participants have confidence that their insurers are in strong financial condition. Although the states have performed admirably, the current financial problems of several large insurance holding companies illustrate the limitations of the current state system, and the need for federal government oversight to ensure the financial soundness and stability of the industry.

III. Systemic Risk

A. What's At Stake?

Whatever the causes, the financial crisis has exposed gaps in the financial regulatory system that must be addressed to avoid a repeat of the current problems and soften the impact of corporate failures going forward. The most widely-agreed upon target to address regulatory effectiveness is the area of systemic risk. We have been carefully considering the notion of systemic risk regulation, both with respect to how property casualty carriers may be implicated in systemic risk and how to approach systemic risk oversight more broadly. As an initial matter, we are mindful that the determination as to whether a company is systemically important does not necessarily depend upon its size or industry, but rather the extent to which its financial condition is potentially so inter-related with other institutions that its failure could cause widespread and substantial economic harm, extending beyond those stakeholders who had assumed the risk. Determination as to whether a company is systemically important does not necessarily depend upon its size ("too big to fail"), but rather the extent to which its financial health is – or could be – so inter-related with other institutions that its failure would cause broader and substantial economic dislocation. Limiting sensible systemic oversight to only large financial institutions may thus leave significant risk in the economy unaccounted for in any meaningful way.

B. The Property-Casualty Industry & Systemic Risk

Property casualty insurance companies, other than those that concentrate in a few specialized areas such as reinsurers or financial guaranty insurers, generally present significantly less systemic risk – at least directly – than other financial services companies. There are several reasons for this:

1. Property casualty insurers generally take on relatively little counter-party risk and their liabilities generally are independent of economic cycles or other systemic failures.

2. Property casualty insurers operate in a highly regulated market, which often includes the amount of premium charged (rate) and the wording of the policy (form). Property casualty insurers prepare financial statements in conformity with statutory accounting practices, which are generally more conservative than GAAP (generally accepted accounting practices). In addition, there are investment and capital limitations and reserve requirements. These limit the types and amounts of investments that insurers may acquire, including the use of derivatives, and require that a set amount of capital must be held based upon the risks it writes and its investment portfolio. The Insurance Holding Company Act, which has been enacted in every state, reduces the amount of systemic risk for property casualty insurers by requiring regulatory approval for dividends and transactions with affiliates that exceed specified thresholds.

3. Risk management of property casualty insurers also plays a key role in limiting systemic risk by its focus on underwriting risk, i.e. the types, amount, and concentration of risk the company is willing to write. As discussed in more detail below, at Travelers, given our size and complexity, our board of directors has for many years maintained a dedicated risk committee to assist our board in fulfilling its obligation to oversee risk and contributed meaningfully to our ability to avoid many of the problems other financial institutions faced during the current crisis.

4. Importantly, property and casualty insurers also can be distinguished from banks by the response of consumers to financial crises. Consumers, when faced with a banking crisis, may go to their depository institutions and withdraw their accounts. In contrast, property casualty insurers do not have asset accumulation products, such as variable annuities or variable life products like those written by the life insurers, so there is no withdrawal demand risk. Moreover, consumers, both commercial and personal, generally cannot go without insurance to protect their businesses, homes, and automobiles, so general economic conditions have less impact on demand for property and casualty coverage.

5. Finally, the types of asset classes that property casualty insurers hold are more conservative in nature because of the need, at any given time, to have large amounts of assets available to respond to catastrophic events, including wind storms and fires. For

> example, last fall during the financial crisis, Travelers and other property casualty insurers responded to hurricanes along the Texas coast that caused billions of dollars in insured losses. Property casualty insurers generally avoided holding significant quantities of investments linked to commercial and residential mortgages because they already had risk tied to writing property coverage. Indeed, potential systemic risk to property casualty insurers is better expressed from the threat of large scale catastrophic events in areas of high density and development than from investment driven financial crises.

Although property casualty insurers thus generally should not be perceived as posing systemic-type risks directly, an essentially unregulated holding company that owns such insurers could represent such a risk. For example, any unregulated holding company with a strong credit rating from its underlying operations could have underwritten credit default swaps, which played an important role in the current financial crisis.

In addition to considering the systemic risk that may be presented by a single entity, we think it also is relevant to consider the systemic risk that may be presented on an aggregate, industry-wide basis. For example, even if a particular community bank or insurance company would not present systemic risk, the widespread failure of community banks or insurance companies could present systemic risk. One or more natural or man-made catastrophic events or a set of circumstances materially and adversely impacting a number of insurers' investment portfolios are examples of circumstances that could cause more than an isolated failure of property casualty insurance companies which, in turn, could be systemically significant.

Another area of concern for systemic risk in the property casualty sector relates to reinsurance. Property casualty insurers may reduce the amount of risk they hold by purchasing insurance from reinsurers. Because reinsurers can accumulate risks from many insurers over an extended period of time, a reinsurer can pose systemic risk to insurers that have large amounts due from an insolvent reinsurer. If there is an insolvency of a property casualty insurer, individual policyholders would be largely protected by the existing guaranty fund system and the policyholders could easily and quickly switch their coverage to other insurers. That system has worked well historically. There is, however, no such guaranty fund protection to pay the claims of an insolvent reinsurer.

C. A Systemic Risk Regulatory Framework

Ultimately, a company's systemic importance should be evaluated not on its size or products, but on its relationships with other institutions and the effect its failure would have on those institutions and, as a result, on the economy at large. In addressing the dangers that arise from such relationships, the government's goal should be to prevent companies from being so financially extended that their failure would create a chain-reaction of failure of other companies such that government intervention would become appropriate. In other words – the primary goal should be to prevent any company (or its failure) from posing a systemic risk at all as opposed to attempting to minimize the systemic risk after the failure occurs. There are two elements in particular that we recommend for your consideration in a reform proposal: mandated internal enterprise risk oversight through board-level risk committees and substantially enhanced disclosure requirements related to risk. I should note one caveat at the outset: what is outlined below is not a comprehensive mechanism for implementing federal systemic risk regulation but a framework for what we believe should be essential components of any such regulatory scheme; many of the details and precise boundaries need to be fleshed out and clarified, including, for example, how and to what extent these suggestions should apply to non-public companies and non-financial services oriented public companies, and the circumstances under which some of the information we suggest be disclosed could be done confidentially if public disclosure would threaten the discloser's competitive position in any way.

1. Corporate Risk Committees

Any response to the current crisis should include corporate governance reform requiring systemically important institutions to assign responsibility for risk oversight to an existing or new committee of independent directors of their Boards of Directors. A board's risk committee should have a management risk officer that reports directly to the committee on a regular basis. This approach is similar to the current relationship between a board's audit committee and the company's chief internal auditor, who often reports directly to that committee.

A board's risk committee would be responsible for overseeing the company's risk-related controls and procedures, and the chief risk officer would be responsible for implementing and managing those controls and procedures. This protocol recognizes the importance of risk management and provides clear responsibility and accountability for the management of risk

The committee's role as educator is important. Financial instruments are constantly evolving and ever-more complicated and it can be challenging for a company's board of directors to get a good understanding of the company's risk profile. A board's risk committee should expect – and be expected to – educate its board members with respect to risks with which they might not be familiar.

At Travelers, for example, our board has for many years maintained a dedicated risk committee to assist the full board in fulfilling its obligation to oversee risk. Our chief risk officer reports to, and works with, the board risk committee on an on-going basis. We also have a separate management risk committee responsible for monitoring and managing the company's overall risk profile and exposure. This management committee meets regularly on its own, as well as with the board's risk committee. The work of the board's risk committee, together with management's focus on risk, is complemented by the work of other board committees, including the audit committee and an investment and capital markets committee. The effective operation of our board risk committee, together with our other board committees, contributed meaningfully to our ability to avoid many of the pitfalls that other insurance and financial institutions recently have faced.

2. Enhanced Disclosure Requirements

In addition to corporate self-policing, there is clearly a role for government oversight of systemically important institutions. Regulation can take different forms and could range from disclosure requirements to prescriptive rules that require and/or restrict certain corporate behavior or encompass a combination of approaches. One of the goals of this regulation should be to enhance the current disclosure regime in order to provide regulators, rating agencies and the public with information necessary to provide a comprehensive understanding of the company's overall risk profile/exposure and be able to identify those institutions that pose a systemic risk to the economy. Market forces would, in turn, help to limit a company's incentive to take risks that could potentially undermine its own long-term success and, as a result, the larger economy. For example, if a company were to disclose that a ratings downgrade would trigger a requirement to post a significant, and quantified, amount of additional collateral, investors may well demand that the company reduce its exposure to this type of risk.

Moreover, additional disclosure would increase the effectiveness and judgment of regulators, rating agencies, and investors. By providing regulators, rating agencies, and the public with the full picture of a company's risk profile, disclosure allows the market to work efficiently and fairly; provides rating agencies with a more robust set of information on which to base their judgments; and gives regulators the information they need to make and enforce applicable prescriptive rules.

For instance, had companies been required to disclose additional information related to their credit default swap exposure - thus putting regulators and rating agencies on notice as to the serious level of risk that certain companies had undertaken with respect to these instruments - such disclosure could have led to appropriate ratings downgrades earlier on and, perhaps, may have resulted in market pressure and, as a result, earlier government intervention.

A robust disclosure regime would require quantitative disclosure of transactions, risks and other factors that could cause a systemically important company to fail. In addition, disclosure rules should include stress test requirements – requiring financial instruments, products and transactions to be put through stress tests to determine their effect on the company under a range of economic scenarios and requiring disclosures of the results of such tests. Any such regime also should provide a mechanism for identifying new financial instruments and transactions entered into by the disclosing entity of which a rating agency or regulator might not be aware. This is critical to ensure that information regarding new risks is not kept under the radar until it is too late for rating agencies, regulators, or consumers to do anything about it.

Finally, disclosure requirements should be principles-based and flexible, designed to address today's financial products and tomorrow's innovations. We operate in a fluid and evolving marketplace. Limiting any disclosure regime to static rules without overarching disclosure principles would result in the rules lagging behind the development of new and sophisticated products and financial structures and keep regulators, ratings agencies, investors and other constituencies from having a complete and accurate understanding of a company's risk profile and financial health. Two major risks of relying on principles – that they cannot be enforced as effectively as rules and that the regulated entities are less certain about the application – can be addressed by insisting on good faith compliance by the regulated entities and vigilance by regulators, and by fostering ongoing communication between the regulated and regulators. Notwithstanding what we see as the potential benefit of principles-based regulation, we could also support incremental rules-based disclosure regulation.

We believe that the combination of private sector self-policing through corporate board risk committees and government oversight through mandatory disclosures and/or prescriptive rules together will provide an effective structure to manage systemic risks. The public and private elements bolster each other. The corporate board risk committees work internally, to ensure understanding of the company’s risk exposures and to provide leadership for regulatory compliance, and they work externally, to ensure robust communications with regulators, rating agencies and other stakeholders. At the same time, the regulators impose prescriptive rules and/or disclosure requirements on companies and look to the CROs as their corporate contacts.

IV. Conclusion

More effective regulation in the current environment is both advisable and inevitable and getting it right is imperative. One of the significant regulatory gaps is with respect to insurance oversight at the federal level. It is critical that this issue be addressed as part of your regulatory reform efforts.

Any regulatory structure designed to manage systemic risk will impact the country's economic success for generations to come. We believe that the combination of private sector self-policing and government oversight would be an effective and common-sense approach to implement systemic risk regulation. But, in so doing, we must be careful to avoid unintended consequences, such as competitively disadvantaging some businesses relative to others in the same industry or U.S. businesses relative to non-U.S. competitors.

Now more than ever, we need thoughtful and effective regulatory oversight that will strengthen our economy and instill confidence in our financial institutions. The regulatory response must reach across disciplines and transcend political agendas in order to be successful. We appreciate the opportunity to testify today on this issue that is so critical to consumers and to our country, and welcome the opportunity to assist you in any way that we can as the legislative process moves forward.

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