Statement of Birny Birnbaum
Executive Director
Center for Economic Justice

Before the

Subcommittee on Insurance, Housing and Community Opportunity
Committee on Financial Services
U.S. House of Representatives

"The Impact of Dodd-Frank's Insurance Regulations
on Consumers, Job Creators, and the Economy"

July 24, 2012

Chairman Biggert, Ranking Member Gutierrez and Members of the Subcommittee, thank you for the opportunity to speak on the impact of the Dodd Frank Act (DFA) on insurance consumers, insurers and the economy. My name is Birny Birnbaum and I am Executive Director of the Center for Economic Justice (CEJ). CEJ is a non-profit organization advocating on behalf of consumers on insurance, credit and utility issues. I have been intimately involved in insurance regulatory policy issues for over 20 years as a regulator and as a consumer representative. I have been an active participant at the National Association of Insurance Commissions (NAIC) and the National Conference of Insurance Legislators (NCOIL) for many years.

To evaluate the impact of the DFA on insurance consumers and insurer, it is necessary to review how the insurance industry contributed to, and was impacted by, the financial crisis starting in 2007. Representatives of the insurance industry have argued that the property casualty industry was not responsible for the economic crisis and poses negligible risk to the financial system.[1] Industry has also testified that state-based insurance regulation has been adaptable, effective and responsive to local and regional markets.[2]

My experience and observation is that insurers did contribute to the financial crisis and the limitations of state-based insurance regulation became apparent as the crisis unfolded. State-based insurance regulation certainly has its strengths, but the DFA has assisted and strengthened state-based insurance regulation.

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[1] Andrew Furgatch on behalf of National Association of Mutual Insurance Companies before the Subcommittee on Insurance, Housing and Community Opportunity, July 28 201.
[2] Andrew Furgatch, July 28, 2011

AIG

On the property casualty side, we must start with the spectacular collapse of AIG, which resulted in a massive taxpayer bailout. AIG certainly contributed to the financial crisis because of its huge bets on credit default swaps. While state insurance regulators have argued that it was the non-insurance subsidiaries of AIG and not the insurance companies of AIG which caused the collapse of AIG, the fact remains that state insurance regulators were not able to monitor AIG at the broader holding company level. State insurance regulators had, and have, limited expertise with the non-insurance aspects of a holding company with significant insurance operations.

In addition, state insurance regulators missed risky investment activities by AIG insurers involving the lending of securities. An NAIC *Capital Markets Special Report*[3] describes how insurer investments contributed to the failure of AIG:

> As we analyze securities lending within the insurance industry, one incident that proved to be an invaluable lesson was with American International Group (AIG). Firm-wide risk management inefficiencies are believed to have played a significant role in AIG's overall financial stress. Although it is most known for the significant losses to AIG Financial Products' (AIGFP) credit default swap (CDS) portfolio, the onset of an overwhelming demand for returned cash by AIG's securities lending counterparties compounded the overall firm's liquidity constraints.
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> Through its securities lending program, AIG generally loaned out securities owned by its insurance company subsidiaries. Between 2005 and 2007, rather than invest the cash collateral it received from the borrowers in conservative, short-term securities, AIG changed the direction of its investment strategy (without disclosing such change in its notes or to the U.S. state regulators) and mostly invested the cash in long-term subprime residential mortgage-backed securities (RMBS). AIG's securities lending portfolio had not been included on the company's balance sheet due to a liberal interpretation of the accounting requirements; therefore, there was no transparency with regard to how AIG had invested the borrowers' posted cash collateral. U.S. regulators became aware of this change in investment strategy during a financial examination in early 2007. Investing in the RMBS resulted in an asset/liability maturity mismatch, and, as it is common knowledge, these securities experienced significant market value declines as the financial crisis emerged. Due in part to the financial distress brought about by AIGFP's CDS portfolio losses, the borrowers in AIG's securities lending portfolio began to return the borrowed securities, requesting the return of their cash, to reduce their exposure to AIG as a firm. AIG was unable to meet the growing demands for cash by its securities borrowers; to do so meant that they would have to sell the subprime RMBS collateral that was now illiquid due to severe market devaluations. Liquidity constraints that developed due to losses on its CDS portfolio were made worse, therefore, by those developing within AIG's securities lending business.

[3] http://www.naic.org/capital_markets_archive/110708.htm

> At its peak, AIG's securities lending program had reached approximately $76 billion of borrowings outstanding. With the assistance of regulators, AIG was able to reduce this exposure to approximately $59 billion before the U.S. government bailout. In November 2008, the Federal Reserve Board and U.S. Treasury announced a restructuring of the U.S. government's financial support to AIG. Consequently, the Federal Reserve Bank of New York created Maiden Lane II LLC (ML II) in November 2008 to "alleviate capital and liquidity pressures on AIG associated with the securities lending portfolio of several regulated U.S. insurance subsidiaries of AIG". Funds provided by ML II were used to purchase RMBS from AIG's securities lending portfolio to help raise cash to return to the securities lending borrowers. As of year-end 2008, ML II had an estimated fair value of $20.5 billion (or $39.3 billion par value).
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> While AIG's losses stemming from its securities lending program did not directly cause the changes in treatment of securities lending by the insurance industry, it did highlight a lack of transparency and varying interpretations of the accounting language related to these investments.

Financial Guaranty Insurance

There were other types of property casualty insurers which contributed to and were dramatically impacted by the financial crisis, including financial guaranty and mortgage insurance. Financial guaranty insurers – also known as bond insurers – mistakenly provided assurance for a variety of asset-backed securities, contributing to the sale of risky and destined-to-fail mortgage-backed securities. The table below shows the premiums and losses for financial guaranty insurers from 2001 through 2011.[4] After years of paying few claims in relation to premium, the bottom fell out starting in 2007. From 2001 through 2006, financial guaranty insurers earned about $13.6 billion in premium while paying out just 9.2% in claims. From 2007 to 2011, financial guaranty insurers incurred almost $37 billion in claims – more than 2.5 times the premium earned.

The financial guaranty insurance market has collapsed. In 2006, financial guaranty insurers wrote about $3.4 billion of premium. By 2011, the remaining financial guaranty insurers still permitted to write new business wrote only $1.1 billion in premium. Further, the weakness and failure of financial guaranty insurers ripple through the economy because the absence of financial guaranty insurance can create great difficulties for states and municipalities to issue debt. State insurance regulators have tried to help a large, weak financial guaranty insurer by splitting off the municipal bond insurance portion of the business from the asset-backed security part of the business.

[4] Data for 2001 to 2010 from NAIC *Market Share Reports for Property/Casualty Groups and Companies*, various years. Data for 2011 from Annual Statement State Page data compiled by CEJ.

Table 1: Financial Guaranty Insurance, 2001-11

Year	***Earned Premium ($ Millions)***	***Incurred Losses ($ Millions)***	***Loss Ratio***
2001	$1,422	$41	2.9%
2002	$1,867	$133	7.1%
2003	$2,389	$182	7.6%
2004	$2,474	$392	15.8%
2005	$2,686	$297	11.0%
2006	$2,725	$200	7.3%
2007	$3,023	$3,949	130.6%
2008	$4,011	$19,239	479.6%
2009	$2,663	$6,669	250.4%
2010	$2,332	$4,186	179.5%
2011	$2,084	$2,846	136.6%
2001-06	$13,564	$1,244	9.2%
2007-11	$14,113	$36,889	261.4%
2001-11	$27,677	$38,133	137.8%

Mortgage Guaranty Insurance

The private mortgage guaranty insurance market also contributed to and was crushed by the financial crisis. Today, the Federal Housing Authority is supporting the mortgage market by providing increased amounts of mortgage insurance. Table 2 shows the performance of private mortgage insurers from 2001 to 2011.[5] As with financial guaranty insurance, after years of very low loss ratios, mortgage insurers' poor risk management resulted in massive losses starting in 2007. The weak financial condition of mortgage insurers PMI caused the Arizona insurance regulator to order the company stop writing new business in October 2011. MGIC received a waiver of minimum capital requirements in order to continue writing new business in 2009 and a second waiver was granted two years later by the Wisconsin insurance regulator.[6]

[5] Data for 2001 to 2010 from NAIC *Market Share Reports for Property/Casualty Groups and Companies*, various years. Data for 2011 from Annual Statement State Page data compiled by CEJ.
[6] "State Regulators Approve New Waivers for MIs," *Insider Mortgage Finance,* January 25, 2012 at http://www.insidemortgagefinance.com/blogs/MIs-Obtain-New-Waivers-1000018864-1.html

Table 2: Primate Mortgage Insurance, 2001-2011

Year	*Earned Premium ($ Millions)*	*Incurred Losses ($ Millions)*	*Loss Ratio*
2001	$4,131	$1,064	25.8%
2002	$4,572	$1,321	28.9%
2003	$4,904	$1,876	38.3%
2004	$5,040	$2,008	39.8%
2005	$5,105	$1,833	35.9%
2006	$5,362	$2,210	41.2%
2007	$5,877	$5,503	93.6%
2008	$6,384	$13,586	212.8%
2009	$5,632	$12,014	213.3%
2010	$4,901	$7,838	159.9%
2011	$4,490	$8,737	194.6%
2001-06	$29,114	$10,311	35.4%
2007-11	$27,285	$47,677	174.7%
2001-11	$56,399	$57,988	102.8%

Title Insurance

Title insurers also contributed to the financial crisis by facilitating dangerous and risky home mortgages. The third largest title insurers, with 20% national market share failed. In all but one state, there is no guaranty fund for failed title insurers. If a title insurer fails, the title insurance policies – which are supposed to remain in force as long as the lender has the insured loan in place and as long as the borrower owns the property – cease to exist and borrowers would be required to purchase new title insurance policies for lenders. In the case of the LandAmerica failure, the failed insurer was taken over by another insurer thereby avoiding an insolvency that would have roiled mortgage markets and borrowers. The title insurance market now features four large national insurers writing over 85% of all title insurance.[7]

[7] Based on First Quarter 2012 countrywide market share.

Force-Placed Insurance

A discussion of the property casualty insurance and the financial crisis is not complete without mention of force-placed home insurance. As part of their mortgage agreements, borrowers agree to maintain insurance on the property serving as collateral for the mortgage loan. If the borrower fails to maintain the required insurance, the mortgage servicer force-places insurance on the property and charges the borrower for that force-placed policy. Table 3 shows the growth in high-cost force-placed home insurance (FPI). Despite significantly less coverage and fewer expenses than a regulator homeowners policy,[8] the average cost of a FPI policy is much greater than a homeowners policy. In Florida, the average LPI premium for one of the two large insurers writing nearly all the LPI business was over $6,500 from the period July 2008 through June 2009.[9] For consumers experiencing financial stress, the imposition of a hugely expensive FPI policy can make the task of staying or getting current on the loan insurmountable. Regulators in New York, Florida and California have begun to take action this year to address excessive rates, but for many years, insurance regulators took no action to address the high rates of FPI and the large sums paid directly or indirectly to mortgage servicers by the FPI insurers.

Table 3: Force-Place Home Insurance, 2004-2011[10]

Year	*Net Written Premium ($ Millions)*	*Loss Ratio*
2004	$796	33.1%
2005	$919	53.5%
2006	$1,074	29.0%
2007	$1,647	20.5%
2008	$2,209	23.3%
2009	$3,049	20.7%
2010	$3,223	17.3%
2011	$3,450	24.7%
2004-2011	$16,368	24.2%

[8] FPI does not include coverage for contents, liability or additional living expense following a catastrophic event.
[9] CEJ Testimony Regarding Praetorian Insurance Company Rate Filing for Force-Placed Insurance before the Florida Office of Insurance Regulation, Table 4, based on data presented by the insurer in its rate filing.
[10] Data source is Credit Insurance Experience Exhibit data from the creditor-placed home columns of part 4 plus the experience of QBE Insurance Corp and QBE Specialty reported in part 5 Other., compiled by CEJ.

Life Insurance and Annuities

The life insurance industry was greatly impacted by the financial crisis. Life insurers sought relief from the federal government in the form of TARP funds and from state insurance regulators in the form of lower claims reserve requirements and changed accounting standards to indicate greater capital with no change in the amount of funds available to protect consumers.

The problems experienced by the life insurance industry stem from the fact that life insurer products have been transformed over time from mortality protection to market return protection. Instead of selling products that simply pay claims in the event of death or long life, life insurers' products began to guarantee market returns. News articles from 2009 describe the situation:

> Many life-insurance companies, like others in the financial sector, got caught carrying too much risk when the financial crisis hit. Some were hurt by their variable-annuity businesses, under which they sold products often linked to equity markets that promised minimum payouts even if markets fell. Insurers also lost money on investments in bonds, real estate and other assets that back their policies.
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> The life-insurance industry is a lynchpin of the financial system, providing millions of Americans with a safety net, and is an important source of savings and wealth management. An erosion of confidence in the industry could cause customers to redeem policies and create a cash crunch for some companies. Insurers also are big sources of capital throughout the economy, as they invest the premiums they receive from customers into bonds, real estate and other assets. Access to federal aid should help life insurers avoid further credit-rating downgrades and the need to raise capital under onerous terms.
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> On Thursday, an industry trade association hailed the news. "By extending funds to certain insurers, Treasury is taking the right step toward helping restore lending and liquidity to the marketplace," said Frank Keating, President and CEO of the American Council of Life Insurers. [11]
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> The news will come as a relief to a number of iconic American companies that have suffered big losses made worse by generous promises to buyers of some investment products. Shares of life insurers have fallen more than 40% this year. Their troubles led to a string of rating-agency downgrades that, in a vicious cycle, made if more difficult for some insurers to raise funds.

[11] Wall Street Journal, "U.S. Slates $$ Billion for Insurers from TARP," May 15, 2009.

> The life-insurance industry is an important piece of the U.S. financial system. Millions of Americans have entrusted their families' financial safety to these companies, so keeping them on solid footing is crucial to maintaining confidence. If massive numbers of customers sought to redeem their policies, it could cause a cash crunch for some companies. And because insurers invest the premiums they receive from customers into bonds, real estate and other investments, they are major holders of securities. If they needed to sell off holdings to raise cash, it could cause markets to tumble.
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> Life insurers had for a time seemed to be somewhat immune from the credit crisis, since they tend to invest in relatively safe assets in order to match their liabilities. These companies got into trouble for two main reasons, both tied to the weak financial markets. First, many of the roughly two dozen insurers that dominate the variable-annuity business made aggressive promises on these popular retirement-income products, guaranteeing minimum returns, no matter what happened to the stock market. With the market's decline, the issuers are on the hook for big payouts, though most of the payments won't come due for 10 or more years. Second, the insurers also have lost money on the investments in bonds and real estate that back their policies.[12]

The life insurance industry came under financial stress because instead of the traditional role of insurers in diversifying risk through pooling of many lives, many vehicles or many properties, the insurers assumed the role of guaranteeing market returns. Insurance regulators never identified or examined the potential for systemic risk to the financial system associated with insurance companies taking on ever greater promises of consumers' return on market investments.

NAIC Capital Relief for Insurers

In November, 2008, the life insurers went to state insurance regulators and the NAIC seeking "capital relief." The insurers asked for lower reserve requirements and changes to accounting rules. The changes to accounting rules were intended to increase the amount of assets recognized by state insurance regulators as acceptable for meeting capital requirements. The principal change was a greater recognition of deferred tax assets. With this change, insurers were able to state greater amounts of capital while, in reality, no additional funds were available to protect policyholders.

The NAIC appointed a working group, which worked quickly to recommend NAIC adoption of most of the insurer requests. But, in January 2009, under strenuous protests from consumer organizations, the NAIC voted not to adopt the capital relief measures and to examine the proposals more carefully. NAIC President Roger Sevigny stated "Simply put, the industry has not made a credible case for why we need to make changes on an emergency basis, and why those changes should be limited to the specific proposals made by the industry."[13]

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[12] Wall Street Journal, "U.S. to Offer Aid to Life Insurers," April 8, 2009

[13] NAIC News Release, "Regulators Deny Industry's Request to Lower Capital, Surplus Standards," January 29, 2009.

At that point, several states granted the capital relief by allowing their domestic insurers to deviate from the insurance accounting rules through state exceptions. These actions created a crisis for state insurance regulation as states which had not granted the capital relief to their domestic insurers had to choose between accepting and rejecting the other states' actions. The remaining states, through the NAIC, were eventually forced to adopt the capital relief proposals to maintain something close to consistent solvency regulation across the states.

The Dodd Frank Act Has Benefitted Insurance Consumers and State Insurance Regulation

This history of insurers and state insurance regulation leading up to and following the financial crisis is essential for evaluating the costs and benefits of the DFA on insurance consumers and insurance companies. The DFA has been very beneficial to insurance consumers and has improved the capabilities of state insurance regulation.

Federal Reserve Regulation

The DFA created the Financial Stability Oversight Council (FSOC) with the authority to designate a financial firm as systemically important and subject to supervision by the Federal Reserve. In addition, insurance companies that are part of a holding company with a bank or a savings and loan are subject to holding company supervision by the Federal Reserve. Given the history of failed oversight at the holding company level of AIG, these provisions of the DFA are reasonable and necessary. While the NAIC has attempted to improve its tools for supervision of holding companies with insurance subsidiaries, it is unclear what expertise insurance regulators have regarding the non-insurance activities of these holding companies. In addition to assigning the Federal Reserve the responsibility to bank and savings and loan holding companies with insurance operation, the DFA provided institutions to assist and inform the Federal Reserve in its efforts, including the Federal Insurance Office (FIO) and a member of FSOC with insurance expertise. As stated in the 2012 FSOC Annual Report, the Federal Reserve recognizes the risks and characteristics of insurers and the need to coordinate with state insurance regulators:

> In addition to its existing responsibility for supervision of a BHC that is a major life insurance company, on July 21, 2011, the Federal Reserve assumed responsibility for over 25 SLHCs that engage in significant volumes of life, property and casualty, or title insurance underwriting. The unique aspects of the insurance industry are addressed in various regulations that have been published for the BHC and SLHC populations. The Federal Reserve developed and implemented a specialized supervisory approach and customized supervisory guidance that reflects the risks and characteristics of the industry. This approach includes communications and coordination with state insurance regulators.

In addition, the DFA, by creating the FIO, provides the federal government with a subject matter expert on insurance to help FSOC identify systemically risky firms. The identification of systemic risk posed by insurance companies and cooperative supervision of holding companies remains vitally important. The need is illustrated by state insurance regulators recent actions with a relatively new product offered by life insurers – the contingent deferred annuity (CDA).

The CDA is a derivative sold to investors which guarantees lifetime benefits if the investor's portfolio is depleted before the investor dies. Unlike an annuity sold by the insurance company for which the investor transfers the assets to the insurance company, the CDA is a stand-alone guarantee. Instead of proceeding with caution on this new product given the problems insurers encountered with market-guaranty products in 2008 and 2009, the regulators are doubling down on the risky products. State regulators review of this product did not include an analysis of the potential for systemic risk posed by a product guaranteeing benefits after investments have been depleted from millions of retirees who would need the product in the same general time period in the event of a major market downturn. The existence of the FIO to provide broader analysis and the FSOC to address systemic risk is a huge benefit for insurance consumers from the DFA and fills a major gap in state insurance regulation.

Resolution Authority

The DFA gives the FDIC orderly resolution authority over a non-bank financial company under certain circumstance and if the failure would have serious adverse impacts on the financial stability of the country. This is another common-sense component of the DFA. To the extent that the state guaranty fund system is able to deal with the insolvencies of insurers, the FDIC's authority would not be required. But the state guaranty fund system is not comprehensive. As mentioned above, title insurers – whose product is necessary for mortgages to be sold – are not covered by guaranty funds. With two title insurers controlling two-thirds of the market and four title insurers controlling over 85% of the market, a failure by a top title insurer could pose systemic risk.

Volcker Rule

The DFA includes a provision – the Volcker Rule – that limits certain proprietary trading and speculative investments in derivatives. The DFA provides an explicit exemption from the Volcker Rule for investment activity of insurers. To the extent insurers engage in these investments for hedging purposes and are subject to state regulatory oversight, the Volcker rule would not apply. However, to the extent that insurers engage in proprietary trading for purposes other than the business of insurance, it is reasonable and necessary for this activity to be subject to the Volcker rule.

Federal Insurance Office

The creation of the FIO by the DFA is a great benefit to insurance consumers, the insurance industry and state insurance regulators. In addition to serving as the federal governemnt's insurance subject matter expert and assisting with the identification of systemically risky products and institutions, the FIO creates a true federal representative to participate in international insurance trade and regulatory issues in coordination with state insurance regulators. The interests of the insurance industry are better represented than before the FIO was created. Prior to the DFA, individual states and the NAIC entered in regulatory agreements with other countries and the NAIC was the voice of the United States in international regulatory issues. The DFA, through the FIO, strengthens the ability of state insurance regulators on international issues.

The DFA also authorized the FIO to examine issues of insurance availability and affordability in traditionally underserved areas. Insurance has long been recognized as essential for individual and community economic development and access to affordable insurance is necessary for individual to build and protect assets. Most state insurance regulators individually and the NAIC as an organization have, for decades, refused to examine and analyze availability issues. In particular, state insurance regulators have consistently refused to collect the detailed data necessary to even assess the state insurance availability and affordability in low-income and minority communities. The DFA gives the FIO authority to collect data from insurance companies, if and only if, those data are not otherwise available and not collected by state insurance regulators.

The Consumer Financial Protection Bureau

The most important part of the DFA for consumer protection was the creation of the CFPB. Although the CFPB has no jurisdiction over insurance products, the CFPB has and will continue to help insurance consumers as well as consumers of other financial products. The CFPB will work to ensure that financial products sold are transparent to consumers and, by doing so, will enable markets to operate more effectively to prevent the sale of dangerous and abusive financial products. The financial system is safer because of the CFPB.

In addition, the CFPB, with other federal regulators, will help fill the gaps created by insurance products sold in connection with loans – like payment protection and force-placed insurance. The CFPB recently took action to stop unfair and deceptive sales of payment protection products, which are the banking analog to consumer credit insurance regulated by state insurance regulators. The CFPB's action to stop unfair sales of payment protection stands in contrast to the limited activity of state insurance regulators regarding sales of consumer credit insurance. The CFPB and other federal regulators have taken steps to improve the performance of mortgage servicers, including servicer standards for force-placed insurance. In the void left by state insurance regulators, the CFPB has helped protect the insurance consumers

Conclusion

The DFA has produced solid benefits for insurance consumers, the insurance industry and state-based insurance regulation.