PERSPECTIVES ON SYSTEMIC RISK

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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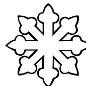

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PERSPECTIVES ON SYSTEMIC RISK

Thursday, March 5, 2009

U.S. House of Representatives,
Subcommittee on Capital Markets,
Insurance, and Government
Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Sherman, Capuano, McCarthy of New York, Baca, Lynch, Scott, Maloney, Bean, Perlmutter, Donnelly, Carson, Wilson, Foster, Adler, Kilroy, Kosmas, Grayson, Himes, Peters; Garrett, Price, Castle, Manzullo, Royce, Biggert, Hensarling, Campbell, McCotter, Neugebauer, McCarthy of California, Posey, and Jenkins.

Ex officio present: Representative Bachus.

Chairman Kanjorski. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Pursuant to agreement with the ranking member, and to allow as much time as possible for members' questions, opening statements today will be limited to 10 minutes on each side. Without objection, all members' opening statements will be made a part of the record.

We meet today to discuss the issue of systemic risk. The bailout of American International Group, the bankruptcy of Lehman Brothers, and the takeover of Bear Stearns each demonstrate that systemic risk is not just confined to the banking sector. We therefore will focus our examinations at this hearing on insurance, securities, and capital market issues.

The ongoing turmoil in our financial markets has led us to a crossroads. Because our current regulatory regime has failed, we must now design a robust, effective supervisory system for the future. In doing so, we must move expeditiously in order to help restore confidence in our markets and to get our economy moving again.

We must, however, also move carefully and take the time to do it right. We should not rush to judgment on developing a new systemic risk overseer. We must also put aside our partisan differences and aim at the onset to reach a genuine consensus. Perhaps most importantly, we must start at the beginning and ask some basic questions.

First, we must define "systemic risk." Does a financial services company pose a systemic risk if it is too big to fail, too interconnected to fail, or too leveraged to fail? Could the independent actions of many small players compound and create a systemic risk? Do only financial services providers pose a risk? For example, could the technology used in our financial markets pose a risk to the broader economy?

Moreover, are there certain financial products, business activities, or industry segments more likely to cause risk than others? How can we distinguish which is which? Today's witnesses will help us to start answering these complex questions and to begin defining more concretely the amorphous concept of systemic risk.

Second, we need to ask ourselves how the government can work to diminish systemic risk. Should we create an umbrella overseer? If so, how should such an entity operate? Alternatively, could existing regulators overtake this objective? If so, how should we address the products and parties that operate in the shadows of our financial system and outside of regulatory oversight?

Third, and arguably most important, how can the government prevent an institution from becoming too important to fail, going forward? Should we impose a systemic risk test as part of a governmental review of mergers? Moreover, could the financial innovations of one company or one sector contribute to systemic risk?

Today, we will spend much time studying insurance issues. Our panel has examined insurance regulation many times, but this debate is different. This debate is about recognizing that insurance is a part of an integrated financial services system.

Insurance companies and their affiliates, in some instances, could pose risk to the broader system. American International Group is a perfect, and severe, example of this reality. In other instances, insurers could be negatively impacted by ratings downgrades, capital impairments resulting from external events, and the application of accounting standards.

We will also learn more about credit default swaps, a product that sometimes operates as an insurance contract and sometimes as a securities product. Credit default swaps have generally fallen through the cracks of our fragmented regulatory system. Therefore, Congressman Bachus joined me in asking the Government Accountability Office to study credit default swaps, and an expert will share GAO's findings today.

Hedge funds, too, are largely unregulated. After the government organized the rescue of Long Term Capital Management in 1998, the President's Working Group made legislative recommendations for preventing future systemic risk by hedge funds. I subsequently joined with then-Capital Markets Chairman Richard Baker in proposing the Hedge Fund Disclosure Act, and moving it through a subcommittee mark-up.

Even though our bill did not become law, I welcome Mr. Baker back to Congress today in his role as the leader of the Managed Funds Association. At this time, he and I have another chance to ensure that hedge funds are appropriately regulated and our economy better protected from systemic risk. This time, we will hopefully succeed.

In closing, the work ahead of us is important and necessary. I look forward to the testimony of our witnesses and to engaging in a productive debate on these issues.

I would like to recognize Ranking Member Garrett for 4 minutes for his opening statement.

Mr. GARRETT. Thank you, Mr. Chairman. As always, it is a pleasure working with you on this subcommittee's business and I look forward to today's hearing and hearing different perspectives on these financial market regulatory systems.

For me as with you, there are several fundamental questions that need to be answered as we embark on examining the potential future for such a systemic regulator.

First, as you say, we still do not have a single agreed-upon definition of exactly what is a "systemic risk," nor do we know exactly what a systemic regulator would be, what roles it would have, who would be under its jurisdiction, etc.

Secondly, the committee needs to be careful not to get ahead of itself. We cannot come up with an appropriate solution in this area until we have a better understanding and more consensus on actually what are the causes of our current financial situation.

This subcommittee and the full committee have a lot on their plates, and a lot is at stake on what this Congress ultimately decides to do in the area of regulatory reform.

I cannot stress this point enough. We need to get this right and not move too quickly simply to illustrate that we are "doing something."

What we do know is that many areas of our financial services sector already are subject to significant regulation, some of the areas with most of the problems—Bear Stearns, Lehman Brothers, not to mention the Bernie Madoff situation.

They were regulated by the SEC. Indy Mac and Washington Mutual were both regulated by the Office of Thrift Supervision. Additionally, OTS has oversight responsibility for the unit of AIG where most of its problems originated.

The Federal Reserve itself, which is often mentioned as a potential candidate for a systemic risk regulator, certainly has a regulatory record that really leaves a lot to be desired. Its handling of monetary policy in the years leading up to the current crisis is often mentioned by many experts as enabling the events.

Furthermore, the Fed already has the role of safety and soundness and prudential limits regulated for large banks, holding companies, companies such as Citi and Bank of America, which are two of the largest recipients, I should point out, of Federal TARP funds, and whose perceived uneasy state have led to much of the uncertainty in the rest of the market.

If you think about it, all these and other regulators were already on the job but did not do a good job with the powers vested in them, so why should we have faith that a new super regulator of systemic risk will do any better than them?

The Fed in particular raises certain concerns for me. It already has significant responsibilities in areas of monetary policy as well as its ongoing bank regulatory role.

In addition, as an independent institution, there seems to be a certain lack of political accountability for its actions. I am not sure

it is really wise to consolidate so much additional responsibility in an entity that does not have to answer to the American people.

Furthermore, the Fed has no particular expertise regulating entities outside the banking area such as insurance and securities, two potential areas that it would be asked to oversee if it was to become the regulator.

There are other aspects that concern me about certain systemic risk regulator proposals that have come out. Chief among these is concerns in identifying institutions with systemic significance.

If this were to be done, the market would likely view these institutions as having de facto guarantee of Federal Government support during times of financial stress.

Does that sound familiar? Not only would this designation likely lead to unfair advantages in the marketplace such as lower cost of capital, but it also will socialize market failure while leaving profits in the private hands.

This is exactly what happened with Freddie Mac and Fannie Mae and we have all seen how that ended up.

In sum, Mr. Chairman, I am not convinced that there is a workable systemic regulator solution that would provide the net benefit to our economy going forward, but with that being said, we are just at the beginning and not the end, and I look forward to the testimony here as we go forward, and I thank all the witnesses for joining us here today.

Chairman KANJORSKI. Thank you, Ranking Member Garrett. Next, we will hear from Mr. Ackerman of New York for 2 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman. In my view, our examination of systemic risk must include both an in-depth analysis of the role that credit ratings and credit rating agencies played in creating the current economic crisis, as well as consideration of the mark-to-market accounting standard.

I have long believed that allowing the SEC to grant the largest credit rating agencies nationally recognized statistical rating organization status is the equivalent of stamping a government seal of approval on the ratings that they issue.

Unfortunately, as we know now, the SEC was woefully inattentive to the rating process over the last several years, and many AAA rated securities, particularly those that were mortgage backed, did not in fact exhibit the fundamental characteristics of a sound and safe investment.

Mr. Castle and I have reintroduced legislation to institute a dual structure for credit ratings issued by NRSROs. Credit rating agencies would still be permitted to assign their own ratings to securities composed of different types of assets that are then consolidated within packages of different types of financial products. However, a new class of ratings would be created under which only homogeneous securities with proven track records could be rated.

As the committee moves to consider reforming our country's financial services regulatory structure, I would urge our colleagues to take a look at H.R. 1181.

I am eager to hear our witnesses' perspectives on the effect that mark-to-market has had on the current market conditions, and if not rescinded, their forecasts for the impact mark-to-market will have on systemic risk in the immediate future.

In the current economy, it makes no sense to compel companies to mark their assets to market since there often is no market. The drastic overnight write down's that many companies have been forced to take because of mark-to-market has surely exacerbated systemic risk, and I am interested to hear from our witnesses how we can alleviate this effect while maintaining an effective and transparent standard for evaluating assets.

I thank you, Mr. Chairman, and I look forward to hearing from our witnesses and welcome back our former colleagues, whom I think I have not seen in about 1 year.

[laughter]

Chairman KANJORSKI. One year? Thank you very much, Mr. Ackerman. Now we will hear from the gentleman from California, Mr. Royce, for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. The fact that many of our financial institutions have become too big to fail or too interconnected to fail has become shockingly apparent.

The steps taken by the Federal Government and the amount of tax dollars allocated because of systemic threats have not been seen in recent history, either here or in the U.K. or by other Central banks around the world or other democracies around the world.

The long term effect of these actions will not be fully understood for some years to come. We cannot wait until then to act on the regulatory shortcomings that have been exposed so far by our economic downturn.

The exact make-up of these reforms will be debated here in the coming months. As the President of the Richmond Federal Reserve has noted, the critical policy question of our time will be where to establish the boundaries around the public sector safety net provided to public market participants now that those old boundaries are gone.

The moral hazard problem created by the implicit government guarantee of Fannie Mae and Freddie Mac is a perfect example of what not to do. This quasi-public model and the apparent market distortions it caused must become a thing of the past.

Richard Baker is here with us today. He—along with the Federal Reserve Chairman and the Treasury Secretaries—came before this committee 16 times, I counted, and warned about the overleveraging at 100 to 1 at Fannie Mae and Freddie Mac, warned about the legislative mandates for those institutions to purchase subprime and Alt-A loans and package them into mortgage backed securities in order to drive affordable housing.

They all warned of the systemic risk of this, and we all witnessed the central role these Government Sponsored Enterprises played in the run up to the housing bubble. Now all Americans are feeling the pain of the economic fallout that originated in our housing sector.

The invitation for political and bureaucratic manipulation will remain as long as the line between the Federal Government and private institutions is blurred.

Beyond re-establishing clear boundaries around the Federal Government's safety net, it is critical that regulatory gaps in our current system be filled.

Our acting systemic risk regulator, Ben Bernanke, made his feelings known earlier this week in this committee when he expressed his frustration first over on the Senate side with AIG's ability to exploit a huge gap in the regulatory system. This regulatory gap must be filled by a world class Federal regulator for insurance, a step supported here last week by Ben Bernanke, the Chairman of the Federal Reserve.

The various State insurance regulators simply do not have the ability to oversee massive global financial firms like AIG. This void has gone unfilled for too long, and the problems that have resulted because of this gap are many.

The Federal Government and now the American taxpayers have a vested interest in the ability of this Congress to establish a world class regulatory alternative to the fragmented 50 State system overseeing the insurance market.

Again, thank you for holding this hearing, Mr. Chairman, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you, Mr. Royce. Now we will hear from the gentleman from California, Mr. Sherman, for 2 minutes.

Mr. SHERMAN. Thank you. Systemic risk regulator—everybody knows that we need one, but nobody knows what it is.

We ought to have many entities that are not regulated, particularly if they are not—when I say "not regulated," not regulated by a systemic risk regulator—if they are not too big and they do not sell insurance.

Other than the bond rating agency problem Mr. Ackerman pointed out, I think one of the key problems that got us into this mess is that companies issued insurance on portfolio's without insurance regulation or insurance reserves. We discovered that a credit default swap is just as risky as earthquake insurance sold in the San Fernando Valley.

I am concerned that we are seeing taxpayer money transferred to Wall Street based on the political power of the entities involved. We just saw $20 billion transferred to the AIG counterparties, billions of taxpayer dollars transferred to foreign entities.

We are in effect providing Federal insurance to the general creditors because the counterparties of AIG have more political power than the uninsured depositors at Indy Mac Bank.

I look forward to matching regulation with the needs of the market without seeing us prevent venture capitalists and others from providing some of the benefits of cowboy capitalism that we have enjoyed, particularly in my State of California.

I yield back.

Chairman KANJORSKI. Thank you very much. Now we will hear from the gentleman from Georgia, Mr. Price, for 2 minutes.

Mr. PRICE. Thank you, Mr. Chairman. Certainly everyone on this committee believes that our existing financial regulatory structure has gaps, but that does not mean that more regulation will be better or that it is possible to create an effective systemic risk regulator to prevent financial crises down the road.

What industry is more regulated than the U.S. financial industry? Despite layers of regulation, we still find ourselves in the midst of a major economic contraction. We ought not lose sight of this fact as we consider the best way to regulate while preserving

a growing and globally competitive U.S. market that will attract investors.

The idea of a systemic risk regulator raises real concerns. If a specific institution is designated as systemically significant, it sends the message that the government will not let it fail.

This clearly gives these institutions a huge competitive advantage over non-systemically significant institutions that will be unable to benefit from the implied Federal backing.

This classification takes us even further into a political economy where the government picks winners and losers, not a market economy where the wonder of America thrives.

To quote AEI's Peter Wallison, "If we go forward with this idea, we will be creating an unlimited number of Fannie Maes and Freddie Macs, companies that are seen in the market as ultimately backed by the Federal Government. Given the fact that the government actually had to take over these entities because they were so unstable, I do not believe we should use them as business models for success."

This reminder should caution all of us as we consider a proposal that will completely change the way our financial system operates and is regulated.

I look forward to an open, honest, and vibrant debate as we move forward. I thank the chairman.

Chairman KANJORSKI. Thank you very much, Mr. Price. Now we will hear from the gentlelady from Illinois, Ms. Bean, for 1 minute.

Ms. BEAN. Thank you, Mr. Chairman. Thank you for holding today's hearing and yielding me the time and to those of our witnesses who are here to testify and share your subject matter expertise, we greatly appreciate it.

Last Fall we learned the dangers of allowing antiquated, inefficient regulation of our financial system, and we have all suffered the consequences.

While there is a difference in viewpoints on what actions are necessary moving forward to stabilize our financial system, most of us agree that we need to create a systemic risk regulator who can monitor the financial data of industry players and positions to prevent systemic wide risk.

The values of our portfolios, homes, and businesses are in decline and there is no question that in good part, the lacking Federal oversight from a regulatory level has contributed, whether you are talking about the roughly $62 trillion unregulated credit default swap market or whether you are talking about the complex and growing insurance industry as an important financial service sector player, lacking any Federal oversight as well.

Moving forward, I think the most important thing we can do is make sure we have a regulator in place who can detect and prevent potential risks and work to make sure that one financial service product, player, or sector's downturn doesn't turn into a problem industry-wide.

Thank you. I yield back.

Chairman KANJORSKI. Thank you, Ms. Bean. Now we will recognize the gentleman from Delaware, Mr. Castle, for 1 minute.

Mr. CASTLE. Thank you, Mr. Chairman. I sort of believe that we should have a systemic risk regulator. I am not sure I can really

define “systemic risk” as well as I would like to or what that regulator should be.

I also have questions about whether the Fed should do it or somebody else should do it.

The bottom line is, I think, a year-and-a-half to 2 years ago, most of us on this committee could not define a “credit default swap.” There are other leverage financial investments that we really do not completely understand.

I am not sure that the regulators who are looking at bottom line accounting numbers in the various institutions really understood all that as well. I think the bottom line is you need somebody who is looking at the new innovations, those things that are happening economically in our economy, and my sense is this could be a positive step for everybody.

I do not know exactly what the position of all our witnesses is going to be, but I think we should be looking at this possibility. Maybe the role of the systemic risk regulator should be lesser rather than greater.

I do not know what the answer is. At least information coming from that and letting us know what is going on would be important.

I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Castle.

Now I will introduce the panel. Thank you for appearing before the subcommittee today, and without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

First, we have Ms. Williams, Director of Financial Markets and Community Investment at the Government Accountability Office.

Ms. Williams will outline the results of a study on credit default swaps that I requested last July, on which Ranking Member Bachus later joined me.

Ms. Williams?

STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Ms. WILLIAMS. Thank you. Chairman Kanjorski and members of the subcommittee, I appreciate the opportunity to testify before you this morning on systemic risk in general and credit default swaps or CDS, in particular.

While the work we initiated at the request of Ranking Member Bachus and Subcommittee Chairman Kanjorski is the primary focus of my written statement, I would like to highlight a few issues related to systemic risk as well as CDS and the lessons learned from recent events.

While CDS have received much attention recently, the rapid growth in this over-the-counter derivative more generally illustrates the emergence of increasingly complex products that have raised regulatory concerns about systemic risk, which is the risk that an event could broadly affect the financial system and ultimately the real economy, rather than just one or a few institutions.

While bank regulators may have some insights into the activities of their supervised banks that act as derivatives dealers, CDS, like

other OTC derivatives, are not regulated product markets. The transactions are generally not subject to regulation by SEC, CFTC, or any other U.S. financial regulator.

Thus, CDS and other OTC derivatives are not subject to the disclosure and other requirements that are in place for most securities and exchange traded futures products.

Although recent initiatives by regulators and industry have the potential to address some of the risk from CDS, these efforts are largely voluntary and do not include all CDS contracts.

In addition, the lack of consistent and standardized margin and collateral practices continue to make managing counterparty credit risk and concentration risk difficult, and may allow systemically important exposures to accumulate without adequate collateral to mitigate associated risk.

This area is a critical one and must be addressed going forward.

Gaps in the regulatory oversight structure of and regulations governing financial products such as CDS allow these derivatives to grow unconstrained, and little analysis was done on their potential for systemic risk.

Regulators of major CDS dealers may have had some insight into the CDS market based on their oversight of the entities, but they had limited oversight of non-bank market participants such as hedge funds or operating subsidiaries of others like AIG Financial Products, whose CDS activities appear to have contributed to its financial difficulties.

This fact clearly demonstrates that risk to the financial system and even the economy can result from institutions that exist within the spectrum of supervised entities.

Further, the use of CDS creates interconnections among these entities, such that the failure of any one counterparty can have widespread implications regardless of its size.

AIG Financial Products, which had not been closely regulated, was a relatively small subsidiary of a large global insurance company, yet the volume and nature of its CDS business made it such a large counterparty that its difficulty in meeting its CDS obligations not only threatened the stability of AIG but of the entire financial system.

In closing, I would like to briefly mention what the current issues involving CDS have taught us about systemic risk and our current regulatory system.

The current system of regulation lacks a clear mechanism to effectively monitor, oversee, and reduce risks to the financial system that are posed by entities and products that are not fully regulated, such as hedge funds, unregulated subsidiaries of regulated institutions, and other non-bank financial institutions.

The absence of such authority may be a limitation in identifying, monitoring, and managing potential risk related to concentrated CDS exposures taken by any market participant.

Regardless of the ultimate structure of the financial regulatory system, a system-wide focus is vitally important.

The inability of regulators to monitor activities across the market and take appropriate action to mitigate them has contributed to the current crisis and the regulators' inability to address its fallout.

Any regulator tasked with a system-wide focus would need broad authority to gather and disclose appropriate information, collaborate with other regulators on rulemaking, and take corrective action as necessary in the interest of overall market stability, regardless of the type of financial product or market participant.

This concludes my oral statement. I would be happy to answer any questions at the appropriate time. Thank you.

[The prepared statement of Ms. Williams can be found on page 156 of the appendix.]

Chairman KANJORSKI. Thank you, Ms. Williams.

Next, we have the distinct honor of hosting our subcommittee's former chairman, the Honorable Richard H. Baker, President and Chief Executive Officer of the Managed Funds Association.

Welcome, my friend. The floor is yours.

STATEMENT OF THE HONORABLE RICHARD H. BAKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MANAGED FUNDS ASSOCIATION (MFA)

Mr. BAKER. Thank you, Mr. Chairman. I am honored to be here. I want to specifically note Mr. Ackerman's kind affirmation on the record that I have not spoken to him for a year. That could be a value going forward.

For the record, it has been 1 year and 1 month since my retirement. I am delighted to be back and engage my former colleagues in discussions as we go forward.

Mr. Chairman, Ranking Member Garrett, I am here today in my capacity as President and CEO of the Managed Funds Association, which represents the majority of the world's largest hedge funds, and is the principal advocate for sound business practice among my members.

Over the last several months, our members have engaged in significant discussions on many of the topics that are of interest to members of this committee.

First, a word about our industry. Hedge funds do provide liquidity to markets and enable effective price discovery and provide capital for businesses to succeed and grow.

We also provide risk management tools to sophisticated investors such as managers of pensions and endowments.

To perform these tasks, our Funds require sound counterparties and stable market conditions. The current lack of certainty with regard to large financial institutions inhibits investors' willingness to put capital at risk in such market conditions.

Establishing a regulatory system that will aid in restoration of market stability will be a service, I believe, to all market participants.

I must also state that the current market circumstance was not initiated in proximate cause by our members, and in fact, some of our members are just as adversely impacted as any other investor in the market.

In many cases, our members have been a vital source of liquidity in these times in helping to establish a supportive floor of value in a declining market.

Notwithstanding these facts, the Association believes that smart regulation will improve overall functioning of the financial system.

Regulation by itself, I would quickly add, however, is not sufficient as past circumstances have clearly demonstrated.

Our own industry best practices, which have been developed over years of market observation by the MFA, coupled with appropriate investor due diligence, will promote efficient capital markets, market integrity, and provide needed investor protection.

Over the last several months, our members have engaged in discussion of what constitutes an appropriate systemic risk regulatory framework. Effective systemic risk regulation would require oversight of the entire financial system. A single regulatory entity should perform this task. Multiple systematic risk regulators would likely have coverage gaps or worse, overlapping and duplicative examination.

To provide this regulator with the appropriate data for this enormous task, MFA supports confidential reporting to a systemic risk regulator of the required information. The substance of that report should be left for the regulator to determine and not, Mr. Chairman, established by statute; and that should be warranted by the current economic conditions at hand for the purpose of assessing a systemic risk potential.

This authority should also enable a forward looking capability as waiting until the adverse event has occurred will protract time for recovery.

We believe granting broad authority with respect to information reporting along with ensuring the regulator has sufficient resources to conduct effective analysis is an appropriate construct.

It is essential, however, that with such a broad ground of authority for reporting virtually any aspect of financial conduct deemed appropriate, that this disclosure be granted full protection from public disclosure.

This can be done and must be done without any adverse effect or in any manner inhibiting the ability of the regulator to conduct its important work.

We also believe it is very important to establish legal clarity in this role of the regulatory mission. It is our recommendation that the singular duty of this office is to preserve and protect the integrity of the financial system. Market integrity and investor protection would remain the responsibility of the current regulatory entities.

Further, the systemic risk regulator should not focus on preventing the failure of any single firm, unless it is determined that such failure would precipitate systemic consequences of grave concern.

Authority to prevent systemic risk should be exercised very carefully, as not to create the moral hazard from the appearance of an implied government guarantee against future failure.

Systemic risk concerns may arise from a combination of factors. Therefore, the regulator should implement its authority by taking an approach that focuses on all relevant sectors of the financial market as well as product.

The regulator would therefore need clear authority to seek to prevent systemic risk in a forward looking manner, to address systemic concerns once they have been identified without hesitation,

and to ensure that a failing firm does not threaten the financial system in a systemic manner.

Mr. Chairman, we are committed to being a constructive voice in this ongoing discussion, which we recognize will be difficult and complicated, but we stand ready to cooperate, and we look forward to responding to your questions.

[The prepared statement of Mr. Baker can be found on page 65 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Baker.

Next, the Honorable Steve Bartlett, President and Chief Executive Officer of The Financial Services Roundtable, here to discuss perspectives on systemic risk, especially with regard to the insurance industry, and, I may add, another former Member whom we welcome back.

Steve?

STATEMENT OF THE HONORABLE STEVE BARTLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, there is no end to the theories and proposals as to exactly how to start the economic recovery, but the fact is that America's economic recovery will start here with the financial services industry and in some ways, it starts today with this committee.

The recovery starts with every new loan, with every new mortgage, with every mortgage modification, with every addition to a retirement portfolio. Most importantly, it starts today with a strong, stable financial services sector, and a coherent foundation of a consistent and coherent regulatory structure.

Our current regulatory non-systemic structure, Mr. Chairman, was created in 20 separate pieces of legislation beginning in 1913, including 1933, 1934, 1989, 1999, 2003, and so on, in a way that often added another agency, structure, or feature, often unrelated to the previous structure.

To say that the financial regulatory system is fragmented and uncoordinated would be an understatement. By 2008, the weight and inconsistency of the patchwork system could bear it no longer.

On that note, The Financial Services Roundtable recommends that the Federal Reserve be created as a systemic risk regulator, but that would not be a super regulator or a new regulator or a regulator of individual institutions, and that it not be merely bolted onto the existing chassis as has happened so often in the past, but rather to be integrated into the system.

Webster's defines "systemic" as "related to a system," and that should be the test for this committee.

The Roundtable's proposed systemic restructuring includes the following:

First, by statute, expand the membership of the Executive Order Agency called the President's Working Group, which has the right idea but no authority, and rename it the "Financial Markets Coordinating Council." The Council should serve as a forum to coordinate national and State financial regulatory policies.

Second, the Federal Reserve be designated by statute as a market stability regulator with NIFO, what it is called in corporate board governance work, NIFO, or "nose in, fingers out" authority.

The Fed would be authorized to act only through Federal prudential supervisors and not unilaterally. The Fed would be entitled to receive information from those primary regulators and act jointly through them when sanctions are required.

The definition of "systemic risk" should not be size based and thus, avoiding the too big to fail syndrome. Rather, systemic risk would be any risk to the broader system that can arise from the collective actions of hundreds or from significant actions of a few.

For example, recent example, a combination of bad underwriting of mortgages, mortgage insurance without proper reserves or oversight, securitizations based on credit ratings alone, little due diligence for mortgage backed securities pools, and off balance sheet vehicles combined collectively or systemically to create the systemic risk that we are now suffering from. That was across several, perhaps hundreds of regulatory agencies.

The Fed would not be a super regulator but would work with and through other regulators. The only exception would be in the event of a well-defined emergency.

That leads to a related point. A market stability regulator does indicate the need for a national insurance regulator. The Fed should work through a national insurance supervisor, not in a vacuum.

A market stability regulator to reduce risk creates the additional need for a national insurance regulator to gather information and to act upon risky market activities in the Federal space in a timely and uniform manner.

The third part of this is to consolidate existing Federal prudential supervisors such as the OCC and the OTS into a single national financial institutions' regulator. The new agency would be a consolidated prudential and consumer protection agency for banking, securities, and insurance.

Fourth, create the National Capital Markets Agency through the mergers of the SEC and the CFTC, and use that, to the point that was made earlier, to supervise or oversee FASB jointly with the Federal Reserve.

Fifth, create the National Insurance and Resolution Authority for depository institutions from the basis of the foundation of the FDIC to create an uniform and coherent way of disposing of failed institutions.

Finally, we proposed that the current Federal Housing Finance Agency remain in place temporarily, pending a full review of the role and structure of the housing GSEs in the future but near term.

Mr. Chairman, thank you for the opportunity to discuss this overwhelming need for a market stability regulator as a necessary first step in a broader reform of our financial regulatory structure.

[The prepared statement of Mr. Bartlett can be found on page 73 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Bartlett.

Next, we will hear from Dr. Therese Vaughan, chief executive officer of the National Association of Insurance Commissioners.

Dr. Vaughan?

STATEMENT OF THERESE M. VAUGHAN, Ph.D., CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

Ms. VAUGHAN. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, thank you for inviting me to testify before the subcommittee on systemic risk.

My name is Therese Vaughan. I am the chief executive officer of the National Association of Insurance Commissioners or NAIC.

Prior to joining the NAIC, I was a professor of insurance and actuarial science at Drake University, where I focused on the management and regulation of financial institutions. From 1994 to 2004, I was the insurance commissioner in the State of Iowa, and I was the NAIC president in 2002.

I am pleased to be here today to discuss the NAIC's activities in the area of financial stability regulation and to offer our assistance and expertise as the committee tackles the enormous challenge of developing legislative solutions to the current financial crisis.

The NAIC is a full partner with Congress and the Administration in seeking ways to improve the financial regulatory system and promoting financial stability.

The State-based insurance regulatory system is one of critical checks and balances. We have a long history of consumer protections, solvency, oversight, and market stability, so any system of financial stability regulation can and must build on this proven regime.

While the current financial crisis illuminates the need for review of regulatory oversight, consumer protections and prudent solvency oversight must not be compromised in the effort to improve or enhance financial stability.

In our view, an entity poses a systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties such that extraordinary is necessary to mitigate it.

The nature of the insurance market and its regulatory structure makes the possibility of systemic risk originating in this industry less than in other financial sectors. The insurance industry is more likely the recipient of systemic risk from other economic agents rather than the driving force that creates systemic risk.

Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant.

If the largest auto insurer in the United States were to fail, its policyholders would be quickly absorbed by other insurers, and backed up further by the State guaranty fund system. This would not pose systemic risk as the impact is isolated, does not ripple to other financial sectors, and does not require extraordinary intervention to mitigate.

Risks in insurance are different from bank risks for three reasons. First, insurers tend to be less leveraged than banks. Second, insurers tend to have liabilities that are different from those of banks, more independent of economic cycles. Third, insurers tend

to have a longer time horizon. They typically do not have to sell assets on a regular basis to meet short-term demands.

An insurance business having special interconnections to capital markets may be capable of generating systemic risk, however, but financial and mortgage guarantee lines have been stressed because of their coverage of mortgage related securities, and as has been well-documented, large, complex financial institutions with insurance operations, like AIG, have produced systemic risks within the economy.

The insurance businesses in these holding companies have thus far been adequately protected by State insurance regulators. 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 should not be misconstrued, however, as simple acquiescence on our part to preemption.

Recognizing the critical need for action in this area, the NAIC has developed a series of principles for systemic risk regulation as it relates to insurance, which we believe must be incorporated into any comprehensive systemic risk system. Our principles recognize that greater collaboration among financial services regulators is needed, preserving the principle of functional regulation.

Any framework established to regulate financial stability must integrate but not displace the successful State-based system of insurance regulation. A Federal financial stability regulatory scheme must provide for sharing of information and formal collaboration among all financial regulators.

In consultation with functional regulators, any financial stability regulator should develop best practices for systemic risk management. Preemption of functional regulatory authority, if ever appropriate or necessary, should be limited to extraordinary circumstances that present a material risk to the continued solvency of the holding company or threaten the stability of the financial system.

For more than 150 years, State insurance regulators, working together with State legislators, have continued to improve, enhance, and modernize State-based insurance regulation for the benefit of consumers and industry alike.

We want to bring the best regulatory minds to bear on the challenges ahead and to serve as your resource as you navigate and analyze the current financial landscape.

I thank you for the opportunity to testify, and I would be happy to answer any questions.

[The prepared statement of Dr. Vaughan can be found on page 147 of the appendix.]

Chairman KANJORSKI. Thank you very much, Dr. Vaughan.

Next, we will hear from Mr. Robert A. DiMuccio, president and chief executive officer of Amica Mutual Group, on behalf of the Property Casualty Insurers Association of America.

Mr. DiMuccio?

STATEMENT OF ROBERT A. DiMUCCIO, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMICA MUTUAL GROUP, ON BEHALF OF THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA (PCI)

Mr. DIMUCCIO. Thank you, Mr. Chairman. I thank you and the members of the subcommittee for this opportunity to present the PCI's solutions for addressing our systemic risk crisis, and thank you for your leadership and that of your colleagues.

I am appearing on behalf of the PCI, the leading property casualty insurance trade association, representing more than 1,000 insurers of different lines and sizes.

I will address three points: One, the definition of "systemic risk;" two, that systemic risk legislation should be the critical first priority addressed to prevent another economic crisis from occurring; and three, how a systemic risk overseer would function.

PCI has defined "systemic risk" of a financial institution as "the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme Federal intervention would be required to ameliorate the effects," or simply stated, if the government has to step in to bail out a company to protect the larger economy, that is a systemic risk.

Traditional antitrust analysis focuses on too big to fail. Recent government intervention decisions have shifted toward too interconnected to fail, which is measured by the degree a company's activities are leveraged throughout the economy such that its impairment would cause additional failures, and the extent to which its failure risk is correlated with other systemic downturns.

For example, even a large auto insurer failure would not create a ripple effect of company failures. Its market share would be quickly absorbed by competitors. Conversely, some small credit default providers have highly leveraged counterparties, with recessions increasing default rates and provider impairment exacerbating the recession.

My written testimony lists the systemic risk characteristics of the different lines of property and casualty insurance, and a similar analysis could be applied to other financial products.

To address the current economic crisis, restore investor confidence, and prevent another economic disaster from occurring, a systemic risk overseer should be created.

The Federal Reserve Board should serve as the systemic risk overseer as it has the appropriate mission and expertise. However, the Federal Reserve Board's systemic risk oversight should be completely separate from other bank holding company oversight powers.

Jurisdiction would include any institution engaged in financial activities that in aggregate present a significant systemic risk. Also included would be any institution engaged in financial activities that chooses to submit to Federal systemic risk oversight such as for international equivalency treatment.

Systemic risk oversight power should be flexible and include the authority to require the following: appropriate transparency and disclosure to overseers for all entities within the regulatory jurisdiction; escalating information sharing with other U.S. and international overseers as a company's systemically risky activities in-

crease; and risk management for specific entities whose financial activities present a significant systemic risk.

However, systemic risk oversight powers would not include the following: solvency oversight for individual companies; business conduct oversight, such as licensing, market conduct, or product approval; duplicative disclosure or transparency information requirements; and general Federal compliance, such as privacy standards and other elements of bank holding company oversight.

Regarding oversight of risk management, oversight standards could consist of: overseeing holding company capital standards and group risk management; monitoring of affiliate transactions and significant off balance sheet obligations; collecting and sharing information related to group systemic risk and holding company solvency; requiring coordination of examination and visits regarding systemic risk; and eliminating duplicative oversight of holding companies.

PCI proposes increasing coordination to detect fraud and improve early risk monitoring through enactment of the Financial Services Antifraud Network that passed the House in 2001.

PCI also proposes requiring the Presidential Working Group on Financial Markets to implement limited information sharing coordination with international overseers regarding potential threats to cross border market stability.

These proposals are practical solutions to solving the systemic risk crisis that do not require a vast new bureaucracy. It does require filling regulatory gaps.

Three final points. To address congressional imperatives, larger regulatory reform and oversight could be analyzed in a second phase. We should not confuse solvency with systemic risk. Solvency regulation is best done by functional regulators to ensure that companies have sufficient capital to fulfill their promises.

Systemic risk regulation is macro oversight to prevent holding company failures from contaminating other markets in the larger economy. Merging solvency regulation into systemic risk oversight will simply create a regulator who is too big to fail.

PCI is committed to working with this committee in advancing appropriate solutions to stabilize the markets and prevent another economic crisis from occurring. Addressing systemic risk is the best action to do so, and we stand ready to assist in any way.

I thank the subcommittee for their time. We would be willing to answer any questions.

[The prepared statement of Mr. DiMuccio can be found on page 100 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. DiMuccio.

Now, we will hear from Mr. Timothy Ryan, Jr., president and chief executive officer of the Securities Industry and Financial Markets Association.

Mr. Ryan?

STATEMENT OF T. TIMOTHY RYAN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. RYAN. Thank you, Mr. Chairman, and members of the subcommittee.

The purpose of my testimony will be to detail SIFMA's views on a financial markets stability regulator or systemic regulator, including the mission and the purpose of such a regulator, and to highlight certain powers and duties that you might want to consider providing to such a regulator.

Systemic risk has been at the heart of the current financial crisis. We at SIFMA have, through committees of our members and roundtable discussions with experts, devoted considerable time and resources of thinking about systemic risk and what can be done to identify it, minimize it, maintain financial stability, and resolve a financial crisis in the future. Through this process, we have identified a number of questions and tradeoffs that will confront policy makers in trying to mitigate systemic risk.

Although our members continue to consider this issue, there seems to be a consensus that we need a financial markets stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure.

At present, no single regulator or collection of coordinated regulators, has the authority or the resources to collect information system-wide or to use that information to take corrective action across all financial institutions and markets regardless of charter.

We believe that a single accountable financial markets stability regulator will improve upon the current system.

While our position on the mission of the financial markets stability regulator is still evolving, we currently believe that its mission should consist of mitigating systemic risk, maintaining financial stability, and addressing any financial crisis.

In my prepared remarks submitted to the subcommittee, I have provided an outline of certain powers and duties of the financial markets stability regulator might have, and some issues you might want to consider in determining the scope of those powers and duties.

I will briefly touch on those powers and duties, but note that my prepared remarks provide a very full discussion of these issues.

The financial markets stability regulator should have authority over all financial institutions and markets regardless of charter, functional regulator, or unregulated status.

In carrying out its duties, the financial markets stability regulator should coordinate with the relevant functional regulators as well as the PWG, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for significant risk in other countries.

It should have the authority to gather information from all financial institutions and markets, make uniform regulations related to systemic risk that are binding on all, and act as a lender of last resort to all.

It should probably have a more direct role in supervising systemically important financial groups, including the power to conduct examinations, take prompt corrective action, and appoint and act as the receiver or conservator of such systemically important groups. These more direct powers would end if a financial group were no longer systemically important.

There are a number of options of who might be the financial markets stability regulator. Whomever is selected, the financial

markets stability regulator should have the right balance between accountability to and independence from the political process.

It needs to have credibility in the markets and with regulators in other countries. It should have the tools necessary to identify systemic risk, take prompt action to prevent the financial crisis, and to resolve a financial crisis if it occurs.

To be truly effective, the financial markets stability regulator would need to have the power to act as the lender of last resort or to provide emergency financial assistance to the markets, and have prompt corrective action and resolution powers over failed or failing financial institutions that are systemically important.

I stand ready to answer any of your questions, Mr. Chairman, and members of the subcommittee. Thank you.

[The prepared statement of Mr. Ryan can be found on page 127 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Ryan.

I thank the panel for their testimony. I am sure we all have some interesting questions. Let me start off with my questioning period.

The thing that sort of disturbs me is what my ranking member referred to in his opening remarks, and that is we have to get this one right. We cannot just hurry to expeditiously conclude something or pass something that appears to be a fix when in fact it does not really accomplish something of a significant nature.

The thing that disturbs me is trying to get my arms around the idea of just what is a "systemic risk." We have all talked about it, I can assure you, and we have heard you.

I think when the question came up in 1964, Justice Potter Stewart, in trying to explain what was "obscene," he said the following, "I shall not today attempt further to define the kinds of materials I understand to be embraced, but I know it when I see it."

I think probably with systemic risk, after the fact, we seem to all know it when we see it, but before it arrives, we have no idea. If you make the proper conclusions, we would not be in the crisis we are in today, if people could have rapidly seen systemic risk would have occurred. We certainly have enough regulators who had eyes on the situation. They just were not analyzing or seeing the situation.

I, myself, think we have in the past constructed some interesting areas, some of which now have been passed over, but the prior practice of the Justice Department to honestly decide whether or not there were antitrust violations in reviewing mergers and consolidations.

With that in mind, it very often accomplished proactively responding to something before it happened, before it caused the occasion to cause something, monopolistic or otherwise, to occur in the system.

That is what we are attempting to do. When I think of it, in most instances in our government at least, we regulate entities. We do not regulate conclusions or finalities that occur.

When you think of it, almost anything could be a systemic risk. I was just talking to my staff and I said if you really think about it, a bad virus could be a systemic risk. Obviously, we are not going to try to regulate viruses so they do not cause systemic risk.

On the other hand, I see a big challenge ahead of us. That is why I agree with the ranking member. You know, we are treading very closely to government authority to encompass regulation of everything, under the excuse of well, it may grow into systemic risk, therefore, we have the right to inquire into it and possibly be an active Congress, we have the right to limit or control that action.

That seems to be an unusually extended role of government, and we have to be very careful we do not carte blanche offer that.

On the other hand, if we do not do something that is severe, we are going to run into the same problem we are in now, in terms of allowing things to grow.

I just point out to the panel, we had the automobile industry here several weeks ago. Their argument to a large extent was they constituted a systemic risk in that if the U.S. Government allowed any one of the three American auto companies to fail because of their intertwined nature of having similar dealers and similar suppliers, those suppliers or dealerships would fail, and therefore, it would fail for all three of the auto companies, not just for the one that had to go into bankruptcy, and that would constitute a systemic risk for the auto industry.

It makes sense. Could we have stopped that from happening? Would we have anticipated that? Is there some magnificent character out there who has the brain power to anticipate all those realities?

I am not even certain in the auto industry that it was controlled by a thinking power, I think it just occurred.

Is that what we are talking about with systemic risk, and now adding on this feature of going to a global economy. It is a frightful thing. I think you have a good idea there, Scott. We have to take our time. We have to make sure we get this right.

Could some of the members of the panel give me an idea, do you see a very grave difficulty in defining what a "systemic risk" is and what part of that risk we really want to pay attention to in the nature of creating some laws?

Mr. Bartlett?

Mr. BARTLETT. Mr. Chairman, I do not think it will be difficult. It will require some thought by the committee, as you have, and by others. I think it is not difficult so long as the committee is looking for a systemic pattern and then the regulation is still by the principal supervisors, by the primary prudential supervisors at the national level.

I heard the consistency on the panel that there is no call here for a new regulator or super regulator to take the place, but rather someone to connect the dots.

A clear example, there were hundreds of regulators regulating thousands of regulated banks and tens of thousands of non-regulated mortgage originators, and those regulators collectively and individually concluded that those things that were called "subprime mortgages" were unsafe, unsound, and bad underwriting.

But they had no connection like upstream to Wall Street to say by the way, so the regulators said you cannot own them, so they did not own them. They sold them. There was no connection to the rest of the system to say that somebody down here has concluded they were unsafe and unsound.

It is that connecting the dots' system that we are calling for, not a new regulator.

Chairman KANJORSKI. Mr. Bartlett, to connect those dots, would that not encompass authority for the existing various regulators that we have to share information and confidential information with one another, and is that not sort of dangerous? Is that not what we would worry about?

Mr. BARTLETT. Mr. Chairman, it is not dangerous. It is dangerous not to. We have discovered that. It does require legislation. Let me say that crystal clear. This cannot just happen because the statutory authority is not there, but it requires the authority of the Federal Reserve and the prudential supervisors to collaborate and share information with one another.

Chairman KANJORSKI. You would be perfectly agreeable to allowing a set of regulators, if we ever get around to regulating hedge funds—I am going to pick on Mr. Baker for a second—that the information they would obtain from the various hedge funds from around the country as to what their investment policy was, that should be disclosed across the regulatory network?

Mr. BARTLETT. No, sir. Disclosed to the Federal Reserve or to the market stability regulator because it is a systemic regulation function.

I think you could make other decisions on disclosure and non-disclosure, but the Fed needs the information to know what is going on.

The first call on Bear Stearns did not come from the SEC and it did not come from Bear Stearns. It came from Treasury, who did not have a regulatory role. They called the Fed as the systemic regulator, even though there was no statutory mandate for the Fed to be a systemic regulator, but the Fed was all they had. It was outside the system, if you will.

Chairman KANJORSKI. You are really talking there about the diagnostician, after a set of facts and circumstances occurred, somebody to blow a whistle, to connect the dots and blow a whistle.

Are we not really talking about someone doing an analysis before the decisions are made, to make the review, so we are one step ahead of where it is easier to define what we are doing?

Mr. BARTLETT. That is precisely the point. How would Bear Stearns have been different had the Fed been authorized to conduct some kind of systemic risk analysis a year or 2 years earlier? Would it have prevented the crisis? I do not know.

The outcome would have been different, and I think better. The first call that there was a systemic problem came after the horses were out of the barn and running around in the pasture.

Ms. VAUGHAN. Mr. Chairman, may I speak to this, please?

Chairman KANJORSKI. Yes, I am going to let you speak, but I am already over my time. Go ahead, Doctor.

Ms. VAUGHAN. Thank you. I used to teach a class at Drake, I mentioned when I started, on the regulation of financial institutions. It was a graduate class.

We would spend some time talking about systemic risk. I find the evolution of this discussion very interesting because if you look at kind of the way systemic risk was thought about around the

time of the savings and loan crisis, way back when, that was very bank centric.

It was because the banks are connected to the payment system, because of the way banks extend credit, that a contagion within the banking system creates systemic risk.

When Long Term Capital Management happened, we began to think about hedge funds and the possibility for them having systemic risk.

I think what we have learned with AIG is there is an issue about activities that create interconnectedness, that we have these credit default swaps that it would have been nice if someone had been looking at this and saying, boy, look at the amount of credit default swaps that the banks have, you know, going in both directions, and where is this stuff going, and who is watching the way this is playing out through the marketplace, and making a decision as to whether these should be regulated.

It strikes me that going back to your suggestion that we are talking about someone who is looking at the marketplace and trying to identify problems before they happen, I think that is one of the things that is very consistent with what the regulators have been saying. It is not the only model but that is consistent with what we have been saying.

We have seen because of AIG—we have a better recognition of how systemic risk impacts our ability to protect our policyholders.

We think it would be helpful to have some mechanism that is monitoring systemic risk within the industry so that we can work with them to make sure that it is not interfering with our ability to do what we do.

Chairman KANJORSKI. Thank you, Dr. Vaughan.

Mr. Garrett?

Mr. GARRETT. Thank you, all, and thank you, Mr. Chairman. I appreciate your comments with regard to the auto industry and as to what the systemic risk is there.

I am thinking at the same time about the technology industry as well, the electronic industry, and all the other ones outside the financial sector that we would have to begin to throw into this mix. Any one of these, if they ever were to fail, could have a systemic problem.

It was prior to everything blowing up in August of last year when Chairman Bernanke said with regard to setting up a regulator, “Some caution is in order. However, as this more comprehensive approach,” which has basically been described by some of you, “would be technically demanding.”

He went on to say, “We should not underestimate the technical and information requirements of conducting such exercises effectively.”

I think he hit it right on the point. How do you do that? When you look to see what the track record has been already for our regulators, who would you suggest that we take to put into this sort of regulator or just a council or what have you?

Should we take it from the SEC, in light of their experience with the Madoff situation and some of these other situations that they have been involved in? Should we take it from the OTS, with respect to what they have done with the banks and AIG subs? Should

we take it from the Federal Reserve, with their experience with setting monetary policy, and their experience with the national banks as well?

Should those be the people whom we are drawing from in order to be able to sit back and get a more comprehensive approach?

On the Federal Reserve, just remember, and I appreciate your comments, Mr. Bartlett, about them looking at one area, but was it not the Boston Federal Reserve back in the early 1990's who said, "The banks could consider such things as welfare payments and unemployment insurance when they decided whether or not they should be giving bank loans to individuals."

Should it be those same individuals that we call upon to be our super regulator in the future, to be able to make these decisions?

If they were not able to do it for the narrow area that we have charged them with, that they had the authority to do, who on the panel thinks we should be drawing from them to be making the decisions for us on an overarching responsibility?

[show of hands]

Mr. GARRETT. You do. Who do you think?

Mr. BARTLETT. Mr. Garrett, I understand your question. The Federal Reserve gathers information and it has for a decade on the production and distribution of corrugated box containers to help them with information about the economy and what is happening in the economy. They are not permitted to gather information about the reserves against the hundreds of billions of dollars of CDS because that is excluded to them.

The Federal Reserve was given the responsibility by regulation, rightly or wrongly, to regulate as a small regulator, HOEPA, and they were busy doing that and regulating it as a consumer protection issue, when the entire system of subprime mortgages collapsed, because they were not authorized to look at that system, but they could look at HOEPA and consumer protection.

We are not, and I do not believe anyone is advocating a super regulator. Rather, we are advocating someone to connect the dots.

Mr. GARRETT. I understand that. In your experience in Congress in the past, when is it ever the case where you have a regulator in place that does not try to grow in its extent of authority? Do they ever just sit and say, "This is our realm of responsibility here and we are not going to exert it more so."

Is that your experience?

Mr. BARTLETT. That is why God made oversight committees.

Mr. GARRETT. Ms. Williams, I have a question. I just need a better picture on this. It is on one of the points I just raised, and I appreciate your testimony.

When OTS is out there, and you used the expression "making their examinations," and you said they had a problem—not a problem—they had the aspect that they were not able to get into the hedge funds and they were not able to have information more particularly with regard to the AIG situation, as far as their offline business and what have you. Can you in a sentence or two elaborate on that? What should have been their authority there? Did they not have the ability to at least look at that and say here is an area where we know something is going on, but we do not have

the authority to look at it, we want to investigate it more, or they just simply did not know that at all?

Ms. WILLIAMS. This is the challenge with holding company oversight, because they have the authority to look at the holding company. In this case, it is a thrift holding company that we were talking about in the case of AIG.

They could look at the holding company and any threats to the holding company, but it creates an issue of they can go in if they believe there is a threat to the holding company, but if you are not looking at all of the subsidiaries within the holding company, how are you going to identify the threat?

Mr. GARRETT. Could they look at all the subsidiaries?

Ms. WILLIAMS. To the extent it poses a threat to the holding company, there are specific cases that they could go in and look at it.

My understanding is that is what they did once the internal auditor raised concerns about risk management of AIG Financial Products. They went in once those concerns were raised because that raised an issue for the holding company.

Mr. GARRETT. I appreciate it. I might have additional questions later. Thank you.

Chairman KANJORSKI. Thank you, Mr. Garrett.

Now, we will have the gentleman from New York, Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Before I ask my questions, I just want to respond to some of the things some of my colleagues put forth as statements or theories or postulates, in saying that the problem that we face really is there is too much regulation. Some of them said it in different ways.

I would just like to analogize that if we had a super highway system for use of mixed vehicles, different kinds, cars, trucks, etc., and there were speed regulations, a lot of speed regulations, but nobody was enforcing the speed regulations because the State Police just neglected to patrol or fine anybody who was speeding. Suddenly, systemically, the entire highway system is filled with crashes and carnage. Is the problem: (a) there are speed requirements; (b) the police are not patrolling; (c) the people trying to figure it out are from outer space; or free feel to add, (d) all of the above.

I think we are getting into an area here where we are talking about philosophy versus fact. That is my observation.

A question: Mark-to-market, where there is no market, and arguably sometimes there is no market, how do you require companies to mark down the value of their company setting off all kinds of crises in the economy and expect there not to be problems?

Anybody?

Mr. BAKER. I will take a pass at it, Mr. Ackerman. I come at it from the experience of the savings and loan debacle, the creation of the RTC and the resolution of property owned by the U.S. taxpayers as a result of closure of significant numbers of institutions.

Real property was sold for about 20 cents on the dollar, notes and securities for 12 and 13 cents. It was a contained geographic downturn in Louisiana and Texas, and the residual economic effects of that distress sale in that environment caused a decade long downturn in those regional economies.

To a great extent, it was brought on by in essence a mark-to-market philosophy, let's get the stuff out the door at an emergency price.

At the same time, I would be quick to add, however, efficient market function only comes with accurate disclosure of values. There will be a very difficult decision to be made by someone in an administrative agency as to how to proceed with government-owned resources in the current environment.

If a bank is to liquidate an asset and it is below whatever value was on the books, they will have to raise capital in a very tough marketplace to offset that material loss.

If they expect to have it sold and—

Mr. ACKERMAN. Which is why the banks are holding onto all that money we gave them.

Mr. BAKER. To a great extent, that is a contributing factor. There would be others better able to respond to that observation than I, but I would also suggest that in order to sell that asset in a difficult market at above book value, it is very problematic for the acquirer because he knows he is not paying market value.

This is going to be a continued and long term problem of resolution. I cannot dispute the fact your observations have merit, although I would say to act without true valuations and allowing parties to come to a negotiated price on any asset disposition, we could not expect that to be the end conclusion either.

Mr. ACKERMAN. Dr. Vaughan?

Ms. VAUGHAN. If I can just speak to this from an insurance perspective a little bit, I have found myself for the last year or so rethinking myself around this subject of mark-to-market. I would say that a couple of years ago, I tended to be thinking that movement, that direction, was a good thing.

When you have a world like we are in today where the liquidity situation is so difficult, and we know that the market values of these assets are depressed for two reasons, one is there are real credit losses coming down the road, but second, there is a depression in market values simply because of the liquidity of the market.

We do not know what the mix of those two is, but to force companies that are going to hold these assets long term that do not have to sell in this illiquid market, to force them to write down to a value that reflects current illiquidity, I am wondering, again, just sort of thinking through it, whether it is sending the wrong signal to the marketplace, and particularly, I think about consumers, is it sending the wrong signal to consumers about the capital that is in these companies and how strong these companies are.

One of my colleagues likes to say the greatest risk we have right now is a crisis of confidence. It is that people are scared. We know our policyholders are scared.

That is one of the reasons that the insurance regulators have really been struggling with what kind of reporting requirements should we be having in this environment right now where the markets are not anything that we have ever lived with before, not in my lifetime.

Mr. ACKERMAN. We cannot address or we certainly cannot legislate the confidence in the market. We are going to do a lot of cheerleading to do that.

In addition to that, if I may for a couple of seconds, Mr. Chairman, just say among the risk to the system, I would think, you have loopholes, which we can do something about, and greed, which we can do nothing about.

Within greed, there are things that we can do to eliminate the loopholes, which include things like reinstating the uptick rule, where people, for reasons of their own, beat down the value of a company to take advantage of the system to make lots of money while distorting the real value that there might be in a company or in the marketplace.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Ackerman. Now, we will hear from the ranking member of the full committee, Mr. Bachus.

Mr. BACHUS. First of all, let me commend Director Williams for her report. I would mention to all of the committee members that Mr. Kanjorski and I requested a GAO study on credit derivatives, and more specifically, CDS. This report was actually filed today. That is what she was giving testimony about. It is something I would direct all our attention to.

Let me make one comment and then I am going to ask questions. Mr. Royce and Mr. Bartlett, you both called for a Federal regulator for insurance.

I think at least implied is that the regulation in insurance had failed, but I really do not see any evidence of that. Our national insurance markets are the strongest component of our financial services market now.

If they are having problems, and they are, it is because of the economy, failures in the banking system and other parts of our financial system.

In fact, one member specifically said the failure of insurance regulators to do anything on AIG. Well, that was actually—that was an alternative investment vehicle that operated, really the only regulation you could say of that was in London, a 300-employee group, AIG Financial Products. There was no insurance regulation of it because it was not an insurance business. You could say CDS' are.

The only Federal regulator was the regulator for a holding company, and that was a bank regulator. It was not an insurance regulator.

I am not sure that other than New York with the bond insurers that you could—I could find literally thousands of instances where we had failures in our bank regulators, but I find very few in insurance.

I am not sure that is a very fair argument to say that what has happened—in fact, I think what has happened has shown that probably our State insurance regulators have done a better job than most everybody else.

Now, we are asking the Fed—Mr. Bartlett, I think you will agree that the President's Working Group in 1988 and then this Congress in 1991 actually directed the Treasury and the Fed to look at systemic risk and see what sort of powers they ought to have to deal with it. Now, we are going to appoint the Fed.

I would associate myself with Mr. Castle's remarks, I think most closely, and Mr. Price's, as to how we address this systemic regulator.

The Congress said that in 1991, a year before I got here.

Having said that, are any of you troubled by giving the Fed so much power with their monetary policy right now? If they are regulating somebody but they are also given the right, as some of you said in your opening statements, to bail them out—I will use those words, you did not use those words, but some of you did use "rescue"—they have been rescuing one institution after another.

Are you troubled by that? Dr. Vaughan, I am going to ask Mr. Ryan. I know how you feel. Mr. Ryan?

Mr. RYAN. I would like to first of all make a general comment and maybe I am dirtied up because I was the Director of the OTS, first Director of OTS.

As a former Federal bank regulator, I can tell you—this is true basically of all former bank regulators. You can take them from all over the globe.

Right now, as the chairman said, we know what systemic risk is and we are living through it right now as we see it.

We know there is no Federal regulator fully equipped with the tools and the information to help us avoid this type of problem in the future. What we are looking for here is we are looking for someone who has the tools, has the information, has the power to hopefully to look a little bit over the horizon. Bank regulators are rear view mirror type people. It is all looking back.

That is why we call it not systemic risk regulator, we call it a financial markets stability regulator. That is what we want this entity to do.

We need someone to do that job.

Mr. BACHUS. I guess what I am asking, Mr. Ryan, is should it be the Fed to do all of that?

Mr. RYAN. We have not really decided that, Mr. Bachus. That is why we kind of dodge that. I think having all these hearings—every time you have a hearing, I will come, to any one of these committees, I will come. We need input, and you all need to make a decision in a timely fashion, and to me that is before the end of this year.

We need a restoration of confidence and a component piece of the restoration is having a regulator who can do this job.

Mr. BACHUS. Let me go back and say this: If you look at most of the institutions that failed, they were not regulated at all. Option One. They were non-banking affiliates, but they were not insurance affiliates. They really were non-regulated institutions. Even GE. They had a non-regulated WMC.

You can just go down the line and probably 70 percent of the losses were in companies that were not regulated by bank regulators or insurance regulators.

Those are the gaps.

Mr. RYAN. We have talked about the shadow banking system and basically unregulated. We need someone who can look over the horizon, not limited by charter, and can pull the information together, and then take action, and the action, as I said in my testimony,

goes from the more simplistic setting standards to also the resolution.

Mr. BACHUS. Let me say this. Dr. Vaughan, I know how you feel. I think I was favorable to your point of view.

What about as opposed to rescuing these institutions, what about two options? One would be an orderly liquidation. Two would be not allowing them to become a systemic risk. Are those not two better options than injecting taxpayer dollars or guarantees into the system?

Mr. BARTLETT. Mr. Bachus, that is what we are proposing. The Fed has a lot of power but they do not have the power to prevent. They are called upon, whether they have the statutory power or not, they are called upon to resolve with a lot of money what they did not have the power to prevent.

Mr. BACHUS. Could Dr. Vaughan just briefly respond? You wanted to answer the first one. I am sorry.

Ms. VAUGHAN. The first one, good. Not to the question about whether we should put taxpayer money into—

Mr. BACHUS. Whichever one.

Ms. VAUGHAN. I would rather do the first one. Thanks.

I appreciate that because it gives me a little bit of an opportunity to make a couple of points I wanted to make.

First of all, the discussion about creating a Federal regulator, a couple of years ago when I was an insurance commissioner, it was all about efficiency, the inefficiency of the State system.

I find it interesting that suddenly this has morphed into we need a Federal regulator so that we have effective insurance regulation, when as you pointed out, there is no evidence that the system has not been effective. In fact, we do not have any policyholders who have lost any money yet.

The credit default swap problem was not in the insurance company because we would not let them do it in the insurance company.

We were regulating that company to protect policyholders. Unfortunately, we are getting hit by things outside the system.

The point I wanted to make is this idea of creating one "uber regulator." We are absolutely not in favor of that, are absolutely opposed to that. We do not want a system that preempts our ability to protect our policyholders, and we think that a system of checks and balances is a very good thing, and that having a lot of eyes on the problem is a very good thing.

The story that I have told many people in the last couple of weeks is that what has happened in the world over the last couple of years has crystallized for me an appreciation of the fact that regulators make mistakes.

I think that is the most important lesson we can draw from this. Regulators will make mistakes. A regulatory system will fail. When you build a regulatory system, you should build that to withstand those kinds of failures.

Bernie Madoff was a big failure. I am absolutely not pointing fingers at the SEC for that failure because I will tell you, the insurance regulators have had failures also. We have been the recipient of several GAO studies, thank you very much, that pointed to problems in our system, and that we then went and fixed.

There was a man named Martin Frankel who, while I was an insurance commissioner, took control of seven insurance companies. He was a fraudster. He began bleeding the insurance companies, stealing money from them.

He got through several insurance commissioners and when he got to the State of Mississippi, which was maybe the 4th State he got to, Commissioner George Dale of Mississippi looked at it and said, this does not look right, and he brought him down. What that illustrates to me is the value of having multiple eyes on the problem. That is what we have in the State system, multiple eyes on the problem.

We do not want our eyes taken away when you build this system. If you want to add another set of eyes, that is great, but do not take our eyes away and our ability to protect our policyholders.

Mr. BACHUS. Thank you.

Chairman KANJORSKI. Thank you very much, Doctor.

As I understand it, we have three votes. We have at least 5 minutes in which Mr. Sherman get his examination in before we recess.

Mr. SHERMAN. Thank you. I will start with kind of a rhetorical question that you should respond to for the record.

A number of those on the other side of the aisle have said, wait a minute, you get this systemic risk regulator and those big enough to be subject to it get this implication of Federal stamp of approval, maybe they are viewed as too big to fail, which means they will get bailed out, and this gives them an advantage in the marketplace, lower interest rates, and worse of all, if they do need to get bailed out and there is an implication that we are going to bail them out, we might bail them out.

One issue is instead of having too big to fail, regulating it in a way that has all the problems that are pointed out by Republican colleagues, we could prohibit too big to fail. Say any financial institution over a quarter of a trillion dollars in size, that is as big as you get. It is time to give your shareholders the joy of a spin off. We do not have to put ourselves in a position where we have to endure too big to fail or we have to insure too big to fail.

I would now like to shift to AIG, which recently transferred, I believe, $20 billion of our money to their counterparties as cash collateral.

I am going to ask first Mr. Bartlett, what portion of those counterparties are likely to be foreign entities? Do you have an understanding of the customers that AIG would have had for its credit default and similar products? Should I as a taxpayer assume that a substantial portion of that is going to foreign entities?

Mr. BARTLETT. I have no idea. It is a global market.

Mr. SHERMAN. It is a global market in which the rest of the world is a very substantial part.

Mr. BARTLETT. And we are a substantial part of the rest of the world also.

Mr. SHERMAN. We would expect that if you are sending $20 billion to AIG counterparties, you are sending a lot of it overseas.

Dr. Vaughan, I realize that the AIG entity involved is the one non-insurance AIG entity. Do you have any understanding as to what portion of that money would be going overseas?

Ms. VAUGHAN. I really do not.

Mr. SHERMAN. Dr. Vaughan, if I went to an investment house and I said, your building may burn down and that could be a problem for you, and I will offer you insurance against that risk, you would probably say that I would have to get registered with my State insurance and have reserves and really be an insurance company. But if I go to them and say, your portfolio may burn down, apparently, I do not need an insurance charter.

What is the definition of "insurance" under the various State laws that says that insuring a portfolio is not insurance subject to State regulation, when clearly most investment houses were more worried about their portfolios burning down than their buildings burning down?

Ms. VAUGHAN. That is a very interesting question that you raise, and one that there is a fair amount of discussion going on about right now in regulatory circles.

At one point recently, the New York Superintendent had suggested that a credit default swap that was actually covering a portfolio, that was insuring a portfolio, would be treated as insurance.

Much of what is being transacted, however, are what you call "naked credit default swaps," where there is no underlying asset that is being "insured."

Mr. SHERMAN. Wait a minute. If I sell life insurance on somebody's husband, they have an insurable interest. That is called "insurance."

Ms. VAUGHAN. That is right.

Mr. SHERMAN. If I sell insurance in my State to somebody who does not have an insurable interest—

Ms. VAUGHAN. That is called "gambling."

Mr. SHERMAN. That is called "gambling," but it would be insurance. It would be the insurance regulator who would say no, I cannot do that. The life insurance companies in my State are in fact told what life insurance they can sell and who they can sell it to.

Ms. VAUGHAN. Right. Actually, the concept of insurable interest is a fundamental concept in insurance. In property and casualty insurance, in order to collect on a claim, you have to have insurable interest at the time of the loss.

In life insurance, in order to buy a policy, there has to be an insurable interest, and it is a little complicated how it can arise, but there has to be one at the time you buy the policy. That concept of insurable interest is fundamental to what we think of as insurance, and then the other part, of course, is risk transfer.

In the issue of credit default swaps, there has been some discussion, and I know they are frequently called insurance—

Mr. SHERMAN. They serve the role of insurance. They may not technically be insurance. As to who would regulate them, one argument would be well, it is insurance and we will have the State regulators insure.

The concern I would have is which State, and would there be a race to the bottom? What protects me as a Californian in the race to a bottom is even if an insurance company is created in the Cayman Islands or in some State that races to the bottom, my insurance regulator can protect me, and I am not going to move to an-

other State. I am not going to move to the Cayman Islands to get an insurance policy.

In contrast, these markets can be moved anywhere. Transactions can be anywhere.

I know you believe in State regulation of insurance for consumers, for those who are in a fixed place. I am not sure we could have the States regulate the insurance of financial interests and/or the gambling on financial interests.

Ms. VAUGHAN. Yes. I said there has been a lot of discussion about this in insurance regulatory circles. I would say there has not been a resolution of where the regulators are.

I share your concern that there are some differences between credit default swaps and other kinds of insurance that we are used to dealing with.

One of the major differences is that credit default swaps are so pervasive now with the banks, with the hedge funds, throughout the system. I think personally that this would be a challenge for the insurance regulators to say we are going to regulate that massive marketplace in addition to what we already do and by the way, do a very good job.

Chairman KANJORSKI. There are three votes, and we will be back in approximately 30 minutes. The subcommittee stands in recess.

[recess]

Chairman KANJORSKI. The subcommittee will come to order. I now recognize the gentleman from Delaware, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

I was a little surprised with what I thought was almost unanimity that we need some sort of a systemic risk regulator out there. I do not disagree with that. One of my concerns is exactly who should be doing this. Several of you mentioned the Federal Reserve.

Mr. Baker, my recollection of your testimony and I may have it wrong, is that you thought it should be an independent agency or somebody different than the Federal Reserve. I have some concerns about the Federal Reserve taking on much more at this point. That is why I asked the question.

Mr. BAKER. Congressman, we as an association have not taken a position on the specific location of the regulatory responsibility. I would quickly add that your concerns and echoed by others relative to the Fed being engaged in monetary policy activities and potentially taking on this role as well, it is a task of enormous responsibility, and significant new resources would have to be made available.

I do not know whether a different shop, a coordinating shop, some have suggested a coordination role, might be sufficient in order to perform the task.

We have focused more on the elements that should be identified and what should be done once those are found. The actual mechanics of who should do it is not a recommendation we have made.

Mr. CASTLE. Does anybody else have any concerns about the Fed doing it? A lot of you expressed the thought they should be able to do it.

Mr. BARTLETT. Mr. Castle, we addressed that issue and thought about it. We find the role of systemic risk regulator or market sta-

bility regulator, as I have described, to be very consistent with the Fed's role in terms of the economy and monetary policy.

It is their job to understand and to strengthen the economy, and that is really what this is all about. We find it to be very consistent.

Mr. CASTLE. Mr. DiMuccio?

Mr. DIMUCCIO. The PCI also feels that it was consistent with the role of the Federal Reserve Board, so we would in fact support that position.

Mr. CASTLE. Mr. Ryan?

Mr. RYAN. We have not decided, but I think the most important issue for us is that it be done in a timely fashion and that the regulator be fully equipped to handle the role which will be complicated and difficult, and trying to create some new agency will be difficult and will provide delays.

It is going to be a difficult choice for the committee and for Congress as to who should do this role.

Mr. CASTLE. Dr. Vaughan, I want to ask you a question, and it pertains to AIG. Of all the consternation from what has happened in the last several months, AIG is at the top. We have—I am going to say, "thrown money at them" with loans or whatever. It seems to repeat. They reported a $62 billion loss quarterly, in the last quarter of last year.

Part of what I hear is—I do not really know all this—this is just anecdotal to me to a degree, that they have a separate financial arm and that really caused a lot of the problems.

I listened to your testimony about being less leveraged and longer time payouts and things, and I guess that is basically correct for the insurance industry, but then you wonder how did AIG, which at its heart was an insurance operation, get into this whole separate financial arm and all the credit default swaps and all the other things that led to its financial demise, and the great taxpayer dollars that are going into it and the continuing losses.

Should we have some sort of separation of the insurance industry from even being able to get into things such as that? Is there some way this could have been prevented or we could prevent it in the future?

Ms. VAUGHAN. I think that is an excellent question. I guess I would answer it this way. I read something recently that Chairman Bernanke said, I think it was Chairman Bernanke, that AIG was basically a hedge fund on top of an insurance company.

The problem is that we did have this—I would say AIG was not an insurance company. It was a large complex financial institution, large globally complex financial institution.

We as insurance regulators have authority that is clearly laid out in McCarran-Ferguson to regulate insurance, so we were protecting those insurance entities.

As I have said already, the insurance companies still remain solvent. What we did was say that these insurance companies cannot do this credit default swap business or have limitations around what they could do, and constrained their ability.

There was nothing that then prevented this large complex financial institution from creating an arm that was unregulated to do that. That is where we come to the problem. A lot of what was

going on here was unregulated activities that then led to further issues.

My members are as interested in solving this as you are because we would like to find a structure where if you have a large complex financial institution, we can regulate our insurance companies in cooperation with other groups that are regulating other operations in that holding company, in a collaborative, working together kind of way.

Mr. CASTLE. My time is up but it seems to be an argument for a systemic risk regulator, somebody who can step in and take a look at what they are doing. I yield back, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Castle. The gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. This is a very timely and important hearing.

I would like to ask a series of questions, but let me try to start out with Ms. Williams with GAO. Could we talk for a moment about your report on credit default swaps?

It seems to me that in the process of dealing with this, they seem to have fallen into the crack. Could you give us an idea as to how do we best regulate these credit default swaps?

Ms. WILLIAMS. I think I would start with kind of focusing on how the product is defined and the definition for CDA was basically set up in the Commodities Futures Modernization Act. Rather than how it functions economically, the definition of the product lies in a statutory definition.

I think if you back away from that and look at this, it is an example of what happens when you focus on a product and regulating a product market versus institutions.

You had OTC derivative dealers who were selling CDS and depending on the type of entity that sold the product, that dictated the type of regulation and oversight it received.

If it is a bank dealer, then it was subject to some level of oversight by its bank supervisor, but if the dealer was affiliated with a conglomerate, AIG, for example, then it was not overseen.

The same would be the case if you had an affiliate that was associated with a broker-dealer, for example, so it illustrates the gaps that exist in the current structure and the inability to have a system-wide view of this particular product.

I think the focus has to be system-wide.

Mr. SCOTT. The best example of that would be AIG being under the risk regulator at the holding company level when underneath it in many of these sub-institutions, financial institutions underneath that, were not under risk regulation.

They did not look down that far?

Ms. WILLIAMS. Correct. With the holding company regulator, the holding company regulator has the ability to go into any part of that structure that has the potential to impact the holding company, but if you are not going in on a regular basis—if there is a concern, you can go in, but if you are not going into the subsidiaries on a regular basis, how do you then identify if a subsidiary is posing a threat to the holding company.

Mr. SCOTT. I see. Thank you, Ms. Williams.

Mr. Baker, good to have you here, my former colleague and good friend. While I have you here, Mr. Baker, I would like to get some clarification on your thoughts on hedge fund operators. Could I do that for a moment?

Mr. BAKER. Certainly.

Mr. SCOTT. Why should not the income from those hedge fund operators who use other folks' money to make money, why should not they be viewed and taxed as regular income as opposed to capital gains, when in fact, if I take my direct money, I should be valued on capital gains, but if I am making money from using somebody else's money, why should I not be evaluated on regular tax structure?

Mr. BAKER. Mr. Scott, the shortest and probably most responsive answer I can give would be when 5 of our largest firms appeared before Chairman Waxman in the last 2 months. They were specifically asked a question about tax increases and all, save one, I think, expressed the view that they would not be surprised to see some adjustment in the taxation system, but I think they made it pretty clear as well that they would hope that any taxable recommendation would be neutral between financial market participants so that the outcome of any tax proposal would not be prejudicial to the hedge fund industry but treated similarly as you were suggesting.

I would be happy to provide you with additional information and will do so following the hearing.

Mr. SCOTT. Do you see the need for any additional legislation along those lines for hedge fund operators or should we leave it alone?

Mr. BAKER. I am sorry. Could you be more specific? Regulation in the context of the funds and how they operate?

Mr. SCOTT. In how they report that income. I think that is the fundamental issue, how hedge funds' income is regulated and reported.

Mr. BAKER. If I can, let me provide, I think, the shism you are referring to. Any U.S.-generated income for a hedge fund manager is fully taxable under ordinary income standards.

Some of the issues have related to a nonprofit's ability or foreign investors to invest in a facility provided by a U.S.-based hedge fund offshore. If you did not have that offshore capability, those currently prohibited investors in U.S. transactions, we would lose that capital to other jurisdictions, London or wherever else they may choose to go to make those investments.

You have the UBIT issue for pensions and endowments that we would need to revisit.

You have touched on a pretty complicated set of relationships that I certainly want to be responsive and knowing your interest, I will get you something back that clearly outlines the concerns.

I do not think at the end of the day, Congress wants to see net revenues to the U.S. Government go down as a result of tax policy.

Mr. SCOTT. My final point is this, Mr. Chairman, if I may, there seems to be some confusion as to what is and who is and who is not a hedge fund operator. Is that true?

Mr. BAKER. Yes, sir. At this time, there are an estimated in excess of 15,000 companies that would call themselves hedge funds. The MFA represents about 1,800 of those associations.

There are many people who fly under—companies—who fly under the banner of hedge fund that may be long only shops or not utilizing hedge fund strategies in their investment practice.

There is a bit of lack of clarity in what constitutes a hedge fund in the current market.

Mr. SCOTT. Thank you, sir. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Scott. Next, we will have the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Earlier, Mr. Bachus alluded to this notion that the underwriting side of AIG overseen by the State insurance regulators was somehow walled off from the abstract securities lending division.

Unfortunately, news reports, such as the Wall Street Journal article that was dated October 10, 2008, which I would like to insert into the record, detail the inaccuracy of this perception.

The gentleman from Alabama and I have disagreed in terms of this issue of systemic risk regulation. For example, the need to have Fannie Mae and Freddie Mac under a regulator who could deleverage those institutions, for systemic risk.

There was an amendment I had that I brought to the Floor. The gentleman from Alabama opposed it. Mr. Baker supported it. It failed to pass. I think in retrospect, the fact that we did not give the Federal Government the right to regulate for systemic risk with respect to Fannie and Freddie was clearly a mistake. Now, we are looking at the situation with respect to AIG.

Let me just read from the article from the Wall Street Journal: "Securities lending has long been a reliable side business for life insurers, approved by state regulators. But Moody's warned in April about the risks that insurers were taking related to these programs.

"Hampton Finer, a deputy to New York State Insurance Superintendent Eric Dinallo, said policyholders in AIG's life-insurance subsidiaries weren't at risk due to the securities-lending program. But, he said, New York will review what types of assets insurers are allowed to invest securities-lending collateral in.

"Mr. Slape said his team is keeping a close watch on three AIG insurance units because of the securities-lending exposure. Ohio's Department of Insurance said it is investigating the securities-lending activities of at least one life insurer. Darrel Ng, a spokesman for the California Department of Insurance, said the state is 'looking at the securities-lending practices of those insurers domiciled in California,' along with AIG's."

The Wall Street Journal story is accompanied by a graph indicating the model AIG used to invest in subprime residential mortgage backed securities, which ultimately led to their demise.

The collapse of AIG was an unfortunate episode, but facts are stubborn things. As I laid out in my opening statement, the various State insurance regulators simply do not have the ability to oversee large, complex financial firms like AIG.

I would like to ask a quick question of Mr. Bartlett, and that goes to the issue on the ideal of insurance regulation as it relates

to systemic risk, financial regulatory restructuring efforts are going to be high on the list on the upcoming London Summit of the G–20, and as part of those talks, the issue of the U.S. 50 State insurance regulatory model is going to arise as other countries criticize what they see as the inefficiencies and anti-competitiveness of this system.

As a member of the Foreign Affairs Committee, I have often dealt with foreign regulators and parliamentary members, and I have heard firsthand the frustration many of them have with the piecemeal regulatory structure for insurance. All of Europe has one regulator; we have 50-plus regulators.

As other countries move forward, what might we learn from our foreign counterparts when it comes to insurance regulation and who is representing the interests of the U.S. Government on insurance in these ongoing discussions that we are having basically with our competitors overseas?

Mr. BARTLETT. Thank you, Congressman. I concur with your point. I would also hope that you would include into the record the underlying report from Brookings entitled, "Regulating Insurance After the Crisis" that was part of that.

Mr. ROYCE. Yes, I would like to ask the chairman to include the Brookings' report, "Business and Public Policy," and their initiative "Regulating Insurance After the Crisis" for the record.

Mr. BARTLETT. Mr. Royce, the fact is our European allies do believe that our 50 State regulation without the opportunity for a national charter is a significant trade barrier. We concur with that.

It is clearly a significant trade barrier. It is a trade barrier that the Europeans are rightfully angered about. It is also quite a high risk to our system and to the global system.

The fact is that AIG failed. It was not as if AIG is still walking around. It has cost the Federal taxpayers so far $145 billion and counting. It did fail. It failed because there was neither a national regulator of the company nor was there a systemic risk regulator involved. It failed, and it failed under the current system.

If you keep the current system, then there will be future failures that will be similar.

Mr. ROYCE. Thank you, Mr. Bartlett. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Royce.

Our next gentleman is Mr. Perlmutter for 5 minutes.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

I have not been able to sit through all of your testimony, but I appreciate everybody being here today.

We have now had, I think, about a year's worth of hearings, sort of dealing kind of around and about systemic failures, systemic regulation. I appreciate everybody really bringing their thoughts to the floor on this.

We have asked our taxpayers to carry a heavy burden to get us through this mess. Mr. Baker, it is good to see you. I wish you were still on this committee to help us with this chore.

Mr. Bartlett, I would like to start with you. I am concerned even if we have the most brilliant person at the top of the pyramid here trying to figure out what is the next thing that could cause trouble to our system, because our system is so connected.

Should we not be putting some brakes and barriers back into the system? That may take away from the efficiency of the system to some degree, you cannot make the last buck but the bottom does not fall out either.

Just throwing a Glass-Steagel kind of approach where you try to maintain some degree of separation between insurance and banking and the stock market, question number one.

Question number two, I think you said size should not be a factor, but I do think size does count in dealing with this kind of problem.

I am just sort of throwing that open-ended question to you and to the other members of the panel.

Mr. BARTLETT. First, Congressman, size does matter but what we are saying is size should not be the criteria that decides whether it is systemic. Systemic is deciding whether it is systemic or not, not how large the individual company is.

Secondly, again, our proposal is not to create someone at the top of the pyramid, but rather to mandate or authorize someone to look at the systemic risk or the gap in coverage, but look at that not through the eyes of a new regulator or an uber regulator, but through the eyes of the prudential supervisors.

Just as the Fed does collect information on the corrugated container industry, the Fed should be authorized much more importantly to collect information on the total financial services industry.

As far as separation, Congressman, that would be quite harmful to the American consumer, harmful to our economy, harmful to job creation because financial services is interrelated. We cannot put that genie back in the box nor should we try. If we were to try, the leakage would be much greater than the container to start with.

A systemic regulator working through the existing prudential supervisors, the national Federal prudential supervisors, plus the addition of a national insurance regulator, working through their powers in order to provide better regulation, and second, in order to prevent occurrences before they happen instead of responding after they happen.

Mr. PERLMUTTER. Dr. Vaughan, do you have a comment?

Ms. VAUGHAN. Yes, I do. I really liked Mr. Bartlett's comments about looking at it through the eyes of the existing functional regulator. I do believe that it is important not to lose the things that we have that work, and the expertise that we have to try to solve this problem.

It is a very complicated problem. At least let's leave what is working, which gets me to the securities lending, if I could just take 2 minutes to talk about what happened with AIG.

Mr. PERLMUTTER. How about 1 minute?

Ms. VAUGHAN. Okay, 1 minute. AIG did have securities lending operations; a number of life companies have securities lending operations. No life insurance has gone insolvent because of its securities lending operations.

The New York Superintendent had been working to address the issue of securities lending in AIG, and the insurance company had reduced the amount, and was in the process of reducing it further,

when it was overtaken by the problems with the credit default swap operation.

Credit default swaps led to a downgrade in AIG, it led to liquidity calls in the insurance company. Still not insolvent but there was a liquidity issue.

What have we learned from this? Well, we have learned two things. One, we are looking at our securities, our regulations around securities lending. We have disclosures. We have strengthened those disclosures. Even before this all happened in 2007, I think, we adopted a risk based capital charge related to securities lending. We have been working on this for several years but the whole credit default swap situation overtook some of the work that we were doing.

Second, the fact that the credit default swap operation at AIG again impacted our insurance company is why we believe that this discussion around systemic risk regulation is worth having, but not to use it as an opportunity to gut a system that has worked, which is we protected the insurance companies and the insurance policyholders.

Mr. PERLMUTTER. Thank you. I yield back, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Perlmutter. Mr. Posey of Florida.

Mr. POSEY. Thank you very much, Mr. Chairman.

I think fundamentally we all agree that the whole crisis was caused by greed, pure and simple, and there is more than enough blame to go around. We can point fingers in all directions for the rest of our lives and not get everybody who is due some blame and probably include a bunch of people who were not.

Fundamentally, I do not think we had a problem with not enough regulation. I think we had too much regulation, too much interference by Congress. I never knew a banker who wanted to make a bad loan until Congress injected itself into the process of determining who should get them and for what.

Ken Lay is in prison because he caused severe losses to a lot of non-risk adverse investors, and yet we have a lot of people walking around free who have caused immeasurable financial harm to every person living in this country and future generations of persons living in this country.

I think every one of you at this table and I will be dead before our country pulls out of this crisis or completely recovers from the doldrums that were caused.

I align myself a lot with the remarks made by Mr. Ackerman earlier. I think it is not a matter of too few regulations. I think it is a matter of regulations we had not being enforced.

I like the analogies he made about crime. If your local police did not arrest and investigate criminals in your neighborhoods, I guarantee crime would be rampant.

We heard the SEC story with Madoff for a decade ago. Basically, no heads fell. Nobody lost their job. Total lack of accountability and responsibility on the government's part, equal, I think, in guilt as Madoff was.

I believe the best regulation that we could have is add some people with accounting degrees to the Justice Department. We need to

make sure this fits into RICO statutes. I think that self regulation would be the best regulation.

I think when people commit these horrendous acts of greed and cause harm to other people—if they cause physical harm, they go to jail. If they cause financial harm, you get a big bonus and you do not care whether you work another day in your life or not.

I would like just a yes or no from each one of you as to whether or not you think that is a good idea conceptually.

Ms. Williams?

Ms. WILLIAMS. Self regulation needs to be part of it and it also has been part of the current structure.

Mr. BAKER. Our industry does not perform well where markets are manipulated. We would like fair and efficient markets.

Mr. BARTLETT. If you commit a crime, you ought to go to jail. We do think there should be more effective regulation. We think the regulation that was in place clearly failed, as there were a lot of other failures, but we look for more effective regulation.

Ms. VAUGHAN. Enforcement is critical and a system of checks and balances increases the chances that will happen.

Mr. DIMUCCIO. We think there should be better coordination of regulation with the help of a systemic risk regulator.

Mr. RYAN. We believe there should be a financial stability regulator.

Mr. POSEY. I got one clear "yes" out of six. That is probably pretty good for up here. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Posey. The gentlelady from Ohio, Ms. Kilroy.

Ms. KILROY. Thank you, Mr. Chairman. I appreciate it.

I would like to ask the panel some questions about credit default swaps and your view of those in this overall topic of systemic risk.

I have heard credit default swaps described as a way for institutions to manage their credit risk. I have also heard them called a dangerous side bet by those with no skin in the game, no ownership interest, in terms of stocks or bonds, that has played a role in this economic downturn.

I would like to know how you come down on credit default swaps and their role in our financial markets. Are they good for us? Are they bad for us? Which way do they tilt?

Mr. RYAN. Our view is that CDS are not insurance products. They are trading products. They do not require an insurable interest. It is not an insurance product. It is trading. It is a very useful product in today's environment.

Ms. KILROY. If they are not an insurance product, what is their functional good use then?

Mr. RYAN. People trade risk on specific names and typically they are trading risks around embedded additional investments. Sometimes they are not, and that is called "naked CDS."

Ms. KILROY. Are they more useful products than offside betting, if they are not an insurance product?

Mr. RYAN. For most global financial institutions, they are very useful hedging products.

Ms. KILROY. Anybody else want to offer on opinion on the usefulness?

Mr. BARTLETT. I would comment they are another example, a very large example of the gaps in regulatory coverage. CDS are just riding the gap. There is no regulation on either side of them. That is why we think a systemic regulator should be able to look at the gaps as well as the coverage.

Ms. KILROY. I understand that we have gaps in regulations, but as I understand it, credit default swaps were not permitted until about a decade ago. Is that correct?

Steve Kroft reported that on CBS News, 60 Minutes, that credit default swaps had been illegal during most of the 20th Century.

Mr. BARTLETT. It had been unheard of before, I suppose. I had never heard of them.

Ms. KILROY. I guess my question is, should we return to that last decade, return to a situation where credit default swaps are at a minimum unheard of?

Mr. BAKER. If I may respond, Congresswoman, I certainly think that the role that credit default swaps play has a structural material business reason for existing.

If I am doing business with you and you have a train of suppliers that enable you to make your product that I am relying on purchasing, but I have a concern that one of the downstream providers of, let's say, the engine for the car you are manufacturing, and the engine manufacturer may be impaired, I cannot enter into a financial transaction and be responsible to my shareholders without ensuring against identified potential risks.

If I take that credit default swap out so in case something does happen to that engine provider, I can be made whole.

Ms. KILROY. Should we limit a credit default swap then to those with some business reason like that, someone with ownership interest, where it is a guarantee?

Mr. BAKER. There is another complicating factor that is unfortunately the result of our credit rating agencies' missteps. The CDS market is increasingly becoming the de facto rating agency because the spreads on credit default swaps are an indicator of the underlying financial condition as determined by the broad market.

All I am suggesting is cautionary action. We certainly want to be involved in the discussion. We have concerns that prejudicial action at this time without fully understanding the consequences would not help our economic recovery.

Ms. KILROY. That is why I am asking questions so we can understand.

Mr. BAKER. Thank you.

Ms. KILROY. Should credit default swaps be regulated then since they are a form of a guarantee as an insurance product?

Mr. BAKER. If I may further continue, the risk with credit default swaps in the current market environment is settlement risk.

There is considerable work done by the New York Fed with significant market participants to create future clearinghouses or exchanges for the purpose of trading standardized CDS contracts.

The difficulty in pursuing that path alone is there are many credit default swaps which are very unique to the two business interests that are involved, called "one off's."

You cannot run one off's through an exchange because of the fact they are unique, so there will be a continued business reason to

have credit default swaps continue to be agreed to that are not exchange or clearinghouse traded.

It will help greatly with some of the concerns I think I have heard expressed about the potential downside risk of a failure to settle.

Ms. KILROY. What you are suggesting would certainly give us more "transparency" in the system, but does that answer the need for regulating credit default swaps?

Let's move from insurance to the banking industry. Banks are the major credit default swaps' dealers, but banks which are subject now to regulation, the regulators do not take a look at credit default swaps.

Is that something that bank regulators should take a closer look at?

Mr. BAKER. I think that would come under the purview of the systemic regulator's responsibilities and to determine where there was aggregation or exposures that warranted some intervention.

In the current market, I do not respectfully see a reason to regulate the instrument. There may be concerns about the counterparties' capital standing or their inadequacy to meet their obligations, which perhaps could be best handled by either the prudential regulator of the counterparty or by the systemic risk regulator.

Ms. KILROY. I have to express some real concern about AIG and the amount of money that our taxpayers have had to pony up for AIG and the continuing saga there, and AIG and AIG FP's role, an unregulated entity engaging in hundreds of billions of dollars in credit default swaps. I have a real concern about this area.

Mr. BAKER. I think that would be certainly addressed by a systemic regulator, particularly in the case of AIG.

Ms. KILROY. Dr. Vaughan?

Ms. VAUGHAN. Thank you. Back to your original question about is there value to these and should they be regulated, the theory always was that the use of credit default swaps would allow this risk to be spread throughout the marketplace, and therefore, it reduced the systemic risk because credit risk was not being held by one bank now. It was being held broadly by lots of people, and that was a good thing.

What we found was that it did not spread the risk. It concentrated it, and it concentrated it in places where we did not see it and we did not regulate it.

I would fall on the side of we need to regulate it, and we need to deal with it, and how you do that, that is for the experts to figure out.

The issue is making sure, to go to what Mr. Baker said about settlement risk, when you have concentrations of this, making sure that they are able to pay off on these losses, and even more, avoid concentrations.

Chairman KANJORSKI. Thank you very much, Ms. Kilroy. Ms. Biggert of Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman. Before I begin, if for Ranking Member Garrett, I can put in the record an article by Investors Business Daily, "For Banks, Help Isn't On The Way."

Chairman KANJORSKI. If there are no objections, it is so ordered.

Mrs. BIGGERT. You know, until the last few years, we have had a market that has had a lot of innovation and a lot of new products that have come in, with the hedge funds and credit default swaps.

I wonder how we are going to find the balance between smart regulation, effective regulation, and really, overregulation. We have been through Sarbanes-Oxley and some other things like that.

How would we structure sensible regulation to manage the risk posed by the credit default swaps?

Mr. Ryan?

Mr. RYAN. As to your first question, the reason our industry has not given you specific answers to many of the questions is that they are very complex. This type of hearing, and I am sure there will be a series of hearings on many of these specific issues, should be part of the dialogue back and forth so that you hopefully get to an answer that provides the comfort and confidence that the marketplace requires without stifling innovation.

Mrs. BIGGERT. Thank you. Mr. Baker, it is great to see you back here. I wish you were still sitting up here. You really provided so much expertise to our committee.

Kind of the same question, how do we judge the credit default swaps? What do we look at? Do we look at the leverage ratios? What would we look at as far as regulation?

Mr. BAKER. Congresswoman, certainly attention ought to be given to where inappropriate aggregation occurs in the market. As a related matter, for example, if we had known the number of people who had Lehman as their broker-dealer counterparty, perhaps some action might have been taken—I cannot say for sure—that would have at least mitigated some of the effects.

As to the settlement responsibility on a CDS exchange, you go to the capital adequacy of the person holding the obligation.

Has the company, as in the case of regulated insurance companies, had adequate reserves to meet its obligations using some sort of reasonable man standard.

Obviously, in a very frothy economic market where outlooks were very positive for continued upswing in values, the pricing of the CDS was under market in relation to the risk they were actually assuming, but it does not mean the economic relationship of acquiring a credit default swap to protect your own business interest is something that is inherently wrong.

It is a way to diversify risk, to spread risk, and to hedge against your own losses. Any instrument inappropriately used can bring about financial dislocation, which regrettably has happened here.

I go back to the purpose of the hearing in suggesting this proposed systemic risk assessment office, if that is what we are going to call it, should have some role in looking at where people are inappropriately concentrating.

Concentration issues are always of concern.

Mrs. BIGGERT. If we do that, with Bear Stearns and the collapse of the two hedge funds in 2007, should there not have been a warning sign to regulators that if not properly managed, even though they were operating within a regulated entity, that there would be a systemic risk?

Mr. BAKER. I think that is what brings most of us here today, to observe that there were regulatory gaps and that we generally

agree that some sort of overview of the system that enables some office somewhere to have that aggregated view of all the interrelationships would be very helpful.

It will not prevent business failure. It will not prevent a bank or a hedge fund from closing its doors, but it will perhaps limit the losses to those appropriately assessed and not to innocent third parties.

Mrs. BIGGERT. Specifically, how do we address the inappropriate behavior that you described?

Mr. BAKER. Well, first the systemic regulator has to intervene as appropriate. Then the prudential regulators who are charged with the enforcement, market discipline and investor protections, who are there today, would continue to need to do their role.

I suspect all those who have been previously identified as engaging in inappropriate conduct are in deep conversations with a lawyer somewhere.

I do not know how quickly the resolution will come, but I suspect it will be appropriate.

Mrs. BIGGERT. Thank you. I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Biggert. Now, the gentlelady from Illinois, Ms. Bean.

Ms. BEAN. Thank you, Mr. Chairman. I apologize for running late. I had another meeting I had to attend. Thank you all for your patience with us today.

My question is for Dr. Vaughan. I missed part of your testimony. I guess my question is, is it your opinion from what you have testified to thus far that the insurance subsidiaries of AIG are solvent, and if that is the case, why has the latest round of Federal dollars gone to the life insurance side of the business?

Ms. VAUGHAN. The insurance companies are solvent. The insurance companies before they got the round of Federal funds had positive capital and surplus. There was a question about at what level did you want that risk based capital to be, and I think that was a determination that was made outside of the insurance regulatory system.

We were fine. Had AIG not gotten that money, no policyholders would have lost money, is my understanding.

Ms. BEAN. You are saying the latest round of Federal monies going to the insurance companies is not necessary?

Ms. VAUGHAN. What I am saying is it is increasing their risk based capital ratios. It is not taking an insolvent company and making it solvent.

Ms. BEAN. The $30 billion additionally is necessary for the insurance companies?

Ms. VAUGHAN. What I am saying—I will try again. Sorry. The AIG insurance company is solvent. They got additional capital through this latest round but it did not take an insolvent company and make it solvent. It took a solvent company and made it more solvent.

Ms. BEAN. I have another question, if I still have time, and I do. What if AIG did not have a thrift company and then would not have OTS oversight? Who would be involved?

Are you also stating that the New York State Commissioner would have had the ability and the processes in place to detect the

challenges of AIG, and does AIG have processes in place to make sure that State commissioners cannot?

Ms. VAUGHAN. That is an excellent question. The insurance commissioners regulate the insurance subsidiaries, and the insurance commissioners work together when there are multiple insurance subsidiaries in an—

Ms. BEAN. Who regulates the holding company?

Ms. VAUGHAN. No one does, and that is part of our problem. The insurance commissioners are regulating the insurance companies, protecting the policyholders in the insurance companies.

They are looking at the relationship between the holding company and the affiliates and the insurance company to make sure it does not impair the insurance company and does not affect negatively the policyholders.

What happened here were unregulated affiliates that created the problem, and we agree that is a problem that needs to be solved.

Ms. BEAN. Clearly, there is no Federal oversight at the holding company level to actually see what is going on.

Ms. VAUGHAN. Right. Had there not been a thrift, that is correct.

Ms. BEAN. Thank you. I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Bean. Mr. Campbell?

Mr. CAMPBELL. Thank you, Mr. Chairman. I also wish to issue my apology for coming in late. I had a conflicting committee hearing, which some of you are familiar with.

I have two questions, and what I will do is kind of explain my thoughts and background on them, lay them out and let you kick them around, answer them as you will.

My questions will be specifically oriented toward insurance, since that is where many of you have at least some focus.

To me, there are two great distinctions in the insurance market today. One is between those things where we are insuring tangible assets, and those things that are insurance of financial products, that have no nexus in any State or anywhere in particular.

Financial products, insurance financial products would include such things as life insurance or annuities, but also such things as credit default swaps and any other financial insurance products.

Within that financial insurance product bin, I agree with my colleague from California, Mr. Sherman, earlier, that there are some products which I would say are in the nature of gambling, and not actually in the nature of real insurance or investment.

To use life insurance as an example because it is something we are all familiar with, Mr. Baker and I enter into a contract for the life of Mr. Baker. He has an interest in the life of Mr. Baker, and we enter into that contract, and that is insurance. That is life insurance. That is the way it works.

If, however, Mr. Kanjorski and I enter into a contract about the life of Mr. Baker and neither one of us have any particular—we are not the company that employs you or whatever and neither of us has any particular interest, most life insurance companies will not go for that because we are just gambling. We are just betting.

He is taking one side of a bet and I am taking the other side of a bet on the life of Mr. Baker and we have no interest in his life other than the bet. Those to me, are gambling.

From this world view that I have, I have two questions. First of all, in my view, these financial products which are insurance in nature and which have no nexus in any State should have some Federal regulator.

Should that Federal regulator be a separate regulator or should it be a part of a larger systemic regulator that looks not only at insurance things, but also at the banking system and all the other systemic issues that we are talking about, or do you think either one of those ideas is bad.

My second question is, do you agree with the viewpoint that there are financial insurance products, and frankly, there are other types of financial products, not insurance, which are in the nature of gambling, and although in my view should not be banned or made illegal, but should be segregated, and there should be a number of restrictions on who can and is allowed to engage in that kind of gambling.

Those are my questions. I would like to hear answers from whomever wants to throw them out.

Mr. BARTLETT. I will try just quickly. We believe that first of all there should be a systemic risk regulator, a market stability regulator, whether it is an insurance product or other kinds of financial services, who would examine the systemic risk and examine the gap in coverage, if you will, of regulators, working through the Federal prudential supervisors, working through their eyes, and with their authority.

We think that covers the systemic side, if these products you describe are systemic, create a systemic risk, the Federal Reserve should have some oversight over identifying the risk, but then working through the prudential supervisors to take action, not taking action unilaterally. Otherwise, you create two new regulators that at best on a good day could conflict, and on a bad day, avoid the question altogether.

We also believe there clearly should be for a Federal company with interstate, with large systems, whether it is an insurance product or other similar kind of product, they should have a national charter, at least be allowed to have a national charter because it is in the national government's best interest to have someone who can regulate those large national companies.

Mr. CAMPBELL. Would that charter be managed then by the systemic risk regulator?

Mr. BARTLETT. No, it should be managed similar to banks, it should be managed by a national insurance regulator who is actually supervising the activities of that company as opposed to the systemic.

Mr. DIMUCCIO. May I?

Mr. CAMPBELL. Yes, the question is open for whoever wishes to answer.

Mr. DIMUCCIO. We believe there should be a systemic risk regulator. We believe there are some immediate needs to bring confidence back to the markets.

However, our Association has a concern that there are many regulatory issues that are being brought into this round, and they need to be talked out. They need to be discussed.

However, putting them together, the systemic risk regulator and the regulation of insurance, into one process that needs to get done quickly may possibly hurt or affect a system that has worked very well up through now.

There has been an insignificant number of P and C insolvencies in the last couple of years, and the vast majority of P and C companies are strong and have worked through this crisis serving their markets.

To disturb a working market and a system that is performing very adequately, at this point, we think that is not the right answer. We think a systemic risk regulator with principles based regulation that allows it to evolve its regulatory oversight to take into account changes in the markets is the necessary infrastructure that we need to put in place.

Mr. CAMPBELL. Mr. Ryan and then Dr. Vaughan.

Mr. RYAN. I would like to associate myself with Mr. Bartlett and our Association, the Securities Industry and Financial Markets Association, believes there should an optional Federal insurance charter.

Mr. CAMPBELL. Dr. Vaughan?

Ms. VAUGHAN. I have said it before and I do not want to sound like a broken record, but to repeat what Mr. DiMuccio said, we have a system that works.

We are used to working in a collaborative way with other regulators. This State-based system is often presented as a system where you have Alabama doing one thing and North Dakota doing another and New York doing another. In fact, we have a highly coordinated system with lots of oversight of each other and nationally.

I am the CEO of the National Association of Insurance Commissioners. My number one job is to make sure that the system works together. I have a staff of over 450 people who do that.

We make sure that groups are coordinating, that if there is a company like—pick any insurance company that has companies in five States, that they are working together and they are gathering information.

We have an office in Kansas City that does its own analysis of financially significant companies, and then creates a peer review process for other States to look at what is going on when they see a problem with that company.

We are used to working together as regulators. We really think that works. We like that model. We would love to have a model where we could work with the banking regulators and the securities regulators, and let's all get together and work on what is going on in this complex financial institution together.

We do it. We know how to do it. We would be happy to work with other people on that kind of a model.

Mr. CAMPBELL. I guess nobody wanted to touch the gambling issue. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Campbell. Mrs. Maloney of New York.

Mrs. MALONEY. Thank you. I thank all the panelists and I particularly thank our colleague, Richard Baker. It is good to see you

again. Thank you for coming to see us. We served together for many years.

I would like to follow up on the chairman's and others' questioning on AIG, which has now received over $200 billion in taxpayer money, 10 percent of the TARP money, $80 billion from the Fed. We continue to use taxpayer dollars to keep AIG from going under, an additional $30 billion was allocated last Monday.

Yet, in the words of Fed Chairman Bernanke, "This was a hedge fund basically, that was attached to a large and stable insurance company that made huge numbers of irresponsible bets and took huge losses. There was no regulatory oversight because there was a gap in the system."

Today, it was reported in the press that Hank Greenberg, a former CEO of AIG, has stated publicly that we should separate AIG out from the risky arm that was added to it, and move it apart.

As Dr. Vaughan pointed out, the insurance arm of AIG is healthy, strong, well-functioning, and respected worldwide.

It is this risky arm that is pulling us down. I would suggest even better to the systemic regulator, which I support, I would not let these risky functions be tied onto core services that are needed by the American people.

When people try to support AIG, it is because of the insurance arm. We need insurance. Our businesses and our people need insurance.

Why can we not just separate out this risky arm? I would like to begin with Dr. Vaughan, but also add that with $200 billion of taxpayer dollars in AIG, the American public deserves to know, as do researchers in government and out of government, where did this money go?

They are telling us it is systemic risk, but how do we know it is systemic risk if we do not even know where the money went?

I respectfully would like to place in the record a letter that I have continued to request from the Federal Reserve to get this information, so that we can make better policy decisions in the future.

My question, beginning with Dr. Vaughan, and anyone can answer, is why not just separate right now by regulation, just take that risky arm out of it, and let the healthy arm continue to serve the American public and the world with a fine insurance product, but let's put this risky arm over on the side. Let's see if that is really systemic risk.

Maybe we do not need to be pouring billions in. We put in $200 billion. Once they said they did not need any money. Then they said they needed a certain amount. It keeps going and going.

That is my question, and my final question to Mr. Bartlett and others and Mr. Baker is, could we have prevented the crisis that we are in now, our current economic crisis?

Do you think it could have been avoided or mitigated if a systemic risk regulator had been in place during that period? Would that have prevented the crisis that we have?

What I find so upsetting is that 9/11, which was another crisis in our country, I truly do not believe we could have prevented it,

but we could have prevented the financial meltdown that we are in today with better regulation and more responsible oversight.

If you could begin, Dr. Vaughan. Why do we not just separate out this risky arm as Hank Greenberg said, who should know, he is the former CEO, he said just separate it out and let that be over in one area and let the insurance be strong and serving the public. Dr. Vaughan?

Ms. VAUGHAN. That is an interesting idea and I have not had a chance to look at what Mr. Greenberg is suggesting.

I guess I would start by saying that to some extent, we have been separating the insurance operations from the risky activities, and that is the reason that the insurance companies are still healthy, because we walled off the insurance companies.

That is the way our system of regulation works. They are walled off.

Mrs. MALONEY. Might I add, when people come to us to bail out AIG, they say we have to bail them out because of the insurance, the insurance product. If it is off on the side, then that is a whole different element of risk.

Ms. VAUGHAN. I am not sure I agree with that argument. I guess I would have to talk to whomever it is. I think it is an interesting idea. Do you just spin the insurance companies off and kind of let them go on their way and do their thing.

We have been trying to work, recognizing that if you spin the insurance companies off, that does not solve the bigger problem that you have, which is these unregulated entities that are soaking up these taxpayer dollars.

We have been really trying to work with the Federal Reserve and the folks who are trying to solve this bigger problem and trying to be partners, and trying to do what is going to be helpful to the bigger problem.

If keeping the insurance companies in there is part of the solution long term, if it is going to help everyone, then we want to work to try to figure out a way to make this work.

We do go into this knowing that our regulatory structure has walled off those insurance companies and we are going to be focused on making sure that the policyholders stay protected as this happens.

I appreciate what you are saying.

Mrs. MALONEY. The systemic risk, would that have prevented the crisis we are in, Mr. Bartlett?

Mr. BARTLETT. I think it would either have prevented it—yes.

Mrs. MALONEY. Mr. Baker?

Mr. BAKER. If I may take just a second, Mr. Chairman. I would respond affirmatively to the gentlelady's question about systemic risk. I do feel the need just to respond to the reference to Chairman Bernanke, referencing AIG as just merely a hedge fund.

Frankly, I wish it had been a hedge fund. It would have been better run. Some have expressed surprise about the depth of loss. It is the leveraging that took place that magnifies the depth and scope of losses that are yet still being identified.

The reason why I wanted to bring this up, I made it a point because I hoped somebody would bring up this comment, and we in the industry took considerable affront in that characterization.

This perhaps will come as some surprise: 26.9 percent of hedge funds use no leverage, zero. Up to 42 percent of hedge funds have a leverage ratio of 2 to 1. Media reports that we have dug out in the last few weeks indicate—this is technical news reports coming from industry surveillance—fund leverage may be down to 1.15 industry-wide from last April's 1.4.

This notion of hedge funds being wild cowboys in the economic west is just ridiculous. I do not know what caused the Fed Chair to come to that conclusion.

Thank you for giving me the opportunity to address it.

Chairman KANJORSKI. Thank you very much. Thank you, Mrs. Maloney. The gentleman from California, Mr. McCarthy.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman. I appreciate having the opportunity.

We all realize we need to modernize an outdated system. My questions kind of stem from looking in the future, and wanting to make sure we get it right. We only get one bite of the apple.

I am a firm believer that structure dictates behavior. You will either adapt to the structure or not.

Being from California, and picking up on what Mr. Baker said earlier to Congresswoman Biggert, you said if you had the regulator, it still would not prevent failure. Then I started looking on the other end, how someone would design this.

When I look at all the IPOs that were created in California, and if you looked at an IPO when it first came out, companies that are wildly successful today, but if you looked at them when they were entered, the market determined, but they were very risky. Not making profit for quite some time, and business model people did not understand because it was new innovative.

My fear would be would it not prevent failure, but would it also prevent innovation in a way.

Would you view a new regulator, that IPOs would have to be measured or go through a regulator as well?

Mr. BAKER. It certainly would not be our recommendation that an IPO or any start up be subject to immediate supervisory review by a systemic risk regulator.

Very small enterprises can in fact cause potential systemic risk because of concentration in certain business activities.

As Mr. Bartlett previously said, assets under management should not be the sole criteria by which one is judged to be systemically relevant. It is your interconnectivity, concentration questions, and it may also be dependent on current market conditions. You may not have been systemically relevant 6 months ago, but in the current liquidity crisis, you may be.

It would be a large investment of authority and discretion in the hands of the systemic regulator to make that judgment.

I will use one quick example because it reflects how complicated this can get. In the 1970's, there was a bank in Germany engaged in significant international currency swaps. In between the time of accepting a large deposit of Deutsche marks and making settlement in U.S. dollars in New York banks, they went bankrupt. It was a very significant and adverse event which led the Bank of International Settlements to ultimately develop a clearing process for currency exchange.

That is an example of how something no one in New York was thinking about a little rural bank in Germany causing that complication. It can happen.

That is the reason why our apparent description of the systemic regulator's role is more nebulous than you may like. It is very, very difficult to describe what will always be appropriate.

Mr. MCCARTHY OF CALIFORNIA. Mr. Bartlett, just before you answer, the only other thing, and it kind of stems from Mr. Baker's answer, we have some of these functional regulators already, the SEC and the Fed.

When you answer, also think from the perspective, and I am just looking forward, would one trump the other if you had a new regulator, and would one new regulator look back at decisions of these past functional regulators' decisions and could that trump another?

Mr. BARTLETT. Our proposal, and this is after a great deal of thought and debate, is that the systemic risk regulator or the Fed should be a regulator to gather information, to consult with the primary regulators, with the Federal financial regulators, and then to act through the Federal financial regulators with the addition of an insurance national regulator, but act through their authority and not with additional conflicting authority.

Mr. MCCARTHY OF CALIFORNIA. Is the Fed trumping the new one then?

Mr. BARTLETT. There is no trump. They work jointly. The Fed would not have the authority to regulate a particular company but to work with the supervisors that do have the authority over that company.

The Fed has the authority to look at the system and to bring that to the attention of the prudential supervisor. The prudential supervisor, the OCC, if you will, the national insurance regulator, would have the authority over that company. They would have the cease and desist orders, if you will. That way, you do not have the conflict.

This has changed in terms of sort of the body politics thinking over the course of the last year, and it seems to be the right way to solve it. You end up without a new uber regulator. You end up with a systemic look at the system, gathering all the information.

Mr. MCCARTHY OF CALIFORNIA. What if those two are in disagreement and you are working through one another? One says A and one says B. At the end—I am just thinking long term, what are the hurdles, what are the challenges.

Mr. BARTLETT. As a practical matter, the Fed always wins, but that is a practical matter, not in a statute. That happens today. Today, the Fed always wins. I am not contemplating a change in statute.

I think if it is a joint examination and joint finding of fact and if the Fed says to a prudential supervisor we believe you need some additional action here on this company or these sets of companies, then in fact they would work together to accomplish it.

It is way better than what we have now in which the prudential supervisors do not have any access to information outside that one company or outside that one sector.

Mr. MCCARTHY OF CALIFORNIA. Thank you. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. McCarthy. It looks like we are getting awfully close to establishing the FSA, if I follow your logic. We will see about that.

Mr. Foster from Illinois.

Mr. FOSTER. Thank you. My first question has to do with complexity and whether part of the solution to making a more stable system is to limit the complexity. A lot of people talk about the complexity of financial instruments, where people are trading in things that they frankly do not understand.

I would like to ask a question about a second kind of complexity, that is organizational complexity. If you look from a regulator's point of view, the difficulty of regulating a diversified entity—you touched on it, Ms. Williams, to do with holding company regulations and the difficulties there.

If you look at the difficulties in unwinding AIG, for example, because it was tremendously diversified and a complex organization, and you can imagine a different world, maybe a future world in which AIG was allowed to exist as an insurance company, well understood by a regulator whose only job was to look at it as an insurance company, and if it wanted to go play in credit default swaps, there would be a credit default swap trading house regulator who really understood that market, and to deliberately segment the markets.

Say you can play in this sandbox or you can play in that sandbox, but you cannot be a big diversified mass because frankly, we do not have the intellectual and manpower in the regulators to handle a big diversified thing.

We are in a situation where it looks like the regulators are always going to be intellectually and manpower outgunned, simply because of the salaries they can give to their employees.

It seems to me there is a big benefit in compartmentalizing things. I was wondering if any of you have a reaction to that.

Mr. BARTLETT. In my view, there are a lot more negatives to try to compartmentalize because it is a complex world and a complex financial services world, and to try to put the finances back into individual boxes, it would do great harm and do not reduce the risk.

I think rather you would want to elevate the statutory authority of the regulators to be able to look across the system, rather than create a smaller system.

Mr. FOSTER. Are there studies that have been done that actually indicate you have more efficient capital markets when you have diversified entities that span many boxes compared to specialized companies that live and work very effectively in their own boxes?

Mr. BARTLETT. Many specialized companies serve their customers well, but the diversified company, yes, there are ample studies for the efficiencies. More importantly for the convenience to the consumers or to the market.

I would be happy to make those available to you for the record.

Mr. FOSTER. Okay. It is very interesting. The tradeoff as I see that is there are perhaps more efficient markets from diversified entities and a whole lot of wealth that was destroyed by the failure to understand the diversified entities.

I would like to see some of the principles we talk about look at that tradeoff of complexity versus reliability.

The second question I have has to do with confidential reporting that was mentioned by Mr. Baker and Mr. Bartlett, I think.

How does it extend overseas? Is it realistic that we are going to ask Russian billionaires and Saudi princes, I am sorry, we have looked at your books, and you have an unbalanced position in some very complicated derivative or something like this?

How is that actually going to happen, both in terms of reporting—do we have to band together all the well-regulated economies and say okay, we are going to have full disclosure among a group of countries that agree to be well-regulated, and then all these black pools of capital are just not allowed to touch us?

How do you anticipate that might work?

Mr. BAKER. That effort really is ongoing. Our counterpart, the Alternative Investment Management Association domiciled in London is actually working with the MFA, working through regulatory harmonization as to standards of conduct for the hedge fund industry. We have much work to do. It is a very difficult task.

I do believe, however, that the U.S. regulatory system has every right to ask of those who do business here to comply with the rules of the road as you designed them.

I would suspect that given the global nature of the financial marketplace today and the worldwide nature of this economic downturn, that for the first time maybe ever, you see an appetite for having global standards of conduct so there will not be great variance from one jurisdiction to the other.

There is one significant difference I would like to point out, however, between us and the U.K. We tend to wall off our hedge funds from taking investments from anyone other than an institutional investor or a person of significant net worth. We do not engage directly with working families.

In the FSA and in the U.K., they are contemplating more retailization, taking it the other direction. That is one significant point of departure where I would want to make you aware.

On the questions of safety and soundness and business conduct, we are rapidly trying to move our standards to look more alike than different. Of course, that would require congressional actions in order for us to be able to do that.

Mr. FOSTER. Mr. Ryan?

Mr. RYAN. This effort of global harmonization is probably the most current issue in the financial markets today. I am sure you have seen this, if you would look at the G–30 report, you look at the recent study by de Larosiere, you look at the financial stability form.

Our people in London spend huge amounts of time trying to coordinate what is going to happen between the United States and Brussels and other developed countries.

You will find in our testimony, Securities Industry and Financial Markets Association, we have to get this right, not just in the United States. These markets are totally global. They are totally interconnected. That is a word we keep using here.

We need insight into it, and that is one of the reasons we are firmly behind a regulator that has this power and information.

Mr. FOSTER. You are optimistic it will happen this year? That is interesting.

Mr. RYAN. That is really up to you and your colleagues. What I have said is the confidence in the system and in the financial markets requires that we take action this year. It is really up to you.

Mr. FOSTER. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Foster. The gentleman from Connecticut, Mr. Himes.

Mr. HIMES. Thank you, Mr. Chairman. Thank you to the panelists for bearing with us and being patient on this very important topic.

You may have noticed this House has a tendency to conduct an unedifying debate about whether there is too much regulation or too little regulation.

We have seen that many markets had no regulation. CDS has auction rate securities, non-bank banks. They screwed up. We have seen heavily, heavily regulated entities like our commercial banks and our broker-dealers, also made mistakes that we are paying for now.

To me, this is a question really of intelligent regulation, which is driven in my way of thinking by a couple of principles. Very good transparency, the concept that risk stays with those who make the decision to take the risk, and be very, very careful about leverage.

With those principles in mind, I have two questions for Mr. Baker and one for Mr. Ryan.

Mr. Baker, you said something that caught my attention, which is that the hedge funds in particular would be willing to disclose their positions but confidentially to a regulator. I understand the proprietary nature of the trades that are taken, but why should we not demand they be publicly disclosed with some reasonable period of time so that there really is good transparency and information in the market?

Mr. BAKER. First, and thank you for the question, there is no at least identifiable from my perspective public value to a disclosure of confidential information currently by a fund to a regulator through to the public.

In fact, there is a perverse potential where selected disclosures of pertinent information may in fact skew the understandings in the public and cause great harm.

We, for example, would not want to disclose our short positions, although we do not mind disclosing whatever information the regulator tells us he wants in whatever form the regulator wants it in order to make the judgments about improper conduct, concentration questions or other matters that may be of importance to the regulator.

Mr. HIMES. Why would you not want to disclose that?

Mr. BAKER. Much of our work has its value in its intellectual content. Reverse engineering, in fact, disclosing the trades would not require reverse engineering.

The sophisticated work that is done by our members and behind which they place significant financial investment is all research. It is academic work. You would be requiring us to disclose our Church's fried chicken, Popeye's fried chicken recipes to Colonel Sanders.

Mr. HIMES. At what point in time does it cease to be proprietary? A month? A week? Two months?

Mr. BAKER. There are varying opinions on that, frankly. Some feel after a semi-annual period of time, perhaps that would no longer be of value. Some of my members have very strong opinions that their analytical skills, once you determine their positions, you can then deploy their particular tactical strategy in the marketplace.

I tend to understand. My entities that I represent have intellectual value based on hard work. That equally has a right to be protected much like not causing a car dealer just to give cars away. It is their real asset.

Mr. HIMES. Thank you. Question number two is about leverage. You indicated that the levels of leverage in the hedge fund industry in particular are down substantially.

Many hedge fund players have assumed in the past substantial leverage, either through the use of debt or through derivatives.

Long Term Capital Management happened to be domiciled in my district.

Is this something we should be focused on when the credit markets return and will in fact start lending to hedge funds again?

Mr. BAKER. That should be an element of this systemic regulator's responsibility to assess and judge. When LTCM went down, they were 32 to 1. When Fannie Mae went down, they were 70 to 1. Fannie was quite heavily regulated and overseen by any number of entities.

I am reminded of a comment by someone, I think it may have been a former CEO of Citibank, who said as long as the music is playing, how do you quit dancing? As long as the market is moving forward, people deploy leverage to take absolute advantage of that positive market environment, and the art form becomes when do you begin to limit your risk taking to prevent the downside risk.

In our industry, we think our guys do that very well. That is why we hedge. We hope it goes well, but if it does not, we limit our exposure on the downside.

Mr. HIMES. Thank you. Quick question for Mr. Ryan. Mr. Ryan, in your testimony, I noted that you included private equity funds as a group or category of entities we should consider for systemic risk.

I do not usually think of private equity funds as employing certainly at the fund level or the partnership level a lot of leverage.

What do you see there that I am not seeing?

Mr. RYAN. The testimony is intended to be all encompassing, principally so that the regulator has the authority should a private equity firm be deemed to be systemically important to have authority to ask for information to regulate that entity. That is the intent of the testimony.

We do not have all the answers as to who is in and who is out, your question on transparency. I think you are going to have to work through many of these issues. I would suspect that Congress is going to have a very difficult time also trying to figure out how specific do you want to be and how much authority do you want to give to the regulator to make some of these decisions.

In our testimony, we were trying to say in the beginning here, we need to look broadly. We are not sure who is systemically im-

portant today and they may be important today, they may not be important tomorrow.

Mr. HIMES. Thank you. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Himes. The gentleman from Florida, Mr. Grayson.

Mr. GRAYSON. Thank you, Mr. Chairman.

There has been a lot of discussion today about how we should deal with systemic risk in the future. I am concerned about how we are dealing with it now.

What I am seeing is a massive transfer of wealth from the taxpayers to the banks in the name of systemic risk. I am concerned about that.

Can you tell me if there is any response to a threat to the system, a systemic risk, that does not involve the transfer of hundreds of billions of dollars out of the taxpayers' pocket to the banks?

Mr. Ryan?

Mr. RYAN. I do not know where you are really going with your question. I am just going to give you my answer.

In our industry, we are in a very tough situation. I think government at all levels has done an excellent job on balance with no real play book, and quite frankly, most of the regulators with inadequate information.

In order to keep this system stable, the government needed and did make funds available to core financial institutions and they are essential to our economic health. I am very pleased they have done it.

What we are talking about here is how do we make sure in the future that we have the ability to look over the horizon and to make some decisions to limit the possibility that we run into this situation again.

Mr. GRAYSON. I understand that. Many people seem to regard the fact that we have already taken trillions of dollars and made them available to certain financial institutions who have failed to be sort of a happy coincidence, that we are bailing these people out for the good of the country.

I understand that is the view of many. I am wondering if there is any other way to do it. That is my question. Is there another way to deal with the systemic risk problem that does not involve the transfer of funds from the government, from the taxpayers, to private entities? In other words, Wall Street socialism.

Mr. Bartlett?

Mr. BARTLETT. There is one way and that is for this committee and the Congress to pass systemic risk legislation and provide for statutory authority to regulate systemic risk.

As far as the current crisis, we are in a crisis. The financial services industry is largely illiquid, has a crisis, and that crisis then has spread to the rest of the economy, whether it is through foreclosures or unemployment.

The government has taken a number of actions that are costly. TARP, the new toxic assets thing, the money market guarantees, FDIC guarantees, in order to stabilize the system so the economy can recover.

For the economy to recover, the recovery starts with the financial institutions and financial services industry, or it does not recover.

That is why this Congress is authorized and the regulatory agencies have taken steps to stabilize the situation.

Mr. GRAYSON. Right. What people are sensing is the idea that they are not getting anything in return. They are being threatened with this idea that the financial system will collapse or is collapsing, and therefore, money has to be taken from the taxpayers and given to the financial system, basically in return for nothing.

What I am asking is, is there an alternative to that because frankly, a lot of people are beginning to see it as extortion.

Ms. Williams?

Ms. WILLIAMS. I would say part of this has to do with the investment that is being made. I think it is important to look at this in terms of an investment. In particular, if you look at TARP and the capital purchase program, the government has made an investment.

We have yet to see what the return will be on that investment, but that was the approach that was taken.

Mr. GRAYSON. When we talk about systemic risk, it seems that we are always talking about letting people off the hook for the mistakes they made in the past.

It seems to me that is the opposite of another concept that we have tried to preserve here in Congress, which is moral hazard. Is there a way to deal with systemic risk that does not involve compromising on moral hazard?

Dr. Vaughan?

Ms. VAUGHAN. Others have mentioned this issue about creating a systemic risk regulator and then publicly branding institutions and saying this company, this is systemically risky, and therefore, does that create an impression of too big to fail.

I do think that is a risk. I really think that is a risk. I do not know how to deal with it. I have talked to a lot of people and I have had some people say to me, look, the horse is already out of the barn and you cannot get it back in.

I am equally outraged. I am a taxpayer. I am outraged at what is going on, this sort of "heads I win, tails you lose" that we seem to have evolved to in the last decade.

I am not a bank regulator. I am an insurance regulator. I cannot tell you how to fix the problem, but boy, I would sure like to find a way so it does not happen again. I am with you on that.

Mr. GRAYSON. Thank you, Mr. Chairman. My time is up.

Chairman KANJORSKI. Thank you very much, Mr. Grayson.

Ms. Williams, you sat there primarily not getting involved, but you just completed a study on CDS. After you have heard all this discussion, is there anything you would like to disclose to the public, the press, and to the panel, that your study has uncovered that may help us with this problem?

Ms. WILLIAMS. Just that I think the study really provides a status of CDS, what they are used for, how the industry as well as the regulators are trying to deal with certain issues.

I think one of the things that we really point out is that with the exception of some oversight being provided by the bank regulators, and it is really focused on bank OTC derivatives' dealers, there really is not a view of the overall market.

CDS to us—it is one of the pieces that we highlight in the report we issued in January in terms of creating a framework for financial regulation—is to look specifically at products like CDS because they illustrate the lack of having any type of system-wide focus, and to also stress that we not get caught up in the types of entities when we talk about regulation or the particular type of product, but to really look to the underlying risk that it may pose to the overall system and make that the focus when you start thinking about a systemic risk regulator.

Chairman KANJORSKI. Thank you very much.

Mr. GARRETT. Just to follow up since I said it at the very beginning, along that line, what is it that currently precluded them from either going down that road and making that investigation in the AIG situation, or if they were precluded, you just do not have the authority, what precluded them from saying here is an area that we know there is something out there, we just do not have the authority, we are going to raise a red flag?

Ms. WILLIAMS. It kind of goes back to the conversation about the holding company oversight structure. The holding company regulator has authority when it comes to the holding company, but there are conditions that they have to go beyond the regulated pieces.

To the extent if there is a national bank or a thrift or a broker-dealer involved, then there is clearly a functional regulator already existing.

If you have a subsidiary or an affiliate that is not subject to regular regulation, there has to be some concern about that affiliate for the holding company regulator to then go in and say okay, this is posing a threat to the holding company.

I go back to the point that if you are not going into the institution on a regular basis, how are you going to identify the fact that it may pose a threat to the holding company?

Mr. GARRETT. They are not going into the subsidiary institution on a regular basis?

Ms. WILLIAMS. Right.

Mr. GARRETT. How are they going to identify that threat?

Ms. WILLIAMS. Yes. They have the authority to do it, but if you are not going in there on a regular basis, how do you know that it poses a threat to the holding company.

Mr. GARRETT. They have the authority?

Ms. WILLIAMS. Yes.

Mr. GARRETT. They just do not execute that authority because they say we really do not know what is going on over there and we are not there on a regular basis, so—

Ms. WILLIAMS. I do not know if it is an issue of that is what they are saying. It is that they do not know. It is an issue of you do not know what you do not know. Yes, you have the authority but until something comes to light to raise an issue, and I go back to AIG, my understanding is with OTS, once the internal auditors raised a concern about risk management with AIG FP in particular, then OTS went in because it posed a threat to the thrift holding company.

Mr. GARRETT. I have been an auditor, never for something like that, but an insurance company. Where there were aspects of the

business that we were looking at that we did not know about, we did not just step back and say well, there is an area of the company that we do not know about, and maybe somebody else is looking at it, we are just going to leave it alone until somebody says there is a problem there.

We would go to somebody else in the company and say there is a black hole over here that we are not too sure about, and we have question marks. That is the way we handled it in the insurance aspect.

Ms. WILLIAMS. That is a valid question.

Mr. GARRETT. Thanks a lot for following up from the very beginning.

Chairman KANJORSKI. None of your clients or customers failed, did they? That is the answer right there.

I first want to take the opportunity to compliment the panel. I did not hear the expression, "so this does not happen again" used. I think we should send the message out wide and clear, the disaster that happened this time is not going to be replicated. It is going to be a new disaster.

What we are trying to do is prepare, as someone said, to look over the horizon. With that, I agree.

Also, a caveat should be entered in there. We ought to recognize and accept there is no perfect system and there is nothing we can do to prevent future disasters. Maybe we can arm regulators with analysis to forestall those potentials, but after all, we have been pretty successful for 65 to 70 years under the present regimentation of regulation.

If we can get another 70 years out, none of us will be here, so we will not have to worry about it.

That is what we are going to strive for.

I want to thank you all very much. I found it very enlightening, your testimony. I look forward to you participating in very big ways with us in the future, if you can. I invite you not to hesitate to send us ideas and information that you have.

One other question, we have a lot of pressure to get this done, and you heard some of the opening statements, so that the President has a concept paper to take over to the G–20 with him or do things in 30 to 60 days.

Do you believe we should rush to formulate legislation and create this potential regulator in that short of time, with the ideas particularly of the two Members of Congress, can we really do that successfully?

Mr. BARTLETT. Mr. Chairman, in the view of our industry, no, you should not rush, but this has some urgency to it. You should concentrate all of your intellectual and capacity resources on examining this, thinking about it, but then moving right along to get it done.

The other half of my testimony was that Congress in our view should act in a comprehensive way and not piecemeal it one step at a time, because Webster's says it is systemic, it is related to each other, and to take out one piece and try to handle that, it means you have neglected the systemic nature.

There is some urgency to it; yes, sir.

Mr. BAKER. Mr. Chairman, I would suggest you at least beat my 20-year record with Fannie Mae and Freddie Mac.

[laughter]

Chairman KANJORSKI. I spent some of those years with you.

Mr. BAKER. You were right there. I would say, as Mr. Bartlett has indicated, this does, however, have some extreme importance and serious effects.

We have not talked much today about our unfunded pension liabilities and what it has done to endowments across the country. The residual effects of this will be long lasting unless you can help us get investor confidence back into these markets.

Chairman KANJORSKI. Thank you. Would anyone else like to add anything?

Ms. WILLIAMS. I would say that you have to proceed with deliberate speed, but do not lose sight of the fact that deliberation has to be an important part of the process.

Chairman KANJORSKI. Very good. Do you agree with that, Doctor?

Ms. VAUGHAN. Yes. I think that was well said.

Chairman KANJORSKI. Mr. DiMuccio?

Mr. DIMUCCIO. We believe addressing the systemic risk issue first and on a timely basis is important. We also believe that bringing in other regulatory aspects too soon to be resolved or debated while we are fixing the systemic risk regulatory issue could lead to unintended consequences.

We think they should be separated. There are a lot of regulatory issues that can be debated down the road, but we believe the systemic risk issue is important and that should be addressed first.

Chairman KANJORSKI. Very good. Mr. Ryan?

Mr. RYAN. I am a little bit of a broken record on this, but our hope is that you complete work on a financial stability regulator before the close of this year. Our main reason for saying that is not only do we need it, but the confidence in the financial markets and among our citizens, we think, requires it.

Chairman KANJORSKI. Thank you very much. Thank you all. The Chair notes that some members may have additional questions for this panel, which they may wish submit in writing. Without objection, the hearing record will be remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Before we adjourn, the following will be made a part of the record of this hearing: Documents provided by the American Council of Life Insurers; and the written statements of the National Association of Mutual Insurance Companies and the American Academy of Actuaries.

Without objection, it is so ordered.

The panel is dismissed and this hearing is adjourned.

[Whereupon, at 1:53 p.m., the hearing was adjourned.]

A P P E N D I X

March 5, 2009

Statement by Rep. Michele Bachmann
House Financial Services Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises

March 5, 2009

Thank you, Mr. Chairman.

This is the first in a series of hearings that our Committee has scheduled about the regulation of systemic risk in the financial services system. Unlike previous actions of late taken by Congress to address the financial markets, I am pleased that our Committee plans to take a more careful and thoughtful approach to this incredibly important matter. The American people deserve our due diligence on this matter. It's time we gave it to them.

The government reacted with a great deal of haste last year when the $700-billion Troubled Asset Relief Program (TARP) was rushed through Congress and the first $350-billion was spent within only a few weeks. At the time of its passage there were – and today there still are – many outstanding questions about this unprecedented program. Those overseeing TARP have struggled to explain where the money has gone and how it is impacting our markets. And American taxpayers have been left wondering where their money went and whether it was put to good use.

It is imperative that as we look toward this next step, Congress does not rush into passing a new regulatory regime of such significance without thoroughly examining what the necessary authorities should be, how they might be implemented effectively to ensure safety and soundness, and how unintended consequences could be avoided. And in order to answer these serious policy questions, it is critical that we better understand what happened in our marketplace to contribute to today's dismal environment.

We know that many mistakes were made by market participants across the financial sector that brought about the turmoil our nation has experienced. We know that the federal government played just as significant a role – from its implicit guarantee of Fannie Mae and Freddie Mac to its excessive encouragement of lower underwriting standards. And, we know that some borrowers across the nation made risky decisions, whether intentionally or not, and as home prices began to fall, their financial stability declined. Our Committee must continue to examine the details of these and other events surrounding the crisis in order to develop appropriate policies to reform our financial regulatory structure.

Chairman Frank has expressed his support for expanding the Fed and giving it the role of systemic risk regulator. But whether the Fed is capable of exercising a more comprehensive systemic risk responsibility, especially since it already has trouble fulfilling its missions of monetary policy and long-term economic stability, is an important question we must first answer. I'd actually argue that a full and open audit of

the Fed is in order. And I have joined several of my colleagues in asking for such transparency now.

The Fed has dramatically expanded its balance sheet by the trillions – something that actually poses systemic risk to the taxpayers in and of itself. And, just yesterday, the Fed announced its newest lending facility, the Term Asset-Backed Securities Loan Facility (TALF), which exposes taxpayers to another $200 billion risk.

Additionally, there are other regulators including the Securities and Exchange Commission (SEC) and the Office of the Comptroller of Currency (OCC) that we should examine to see whether the existing tools and resources they have are sufficient to weed out fraud and abuse in the financial markets.

I appreciate the Chairman holding this hearing and thank the witnesses for being here to discuss this important issue.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Perspectives on Systemic Risk

Thursday, March 5, 2009, 10:00 a.m, 2128 Rayburn House Office Building

Opening Statement – Congressman Ron Klein

Thank you, Chairman Kanjorski, for holding this important hearing.

In 1999, the Gramm-Leach-Bliley Act repealed the Glass-Steagall separation of commercial banking, investment banking, and insurance companies. These financial institutions entered into new markets with more diversified banking authority, yet Congress did not extend the regulatory framework to meet the challenges posed by this new financial order. Further, there are non-bank financial institutions that have not been integrated into the regulatory structure.

We currently have a fragmented and overlapping regulatory system. The Federal Reserve, FDIC, SEC, CTFC, and OCC are among the institutions that share responsibility for regulating the financial system in America, and this is just at the federal level. These regulatory bodies do not always function in a smooth, consistent or coordinated way, and in fact can sometimes have conflicting objectives.

Unfortunately, we are seeing the consequences of this faulty regulatory system today, and the current downturn shows the importance of smart regulation of the financial system in the future.

Yes, government regulation should always be done with a light touch, setting the rules of the game and ensuring the transparency of balance sheets and other essential documents related to the economic health of financial institutions. But government oversight is essential to the sound functioning of credit and asset markets and to ensuring that investors have the appropriate information to make knowledgeable decisions. Without proper regulation, financial institutions can build up an inappropriate amount of systemic risk which can endanger the entire economy.

Further, the current economic slowdown has been a global phenomenon, and it shows how interdependent financial markets and institutions have become. We must work with other countries to develop a basic framework for the operation of financial institutions in the global economy.

The time is now for Congress to move toward a simpler, smarter, and more comprehensive financial regulatory structure. I am pleased that there will be a series of hearings to determine the best way to regulate the U.S. financial system going forward, and I look forward to the testimony today.

MANAGED FUNDS ASSOCIATION

TESTIMONY
OF

RICHARD H. BAKER
PRESIDENT AND CHIEF EXECUTIVE OFFICER

MANAGED FUNDS ASSOCIATION

For the Hearing on

"Perspectives on Systemic Risk"

BEFORE THE

U.S. HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

MARCH 5, 2009

TESTIMONY OF MANAGED FUNDS ASSOCIATION

"Perspectives on Systemic Risk"
March 5, 2009

Managed Funds Association ("MFA") is pleased to provide this statement in connection with the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises' hearing, "Perspectives on Systemic Risk" held on March 5, 2009. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. MFA's members manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies around the world.

MFA appreciates the opportunity to express its views on the important subject of systemic risk regulation and the systemic relevance of the hedge fund industry. In considering the issue of systemic relevance, we believe that it is important to focus not just on potential risks to our financial system, but also on ensuring that systemically important institutions are able to perform their important market functions.

Hedge funds play an important role in our financial system, as they provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. Hedge funds engage in a variety of investment strategies across many different asset classes. The growth and diversification of hedge funds have strengthened U.S. capital markets and allowed investors means to diversify their investments, thereby reducing their overall portfolio investment risk. As investors, hedge funds help dampen market volatility by providing liquidity and pricing efficiency across many markets. Each of these functions is critical to the orderly operation of our capital markets and our financial system as a whole.

In order to perform these important market functions, hedge funds require sound counterparties with which to trade and stable market structures in which to operate. The recent turmoil in our markets has significantly limited the ability of hedge funds to conduct their businesses and trade in the stable environment we all seek. As such, hedge funds have an aligned interest with other market participants, including retail investors, and policy makers in reestablishing a sound financial system. We support efforts to manage systemic risk responsibly, and ensure stable counterparties and properly functioning, orderly markets.

Hedge funds were not the root cause of the problems in our financial markets and economy. In fact, hedge funds overall were substantially less leveraged than banks and brokers, performed significantly better than the overall market and have not required, nor sought, federal assistance despite the fact that our industry, and our investors, have

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suffered mightily as a result of the instability in our financial system and the broader economic downturn. We believe that the public and private sectors share the responsibility of restoring stability to our markets, strengthening financial institutions, and ultimately, restoring investor confidence. Hedge funds remain a significant source of private capital and can continue to play an important role in restoring liquidity and stability to our capital markets. The value of hedge funds (and other private pools of capital) as private investors has been recognized by Treasury Secretary Geithner in his proposals for a public/private investment fund and implementation of the Term Asset-Backed Securities Loan Facility, each of which is dependent on private investor participation to be successful. In addition to providing liquidity, managers of private pools of capital have significant trading and investing experience and knowledge that can assist policy makers as they continue to contemplate the best way to implement the Administration's Financial Stability Plan.

Regulatory reform will be an important part of stabilizing markets and restoring investor confidence, but it will not, in and of itself, be sufficient to do so. The lack of certainty regarding major financial institutions (*e.g.*, banks, broker dealers, insurance companies) and their financial condition has limited the effectiveness of government intervention efforts to date. Investors' lack of confidence in the financial health of these institutions is an impediment to those investors' willingness to put capital at risk in the market or to engage in transactions with these firms, which, in turn, are impediments to market stability. The Treasury Department's plan to conduct comprehensive stress tests on the 19 largest bank holding companies is designed to ensure a robust analysis of these banks, thereby creating greater certainty regarding their financial condition. Treasury's announcement that it plans to involve private asset managers in helping to value illiquid assets held by banks as part of the public/private investment fund recognizes the beneficial role that private asset managers can play in helping provide that certainty.

While "smart" regulation cannot, in and of itself, restore financial stability and properly functioning markets, it is a necessary component of any plan to achieve those ends. "Smart" regulation would include appropriate, effective, and efficient regulation and industry best practices that better monitor and reduce systemic risk and promote efficient capital markets, market integrity, and investor protection. Regulation that addresses these key issues is more likely to improve the functioning of our financial system, while regulation that does not address these key issues can cause more harm than good. We saw an example of the latter with the significant, adverse consequences that resulted from the SEC's bans on short selling last year.

A smart regulatory framework should also include comprehensive and robust industry best practices designed to achieve the shared goals of monitoring and reducing systemic risk and promoting efficient capital markets, market integrity, and investor protection. Since 2000, MFA has been the leader in developing, enhancing and promoting standards of excellence through its document, *Sound Practices for Hedge Fund Managers ("Sound Practices")*. As part of its commitment to ensuring that *Sound Practices* remains at the forefront of setting standards of excellence for the industry, MFA has updated and revised *Sound Practices* to incorporate the recommendations from

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the best practices report issued by the President's Working Group on Financial Markets' Asset Managers' Committee.

Because of the complexity of our financial system, an ongoing dialogue between market participants and policy makers is a critical part of the process of developing smart, effective regulation. MFA and its members are committed to being active, constructive participants in the dialogue regarding the various regulatory reform topics, including the primary topic of today's hearing, systemic risk regulation.

The first step in developing a systemic risk regulatory regime is to determine those entities that should be within the scope of such a regulatory regime. There are a number of factors that policy makers are considering as they seek to establish the process by which a systemic risk regulator should identify, at any point in time, which entities should be considered to be of systemic relevance. Those factors include the amount of assets of an entity, the concentration of its activities, and an entity's interconnectivity to other market participants.

As an Association, we are currently engaged in an active dialogue with our members to better understand how these factors, among others, may relate to the systemic relevance of all financial market participants – including our industry and its members. MFA and its members acknowledge that at a minimum the hedge fund industry as a whole is of systemic relevance and, therefore, should be considered within the systemic risk regulatory framework. We are committed to being constructive participants in the dialogue regarding the creation of that framework.

There are four primary components of a systemic risk regulatory framework that I will discuss today. Those components are: a central systemic risk regulator; confidential reporting of information to a systemic risk regulator; establishing a clear regulatory mandate to protect the financial system; and the scope of authority of the systemic risk regulator.

CENTRAL SYSTEMIC RISK REGULATOR

Under our current regulatory structure, systemic risk oversight is the responsibility of multiple regulatory entities, or worse, no one's responsibility. For systemic risk oversight to be effective, there must be oversight over the key elements of the entire financial system, across all relevant structures, classes of institutions and products, and an assessment of the financial system on a holistic basis. We believe that a single central systemic risk regulator should be considered to accomplish this goal. This central regulator should be responsible for oversight of the structure, classes of institutions and products of all financial system participants. MFA is engaged in discussions with its members with respect to which regulatory entity, whether new or existing, would be best suited for this role.

We believe that having multiple regulators with responsibility for overseeing systemic risk likely would not be an effective framework. Jurisdictional conflicts,

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unintended gaps in regulatory authority, and inefficient and costly overlapping authorities likely would inhibit the effectiveness of such a regulatory framework. Moreover, in a framework with multiple systemic risk regulators, no one regulator would be able to assess potential systemic risks from a holistic perspective, as no regulator would oversee the entire system.

CONFIDENTIAL REPORTING TO REGULATOR

MFA and its members recognize that for a systemic risk regulator to be able to adequately assess potential risks to our financial system, that regulator needs access to information. We support a systemic risk regulator having the authority to request and receive, on a confidential basis, from those entities that it determines (at any point in time) to be of systemic relevance, any information that the regulator determines is necessary or advisable to enable it to adequately assess potential risks to the financial system.

In considering the appropriate scope of this authority, we believe that it is important for the systemic risk regulator to have sufficient authority and flexibility to adapt to changing conditions and take a forward-looking view toward risk regulation. Attempting to pre-determine what information a regulator would need would not provide sufficient flexibility and likely would be ineffective as a tool to address potential future risks. We believe that granting the systemic risk regulator broad authority with respect to information gathering, along with ensuring that it has the appropriate resources and capabilities to effectively analyze that information, would be a more effective framework.

While we support a systemic risk regulator having access to whatever information it deems necessary or advisable to assess potential systemic risks, we believe that it is critical for such information to be kept confidentially and granted full protection from public disclosure. We recognize the benefit of a regulator having access to all important data, even potentially sensitive or proprietary information from systemically relevant entities. A systemic risk regulator can fulfill its mandate to protect the financial system without publicly disclosing all the proprietary information of financial institutions. We do not believe that there is a public benefit to such information being publicly disclosed.

Moreover, public disclosure of such information could be misleading, as it would likely be incomplete data that would be viewed by the public outside of the proper context. Public investors may be inclined to take action based on this data without fully understanding the information, which could lead to adverse consequences for those investors, for the investors in systemically relevant entities, and for the stability of the financial system as a whole. Public disclosure of proprietary information also harms the ability of market participants to establish and exit from investment positions in an economically viable manner. Such disclosure also could lead to systemically relevant entities being placed at an unfair competitive disadvantage compared to non-systemically relevant entities, as sensitive and proprietary information of only the systemically relevant entities would be publicly available.

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MANDATE TO PROTECT THE FINANCIAL SYSTEM

Setting a clear and specific mandate is important for any regulator to be effective. This is particularly true in a regulatory framework that has multiple regulatory entities, as a lack of clarity in the mandates of regulators can lead to gaps in oversight, or costly and inefficient overlapping regulation. We believe that the systemic risk regulator's mandate should be the protection of the financial system. Investor protection and market integrity should not be part of its mandate, but should instead be addressed by other regulatory entities. Congress should be clear in stating that the risk regulator should collect information only for its mandate to protect the financial system, and should not use that authority for other purposes.

To fulfill its mandate to protect the financial system, we recognize that the regulator would need to take action if the failure of a systemically relevant firm would jeopardize broad aspects of the financial system. Absent such a concern about broad systemic consequences, however, the systemic risk regulator should not focus on preventing the failure of systemically relevant entities. Systemically relevant market participants do not necessarily pose the same risks or concerns as each other. There likely are entities that would be deemed systemically relevant for purposes of reporting information, but whose failure would not threaten the broader financial system. For this reason, we believe that the systemic risk regulator should focus on preventing failures of market participants only when there is concern about the consequences to the broader financial system, and should not focus on preventing the failure of all systemically relevant entities.

Consistent with this mandate, the systemic risk regulator should not equate systemically relevant entities with entities that are too big, or too interconnected, to fail. An entity that is perceived by the market to have a government guarantee, whether explicit or implicit, has an unfair competitive advantage over other market participants. We strongly believe that the systemic risk regulator should implement its authority in a way that avoids this possibility and also avoids the moral hazards that can result from a company having an ongoing government guarantee against its failure.

SCOPE OF REGULATORY AUTHORITY

The last topic that I would like to address in my testimony is the scope of authority that a systemic risk regulator should have to fulfill its mandate to protect our financial system. There are a number of suggestions that various people have made as to the type of authority a systemic risk regulator should have. We continue to discuss with our members what the appropriate scope of authority should be for such a regulator.

We believe that whatever authority the regulator has should ensure that the regulator has the ability to be forward-looking to prevent potential systemic risk problems, as well the authority to address systemic problems once they have arisen. The systemic risk regulator's authority must be sufficiently flexible to permit it to adapt to changing circumstances and address currently unknown issues. An attempt to

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specifically define the regulator's authority must avoid unintentionally creating gaps in authority that would prevent the systemic risk regulator from being able to fulfill its mandate to protect the financial system in the future.

We do believe that the systemic risk regulator needs the authority to ensure that a failing market participant does not pose a risk to the entire financial system. In the situation when a failing market participant does pose such a risk, the systemic risk regulator should have the authority to directly intervene to ensure an orderly dissolution or liquidation of the market participant. The significant adverse consequences that resulted from the failure of Lehman Brothers, Inc. this past fall is an example of what can happen when there is not an intervention to prevent a disorderly dissolution of such a market participant. The continuing market disruption caused by the failure of Lehman Brothers also demonstrates the importance of ensuring that there is a coordinated global effort with respect to such interventions.

Whatever the scope of authority that a systemic risk regulator has, its implementation of that authority will be critical to the effectiveness of any regulatory regime. We believe that the systemic risk regulator should implement its authority by focusing on all relevant parts of the financial system, including structure, classes of institutions and products. Because systemic risk concerns may arise from a combination of factors, rather than from the presence of any particular factor, a holistic approach is more likely to successfully identify and assess potential systemic risks.

Recent coordinated efforts between the Federal Reserve Bank of New York (the "New York Fed") and industry participants provide a good example of how a systemic risk regulator could address systemic risk concerns posed by structural issues in our markets. In recent years, the New York Fed, working with MFA and other industry participants through the Operations Management Group ("OMG") and other industry-led initiatives has made notable progress in addressing concerns related to the over-the-counter ("OTC") derivatives market. Some of the more recent market improvements and systemic risk mitigants have included: (1) the reduction by 80% of backlogs of outstanding credit default swap ("CDS") confirmations since 2005; (2) the establishment of electronic processes to approve and confirm CDS novations; (3) the establishment of a trade information repository to document and record confirmed CDS trades; (4) the establishment of a successful auction-based mechanism actively employed in 14 credit events including Fannie Mae, Freddie Mac and Lehman Brothers, allowing for cash settlement; and (5) the reduction of 74% of backlogs of outstanding equity derivative confirmations since 2006 and 53% of backlogs in interest rate derivative confirmations since 2006.

In addition to these efforts, MFA, its members and other industry participants have been working with the New York Fed to expedite the establishment of central clearing platforms covering a broad range of OTC derivative instruments. We believe a central clearing platform, if properly established, could provide a number of market benefits, including: (1) the mitigation of systemic risk; (2) the mitigation of counterparty risk and protection of customer collateral; (3) market transparency and operational

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efficiency; (4) greater liquidity; and (5) clear processes for the determination of a credit event (for CDS).

CONCLUSION

Hedge funds have important market functions, in that they provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries. MFA and its members acknowledge that smart regulation helps to ensure stable and orderly markets, which are necessary for hedge funds to conduct their businesses. We also acknowledge that active, constructive dialogue between policy makers and market participants is an important part of the process to develop smart regulation. We are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA appreciates the opportunity to testify before the Subcommittee. I would be happy to answer any questions that you may have.

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Statement of

The Honorable Steve Bartlett

President and Chief Executive Officer

The Financial Services Roundtable

Before the

House Financial Services Subcommittee on

Capital Markets, Insurance, and Government Sponsored Enterprises

U.S. House of Representatives

March 5, 2009

Chairman Kanjorski, Ranking Member Garrett, and members of the Committee, I am Steve Bartlett, the President and CEO of the Financial Services Roundtable (Roundtable). The Roundtable is a national trade association composed of the nation's largest banking, securities and insurance firms. Our members provide a full range of financial products and services to consumers and businesses, accounting directly for $85.5 trillion in managed assets, $965 billion in revenue, and 2.3 million jobs.

I would like to begin my remarks by commending you and all the members of this Committee for your efforts to restore stability and liquidity to the markets. Equally important to restoring stability and liquidity is implementing policy reforms to prevent a recurrence of these events.

The financial crisis exposed critical gaps in financial regulation, as well as the absence of a method for comprehensive oversight of our financial system. Consider our current regulatory structure which was created in piecemeal fashion beginning in 1912 and through a series of incremental changes through 1999; these changes didn't build upon one another logically, but often added another regulatory structure or feature that would sometimes conflict with the existing structure. This system seemed to withstand time – but over the last two years, at the onset of the current crisis, the system got pulled down by the weight of hundreds of federal and state agencies that regulate the U.S. financial services industry today, often in an ad hoc way. To say the financial regulatory system is fragmented or uncoordinated would be an understatement.

Webster's Dictionary defines "systemic" as "of, relating to, or common to a system." I've been asked to provide the Roundtable's view of a systemic risk regulator, which the Roundtable refers to as a market stability regulator. In light of the regulatory gaps and "weight," it is important first to look at how that regulator fits into broader financial reform, because, by definition, to consider regulation that simply "bolts" a new regulator onto the existing chassis may not result in a reduction of risk that is "systemic" in nature.

My testimony is divided into three parts. First, I will outline how a market stability regulator should fit within our larger financial regulatory structure. Second, I will discuss the need for a market stability regulator to identify systemic risk. Third, I will propose a definition of a systemic risk and discuss the role and structure of a market stability regulator.

I. Market Stability and Our Financial Regulatory Structure

The creation of a market stability regulator is just one piece of the bigger puzzle – the need for better, more effective financial regulation that can evolve with global financial markets. In recent testimony, Federal Reserve Chairman Ben Bernanke identifies the need for better regulation stating, "As we look at regulatory reform, we need to ask the question, are all sectors of the economy that need oversight – are they being watched by somebody and/or are there major gaps where there's no effective oversight where there needs to be? That's. . . a very basic

aspect of the reform that Congress needs to address."[1] As such, the Roundtable recommends that Congress consider the market stability regulator's role within the broader need for sweeping reform of our regulatory architecture.

Like others in the financial services industry, the members of the Roundtable have been engaged in a dialogue over how to reform our current financial regulatory system. While our internal discussions continue, we have developed a set of proposals, including a "Financial Regulatory Architecture Proposal" that is intended to close the gaps in our existing system.

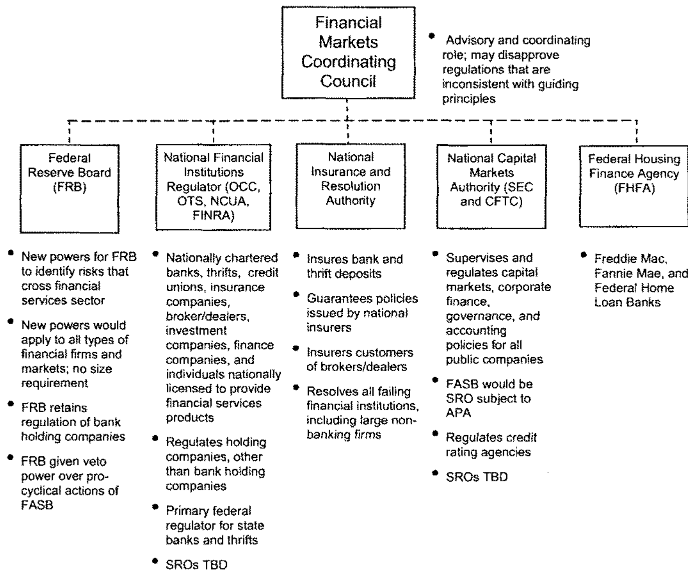
Specifically, the Roundtable's proposals for regulatory reform are:

- **New Architecture.** *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*

The key features of our proposed regulatory architecture are explained below, and are illustrated in the following chart.

[1] Testimony of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Feb. 24, 2009.

FINANCIAL REGULATORY ARCHITECTURE PROPOSAL



Financial Markets Coordinating Council

To enhance coordination and cooperation among the various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it the Financial Markets Coordinating Council (FMCC). We believe that this Council should be established by law, in contrast to the existing PWG, which has operated under a Presidential Executive Order since 1988, thereby permitting this Committee and the Congress to oversee the Council's activities on a regular and ongoing basis. We also believe that the

Council should include representatives from all major federal financial agencies, as well as individuals who can represent state banking, insurance, and securities regulation.

This Council should serve as a forum for national and state financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections. In other words, it should help to better coordinate policies within our fragmented regulatory system.

We do not believe that the Council should have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of federal and state financial agencies, and thereby ensure that they are consistent.

Federal Reserve Board

As I will discuss below in more detail, to address systemic risk, the Federal Reserve should be authorized to act as a market stability regulator. As a market stability regulator, the Federal Reserve should be responsible for looking across the entire financial services sector to identify interconnections that could pose a risk to our financial system and to perform the functions that I describe below.

National Financial Institutions Regulator

To reduce regulatory gaps and arbitrage, we propose the consolidation of several existing federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for three broad sectors of the financial services industry: banking, securities, and insurance.

More specifically, this new agency would charter, regulate, and supervise: (1) banks, thrifts, and credit unions, currently supervised by the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration; (2) licensed broker/dealers, investment advisors, investment companies, futures commission merchants, commodity pool operators, and other similar intermediaries currently supervised by the Securities and Exchange Commission (SEC) or the Commodities Futures Trading Commission (CFTC); and (3) insurance companies and insurance producers that select a federal charter. The AIG case illustrates the need for the federal government to have the capacity to supervise insurance companies. A federal insurance regulator also is needed to work with the Federal Reserve in its capacity as a market stability regulator.

With the exception of holding companies for banks, the NFIR would be the regulator for all companies that control broker/dealers or nationally chartered insurance companies.

The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these nationally chartered or licensed entities. For example, national banks, federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards.

In the area of mortgage origination, we believe that the NFIR's prudential and consumer protection standards should apply to both national and state lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate. Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

We believe that is it important for this agency to combine both safety and soundness (prudential) regulation and consumer protection regulation. Both functions can be informed, and enhanced, by the other. Prudential regulation can identify practices that could harm consumers, and can ensure that a firm can continue to provide products and services to consumers.

National Capital Markets Agency

To focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency (NCMA) through the merger of the SEC and the CFTC, preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as broker/dealers, investment companies, investment advisors, futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

National Insurance and Resolution Authority

To protect depositors, policyholders, and investors, we propose the National Insurance and Resolution Authority (NIRA) to manage insurance mechanisms for depository institutions, federally chartered insurance companies, and federally licensed broker/dealers. These three insurance systems should be legally and functionally separated. Additionally, this agency should be authorized to act as the receiver for large non-bank financial services firms. The failure of Lehman Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

Federal Housing Finance Agency

Finally, to supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing Government Sponsored Enterprises (GSEs) in our economy.

The Roundtable's other proposals on regulatory reform include:

- **Common Prudential and Consumer and Investor Protection Standards.** *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide.*

- **Balanced and Effective Regulation.** *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*

- **International Cooperation and National Treatment.** *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should*

continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.

- **Accounting Standards.** *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

II. Why We Need a "Market Stability and Systemic Risk" Regulator

The on-going crisis in our nation's financial markets demonstrates the need for some federal agency or authority to act as a market stability regulator. This crisis is not the result of any single action, but the result of multiple, unconnected actions taken across industry sectors. Yet, throughout the run-up to this crisis, no single agency was monitoring the connections between different market participants across the nation's financial markets.

The creation of an agency that was charged with monitoring activities and practices across all markets may not have been able to prevent this crisis but may have been able to put the pieces together sooner and propose corrective actions before this crisis occurred, rather than after.

While it is often assumed that some combination of the U.S. Treasury Department (Treasury) and the Federal Reserve Board (Federal Reserve) are responsible for broad financial market stability, neither the Treasury nor the Federal Reserve has the explicit mandate and the full arsenal of regulatory powers to promote market stability and prevent systemic risk across different company charters and products.

Prior to 2008, the only authority the Secretary of the Treasury (Secretary) had to look at the financial markets as a whole was the authority delegated to the Secretary by the President (through an Executive Order) in 1988 to chair and convene the PWG. The PWG could only ask regulators to cooperate on key issues and issue occasional reports. In 1991, the Congress gave the Secretary a pivotal role in the implementation of the systemic risk exception to the Federal Deposit Insurance Corporation's (FDIC) least-cost resolution process. Under that process, the Secretary, in consultation with the President, must agree that paying uninsured depositors or creditors "would have serious adverse effects on economic conditions or financial stability" and as such, the FDIC would have the power to intervene in the market to address systemic risk.[2] Yet, the *FDIC Improvement Act* did not give the Secretary any additional responsibilities, either

[2] 12 U.S.C. § 1823(c)(4)(G)(I)(i).

to determine what constitutes systemic risk, to more closely monitor systemically relevant institutions, or to make any detailed reports about its analysis when this exemption is invoked.

The Federal Reserve plays multiple roles in financial markets, yet does not have an explicit market stability mandate or clearly defined role to identify and prevent systemic risk to U.S. financial markets. As the nation's central bank, it has broad monetary policy tools to promote price stability and full employment in the U.S. economy. It oversees part of the U.S. payments system, but not all. It regulates and supervises state-member banks at the national level, but not national banks, which are regulated by the OCC or state nonmember banks, which are regulated by the FDIC. It regulates and supervises all bank and financial holding companies, but not thrift holding companies, which are regulated and supervised by the OTS, or investment bank holding companies, which are supervised by the SEC. It lends to financial institutions through normal discount window operations. Starting in 2008 during the current crisis, the Federal Reserve greatly expanded its emergency lending to financial institutions and others using its authority to lend in Section 13(3) during "unusual and exigent circumstances."[3] But even in these roles, the Federal Reserve's market stability activities are confined mainly confined to *reactive* actions and financing vehicles under its unique lending powers.

The missing link is a single federal authority with the mandate, responsibility, and expertise to oversee the nation's entire financial system, not just its individual parts, and to promote market

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[3] 12 U.S.C. § 342.

stability while preventing systemic risk for firms that operate in this global marketplace. This would resolve the regulatory redundancy that currently creates the gaps in oversight.

III. "Systemic Risk" and the Role and Structure of a Market Stability Regulator

Systemic risk could be related to the size of an institution, counterparty risks, accounting treatment of investment vehicles or the diversity of customer relationships. We do not believe that this risk should be associated with any single factor, especially the size of an institution. In our view, systemic risk is a significant, industry-wide threat or vulnerability based on market interconnections and regulatory gaps across the financial services industry as a whole (including products, markets, and firms), which, if left unaddressed, could have material and adverse effects on either our financial markets or the U.S. economy.

In other words, systemic risk is not an isolated risk posed by a single institution or a solitary practice. It is a risk that crosses market segments as well as whole markets, domestic and globally, in addition to firms.

Several respected authorities have suggested that systemic risk regulation should be focused on the nation's largest financial services firms. We do not support this approach. While large firms can create large risks, systemic risks can arise from the collective actions of many firms, both small and large. Moreover, the classification of large firms as "systemic" not only would create

a competitive imbalance between those and other firms, but it also would give rise to a "moral hazard" as systemic firms were perceived as "too big to fail."

In hindsight, we now can identify some of the practices and activities from the current crisis that, collectively, created a "systemic risk" to the economy. These include underwriting standards based on short-term adjustable rates, not rates over the term of a loan; securitizations based only upon a credit rating, with little due diligence by investors; and pro-cyclical capital standards that promoted the development of off-balance sheet vehicles. Individually these actions did not give rise to systemic risk, but collectively they did.

One of the challenges in identifying systemic risk is not to discourage innovation. Indeed, innovation is important to economic growth and development. Therefore, in the design of a market stability regulator, Congress should explicitly instruct the regulation to balance market stability with innovation.

Within the Roundtable's proposed architecture, which I described above, we believe the Federal Reserve should be authorized to act as a market stability regulator.

As the market stability regulator, the Federal Reserve should have the ability to monitor broad market trends to discover potential vulnerabilities and significant risks to the financial system and our economy at the earliest possible stage. It should have the authority to collect

information on all types of financial services firms, including depository institutions, broker/dealers, insurance companies, hedge funds, private equity firms, industrial loan companies, credit unions, and any other financial services firms that facilitate financial flows (e.g., transactions, savings, investments, credit, and financial protection) in our economy.

Like the National Weather Service, a market stability regulator should be able to monitor and study the financial "weather," analyze and report on developing conditions and trends, and issue public alerts as necessary when there is hurricane forming or a winter storm heading our way. In other words, the market stability regulator should have the authority to establish an activities-based surveillance system to detect early crisis warning signs and vulnerabilities, develop scenario planning, conduct contingency planning with other financial regulators across all financial markets, and, in exceptional cases, examine individual financial services firms in conjunction with the prudential regulator for a firm.

This next point is critical: the market stability regulator must be in a position to work with other regulators to enforce the proper corrective action to identify, prevent and address systemic risks, regardless of whether that action is taken against a set of institutions that are deemed to be systemically relevant or against a particular activity that spans a range of institutions with different types of charters or business licenses. In other words, the market stability regulator should not be a "super regulator." This ensures a solid working relationship between the market

stability regulator and prudential regulators and ensures that individual prudential regulators are sensitive to larger systemic risks. Today we spend more than $5 billion for the direct cost of financial supervision, not counting the cost of compliance, and not a single agency adequately saw the crisis coming or took any precautionary actions until it was too late. We can no longer afford a financial regulatory system in which individual regulators remain in a "silo." It also warrants a system in which no company will be subject to two regulators with conflicting regulations.

This brings me to a related issue. As the market stability regulator interacts with prudential regulators, there is an evident need to create a national insurance regulator for the insurance industry. Insurance is a national and global business and yet, it lacks a national insurance prudential regulator. In response to a direct question posed at last week's full committee hearing, Federal Reserve Chairman Bernanke further emphasized this point when he said that he thought "it would be a useful idea to create a federal option for insurance companies," particularly "systemically important ones."[4] Effective systemic risk regulation should include a strong national insurance regulator with the authority to charter companies and to establish uniform national standards for market conduct and consumer protection activities. Only through coordination with a national insurance regulator, will a market stability regulator have the ability to both detect, and to act upon, risky market activity and business practices in a timely, uniform, and comprehensive fashion. Asking the market stability regulator to coordinate actions by

[4] Testimony of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Financial Services, U.S. House of Representatives, Feb. 25, 2009.

multiple state insurance regulators is not an option that will effectively address systemic risk due to the different state and territorial insurance regulators, with varying legal and budget authority, and varying levels of expertise.

A national insurance regulator should have the authority to charter insurance companies, establish and enforce uniform national standards for all factors material to the solvency of nationally chartered insurance companies and the protection of consumers, and represent the U.S. internationally on behalf of federally chartered institutions. The national insurance regulator's authority should be an independent bureau within a federal agency headed by a Presidential appointee.

Some may say that creating a national insurance regulator creates regulatory redundancy. The Roundtable does not believe this is accurate. Just as the state/federal banking system works well for the industry and the economy – so too can a similar insurance system. It would provide companies the ability to decide which system works best to serve their customers, a state or a national system. Regardless, there should be common principles in the national and state insurance systems. We commend Congresswoman Melissa Bean and Congressman Ed Royce for their tireless work on this specific issue, and we look forward to working with this Subcommittee toward the creation of the national insurance regulator to enhance stability in our national insurance markets and reduce systemic risk in the future.

The only time we would recommend that the market stability regulator intervene and effectively preempt the primary regulator would be in a significant, systemic market emergency, when it needs to react swiftly to market developments that pose an immediate and equally significant risk to our economy. After such immediate risk, the market stability regulator will return to a normal course of action and work in conjunction with the primary prudential regulator, as I previously described. In any event, the Roundtable would still recommend that emergency actions should be approved by a super-majority of the Federal Reserve and agreed to by the Secretary of the Treasury, following consultation with the President. Such emergency actions should be reported immediately to the public.

Some have suggested that granting the Federal Reserve the authority to act as a market stability regulator would create conflicts due to the Federal Reserve's current mandates. However, we believe it's just the opposite. In layman's terms, the Federal Reserve's charter gives it the authority to protect the economy. While looking at "systemic risk" as the market stability regulator – the risk posed to the industry as a whole and the economy – the Federal Reserve will be doing just that – protecting the economy.

Conclusion

Mr. Chairman, I again commend this Committee for discussing an important issue that must be addressed – the need for a market stability regulator is a necessary first step in broader reform of

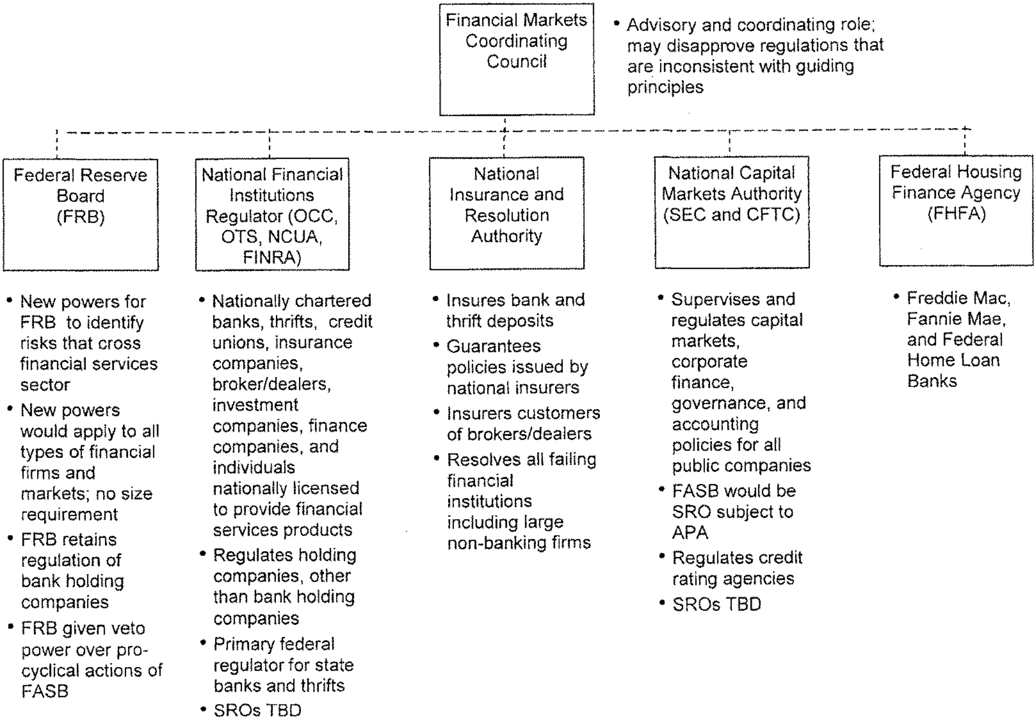
our financial regulatory architecture. We must be able to explain with confidence how our financial markets will be strengthened and what a new regulator would do differently to prevent this kind of turmoil in the future. The crisis, while devastating, does afford us the opportunity to build a state-of-the-art regulatory apparatus, and that apparatus should be carefully considered.

While looking at the role of a market stability regulator, you should not lose sight of the forest through the trees — and examine the role of this regulator in the larger regulatory reform that is required. Broader regulatory reform is important not only to ensure that financial institutions continue to meet the needs of all consumers, but also to restart economic growth and much needed job creation. We need a financial system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy, a modern financial regulatory system unrivaled anywhere in the world.

As President Lincoln said in his first inaugural address, "The dogmas of the quiet past are inadequate to the stormy present. The occasion is piled high with difficulty, and we must rise -- with the occasion. As our case is new, so we must think anew, and act anew." The Roundtable is poised and ready to work with you – to think anew and act anew - on these initiatives, starting with the creation of a market stability regulator and regulatory restructuring of our financial industry.

THE FINANCIAL SERVICES ROUNDTABLE

FINANCIAL REGULATORY ARCHITECTURE PROPOSAL



THE FINANCIAL SERVICES ROUNDTABLE
PROPOSAL FOR FINANCIAL REGULATORY REFORM

In anticipation of the most sweeping financial regulatory reforms since the Great Depression, the Financial Services Roundtable's Executive Advisory Council on Regulatory Restructuring has developed six proposals for financial regulatory reform. The first proposal addresses the need for a modern financial regulatory architecture, and the remaining proposals address new regulatory standards to guide the behavior of all financial services firms and regulators.

Six Proposals for Financial Regulatory Reform

1. New Architecture. *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*

2. Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide.*

3. Balanced and Effective Regulation. *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*

4. International Cooperation and National Treatment. *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.*

5. Failure Resolution. *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*

6. Accounting Standards. *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

THE FINANCIAL SERVICES ROUNDTABLE
PROPOSAL FOR FINANCIAL REGULATORY REFORM

Discussion of Proposals

The on-going crisis in world financial markets has revealed both market failures and fundamental weaknesses in the U.S. financial regulatory system. Our fragmented financial regulatory system has resulted in gaps in regulation, which allowed imprudent lending and investment practices by both regulated and unregulated financial firms. Our diverse national and state financial regulatory agencies do not share a common vision and approach to supervision. There is no coordinating body where all regulators can meet to identify problems, exchange information, and devise solutions. Our rules-based system of regulation makes it difficult for regulators and firms to adjust policies and practices in response to rapidly changing market developments.

The Roundtable's six proposals are intended to guide the reform of the financial regulatory system. The Proposals would not only enable regulators to focus on desired policy outcomes and material risks to markets, but also reduce the potential for consumers to fall through gaps between the national and state legal and regulatory systems.

Proposal 1. New Architecture — *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*

Proposal 1 calls for the existing financial regulatory system to be better aligned with modern market conditions. The "Draft Financial Regulatory Architecture" that is described below is one possible approach to meeting this proposal. The "Draft Financial Regulatory Architecture" is designed to: preserve state financial regulation; provide for greater coordination among all financial regulators; provide for national regulation for insurance companies and insurance producers; reduce regulatory overlap; promote uniform regulation and supervision; limit systemic risk; and create a failure resolution mechanism for non-banking financial firms.

Financial Markets Coordinating Council

To enhance coordination and cooperation among the many and various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it as the Financial Markets Coordinating Council (FMCC). This Council should be established by law, in contrast to the existing PWG which has operated under a Presidential Order. This would permit Congress to oversee its Council's activities. The Council should include representatives from all major federal financial agencies, as well as individuals who can represent state banking, insurance and securities regulation. The Council should serve as a forum for national and state financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections.

THE FINANCIAL SERVICES ROUNDTABLE

PROPOSAL FOR FINANCIAL REGULATORY REFORM

The Council should not have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of federal and state financial agencies, and thereby ensure that they are consistent.

Federal Reserve Board

To address systemic risk, the Federal Reserve Board (Board) should be authorized to act as a market stability regulator. As a market stability regulator, the Board should be responsible for looking across the entire financial services sector to identify interconnections that could pose a risk to the financial system. To perform this function, the Board should be empowered to collect information on financial markets and financial services firms, to participate in joint examinations with other regulators, and to recommend actions to other regulators that address practices that pose a significant risk to the stability and integrity of the U.S. financial services system. The Board's authority to collect information should apply not only to depository institutions, but also to all types of financial services firms. This authority should not be based upon the size of an institution. It is possible that a number of smaller institutions could be engaged in activities that collectively pose a systemic risk. As the market stability regulator, the Board must work in coordination with the primary regulators of the financial services firms.

National Financial Institutions Regulator

To reduce gaps in regulation, we propose the consolidation of several existing federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for banking, securities and insurance. The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these of nationally chartered or licensed entities. For example, national banks, federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards. Each industry would be legally and functionally separated within the NFIR.

In the area of mortgage origination, the NFIR's prudential and consumer protection standards should apply to both national and state lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate. Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

National Capital Markets Agency

To focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency through the merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC),

preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as broker/dealers, investment companies, investment advisors, and futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

National Insurance Resolution Authority

To protect depositors, policyholders, and investors, we propose the creation of the National Insurance and Resolution Authority (NIRA) to act as the insurer of bank deposits, the guarantor of retail insurance policies written by nationally chartered insurance companies, and a financial backstop for investors who have claims against broker/dealers. These three insurance systems would be legally and functionally separated. Additionally, this agency should be authorized to act as the receiver for large non-bank financial services firms. The failure of Lehman Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

Federal Housing Finance Agency

To supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing GSEs in our economy.

Proposal 2. Common Prudential and Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide.*

This proposal calls for comparable prudential standards (e.g., capital requirements and financial reporting) for financial services firms engaged in comparable activities. Such standards would reduce the potential for regulatory arbitrage and the potential for gaps in regulation. The proposal also calls for comparable consumer and investor protection standards for specific financial products and services. For example, residential mortgage loans should be subject to the same consumer protection standards regardless of what type of entity offers the loan. This would ensure that consumers are protected, regardless of where they live.

THE FINANCIAL SERVICES ROUNDTABLE

PROPOSAL FOR FINANCIAL REGULATORY REFORM

Proposal 3. Balanced and Effective Regulation — *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*

Balanced, effective regulation requires: (i) greater reliance on principles-based regulations that are responsive to changes in market conditions and are focused on desired regulatory results; (ii) greater reliance on a system of prudential supervision that is based upon an on-going exchange of information between regulated firms and regulators that seeks to solve common problems before they pose a risk to consumers or the financial system; and (iii) a reduction in the pro-cyclical effects of accounting and capital requirements.

Proposal 4. International Cooperation and National Treatment — *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.*

This proposal calls for the coordination of international financial regulations and the continuation of the national treatment for foreign firms doing business in the United States. The on-going financial crisis indicates that global financial markets require coordination and cooperation among financial regulatory authorities. Also, the benefits of national treatment for foreign firms operating in the U.S. are proven. National treatment promotes open, fair competition not only in the U.S., but abroad.

Proposal 5. Failure Resolution — *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*

This proposal calls for the establishment of orderly resolution procedures to apply to large non-banking firms. The failure of Lehman Brothers illustrated the limitations of existing receivership procedures. As discussed above, it is envisioned that the National Insurance Resolution Agency would perform this function.

Proposal 6. Accounting Standards — *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

This proposal calls for a review of the use of current accounting standards, such as fair value accounting and impairment accounting, when there is an illiquid market. Accounting requirements to write-down securities to observable prices encourages some companies to sell

sooner than they otherwise would, further depressing prices in an illiquid market. Problematic pro-cyclical effects have created further problems in the areas of purchase accounting, accounting for annual pension expenses, mergers/acquisitions, adjustment of loan loss reserves, and auction rate securities. This proposal also recommends that the U.S. work with International Regulators to develop and harmonize accounting standards around the globe, providing both U.S. and foreign companies the opportunity to remain competitive in a global marketplace.

Testimony of Robert A. DiMuccio
President & Chief Executive Officer of Amica Mutual Group
On Behalf of the Property Casualty Insurers Association of America (PCI)
Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
United States House of Representatives
Thursday, March 5, 2009

Chairman Kanjorski, Ranking Member Garrett, and other Members, thank you for this opportunity today to present specific solutions for addressing our systemic risk crisis. My name is Bob DiMuccio, and I am President and CEO of Amica Mutual Insurance Company. Amica is a hundred year old Rhode Island company that issues personal lines insurance products, such as auto home and excess liability, to consumers throughout the country. Amica stands as a leader in its financial security and is known for its world class customer service. I am appearing today on behalf of PCI, the leading property-casualty insurer trade association representing more than 1,000 insurers of all different lines and sizes.

I have 5 main points today:

(1) The property casualty industry is stable, did not cause this crisis and is not seeking federal assistance;

(2) As consumers, we are negatively impacted by ongoing market instability since as insurers, we invest our own money;

(3) Strengthened systemic risk oversight is the critical first priority for market stability that Congress needs to enact before considering comprehensive reform;

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(4) There is an effective and politically achievable solution for overseeing and managing systemic risk; and

(5) PCI is committed to working responsively and constructively with your leadership.

First though, I would like to underscore that the property casualty industry did not cause the economic crisis and overall, is managed successfully for solvency at the state level. There were no property-casualty insolvencies last year, despite suffering the fourth most expensive hurricane in our history and the greatest market crash in half a century. The vast majority of industry credit ratings were stable last year, with AM Best actually announcing more property-casualty rating upgrades than downgrades. The surplus that stands behind our policies remains at relatively strong levels and almost all segments of our marketplace remain stable and sound. Unlike the capital and credit markets, our insurance operations have proceeded uninterrupted. The historical level of insolvencies in the p/c and life industry over the last several decades as a percentage of industry assets have been much lower than that of the banks and far lower than that of the perennially troubled thrift industry. And, PCI has reiterated that our industry neither needs nor wants federal help.

Our industry has suffered deeply from this crisis, but, in the same manner as any other American consumer – significant investment losses and decline in economic activity. Unlike many other financial providers, we invest our own money. While we do so very conservatively without excess leveraging, we share Congress's interest in stabilizing the market and fixing the systemic risk regulatory gaps.

Former Federal Reserve Board Chairman Alan Greenspan admitted to this Committee that the current crisis was caused in part by the failure of financial institutions to monitor and manage their capital and risk positions, and the failure of our existing regulatory system to limit

such risks. Congress created systemic risk oversight in the Gramm-Leach-Bliley Act in 1999. Let me quote a Board speech immediately following GLBA's enactment:

> the Board will need to focus on "the systemic risks posed by large, complex, and diversified financial services companies [while having] to avoid imposing an excessive or duplicative regulatory burden and avoid creating a false impression that the benefits of the federal safety net extend to non-bank activities....We must be cautious, however, in assuming that the more diversified banking organizations will be inherently less risky and hence less likely to be a source of systemic risk. Past experience with consolidation in banking and geographic diversification suggests that banking organizations often use the benefit gained from diversification to increase the risk of individual components of their portfolios....What remains clear, however, is that appropriate disclosure and strong risk-management practices will become even more important in the years ahead, especially for larger banking organizations.... These challenges will require a new relationship between the Federal Reserve and the functional regulators of banks' insurance and securities affiliates. And they will place a premium on cooperation and appropriate information sharing [with] the Federal Reserve as umbrella supervisor...."

Ironically, ten years ago the Board described exactly what needed to be done and the course that led to our failure.

So, what went wrong? Congress first tried to create systemic risk oversight in the GLBA by making the Federal Reserve Board an umbrella supervisor. But the Board was given systemic risk oversight only over financial holding companies, not thrifts or thrift holding companies such as Indymac, Countrywide, Merrill Lynch, and Washington Mutual; not investment bank holding companies such as Lehman Brothers or Bear Stearns; and not other entities such as derivatives firms not subject to GLBA systemic risk oversight. Not only did systemic risk oversight apply to a too-limited universe of entities, but the focus was on the risk of other affiliates to the bank and the systemic risk of the banks to the larger economy. We now understand that systemic risk is not solely bank-centric. Greenspan now admits that the risk models created were inadequate, particularly to guard against irrational systemic behaviors. And the need for institutionalized and systematic information sharing envisioned at the time was never adequately realized.

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These are the precise gaps that need to be addressed immediately, and that can be fixed quickly using the existing regulatory structure. Then, if necessary to address the Congressional imperatives, larger regulatory reform and solvency oversight could be analyzed in a second phase.

PCI proposes beginning with the definition of systemic risk: which for financial institutions is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects. Simply put, if the government has to step in to bail out a company to protect the larger economy, that's a systemic risk.

The requisite threshold for a government rescue has to date not been fully articulated. Older metrics focused primarily on size, with the traditional antitrust analysis based on "Too Big to Fail." Recent government intervention decisions, however, have shifted away from a Too Big to Fail approach towards a more pertinent analysis that PCI and many others have termed "Too Interconnected to Fail."

There are two primary measurements for Too Interconnected to Fail: First: to what extent are a company's activities leveraged throughout the economy such that the company's impairment would cause additional impairments; Second: to what extent is a company's risk of failure correlated with other systemic waves or economic downturns. For example, even the failure of a very large auto insurer would not require significant deleveraging by hedge funds and other third parties or create a ripple effect of supply company failures; its market share would be quickly absorbed by competitors, and the number of auto accidents does not increase in a recession. Conversely, credit default swaps or payment risk insurance such as large scale mono-line financial guarantees, are often further leveraged by third parties, in a more concentrated

marketplace, and an economic downturn increases the likelihood of payment default, with the company's impairment exacerbating the recession.

So, it is not a question simply of size or industry, but rather the systemic risk characteristics of a company's aggregate activities at issue. (See the attached Appendix – Systemic Risk Defined.) Few lines of property-casualty insurance, and few P/C insurance companies, pose significant systemic risk (See Appendix – Insurance Line Systemic Risk Grouping.) Among the few might be financial obligation insurance (e.g. mono-line financial guaranty and mortgage guaranty). (See Appendix – Financial Obligation Insurance: Systemic Risk Differences.)

To address the current economic crisis, restore investor confidence, and prevent another economic disaster from reoccurring, a systemic risk overseer should be created. The Federal Reserve Board should serve as the systemic risk overseer as it has the appropriate mission and expertise. However, the Federal Reserve Board's systemic risk oversight should be completely separate from other bank holding company oversight powers.

Incorporating Congressional imperatives, PCI recommends a three-tiered regulatory approach that is flexible and to match Federal Reserve Board umbrella oversight to the level of systemic risk. (See attached Appendix – Systemic Risk Oversight Proposal.)

1. Appropriate transparency and disclosure to overseers for all entities within the regulatory jurisdiction;
2. Escalating information sharing with other U.S. and international overseers as a company's systemically risky activities increase; and

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3. Risk management for specific entities whose financial activities present a significant systemic risk.

Jurisdiction would include any institution engaged in financial activities that in aggregate presents a significant systemic risk. Also included, would be any institution engaged in financial activities that chooses to submit to federal systemic risk oversight, such as for international equivalency treatment.

However, systemic risk oversight powers would not include the following:

1. Solvency oversight for individual companies;
2. Business conduct oversight, such as licensing, market conduct, or product approval;
3. Duplicative disclosure or transparency information requirements;
4. General federal compliance, such as privacy standards; and
5. Other elements of bank holding company oversight.

Regarding oversight of risk management, oversight standards could consist of:

1. Overseeing holding company capital standards and group risk management;
2. Monitoring of affiliate transactions and significant off-balance sheet obligations;
3. Collecting and sharing information related to group systemic risk and holding company solvency;
4. Requiring coordination of examinations and visits regarding systemic risk; and
5. Eliminating duplicative oversight of holding companies.

Two other critical gaps in systemic risk regulation that need to be swiftly addressed are to increase coordination of oversight efforts to prevent and detect financial fraud, both domestically and internationally, and to promote sharing of existing financial holding company information among financial services regulators, both nationally and internationally, to improve early warning risk monitoring. Again, these gaps can be relatively easily addressed without imposing significant new burdens or requiring fundamental changes in our regulatory structure. In 2001 this Committee and the House passed nearly unanimously, with very broad industry and consumer support, the Anti-Fraud Network Act (H.R. 1408), institutionalizing regulator fraud information sharing – the type of system that the prosecutor in the Madoff scandal also recently testified was necessary. PCI also proposes requiring the Presidential Working Group on Financial Markets to develop and implement a plan for limited information sharing coordination with international overseers regarding holding company solvency and potential threats to cross-border market stability, focused on group level financial information related to solvency, such as capital levels and off-balance sheet or significant cross-affiliate obligations. (See Appendix – Information Sharing Proposal.)

These proposals are practical solutions that address systemic risk and holding company oversight concerns. The Federal Reserve Board already sets consolidated capital requirements, monitors affiliate transactions, and guards against systemic risks. As required under GLBA, it also relies on the primary regulators, such as the Securities Exchange Commission (SEC) and state insurance regulators, to oversee the solvency and business conduct of the individual subsidiaries and to pass along critical information. Solving the systemic risk crisis does not require a vast new bureaucracy or radical restructuring of our regulatory system. It does require addressing the loopholes and refocusing the existing system of holding company systemic risk

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regulation that, in hindsight, was clearly too limited. Congress can ensure that a strengthened systemic risk overseer and information sharing system works in tandem with the existing primary functional regulators.

Three final points:

(1) Consolidation of federal banking agencies, restructuring of the SEC, and regulation of derivatives are issues Congress needs to think through very carefully. But we need investor confidence in systemic risk oversight now; and focused systemic risk oversight can be accomplished quickly with minimum new bureaucracy and without unintended, negative consequences.

(2) Don't let outside groups try to confuse solvency with systemic risk regulation as part of a "Super-Size Us" regulatory agenda to collapse the multiple banking regulators into three cross-industry regulators for systemic risk, market conduct, and solvency. Solvency regulation is done by functional regulators to ensure that individual companies have sufficient capital to fulfill their promises. Systemic risk regulation is macro oversight by the Federal Reserve Board to prevent a holding company failure from contaminating other markets and the larger economy. This distinction was enshrined in current law by GLBA and more recently recognized by the Treasury Blueprint. Merging solvency regulation into systemic risk oversight will simply create a Too Big to Fail regulator where a mistake by the single agency head would jeopardize the entire financial marketplace. (See Appendix – Regulatory Distinctions Between Solvency and Systemic Risk Regulation.)

(3) My last point is that PCI is committed to working with this Subcommittee and Committee as the process evolves. We are in the unique position that we do not need federal help, but are dedicated to advancing appropriate solutions to stabilize the markets and prevent

another economic crisis from reoccurring. Addressing systemic risk is the best action to do so and we stand ready to assist in any way we can.

Thank you.

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Shaping the Future of American Insurance

Appendix to PCI Testimony
House Financial Services Committee – Capital Markets Subcommittee
March 5, 2009

Deal With Systemic Risk Now!

- Systemic Risk Defined
- Insurance Line Systemic Risk Grouping
- Financial Obligation Insurance: Systemic Risk Differences
- PCI Systemic Risk Oversight Proposal
- PCI Information Sharing Proposal

Deal With Systemic Risk First!

- Regulatory Distinctions Between Solvency and Systemic Risk Regulation

For more information, please go to: www.pciaa.net/reg-reform.

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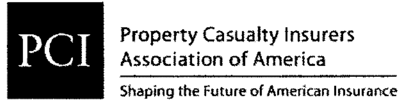

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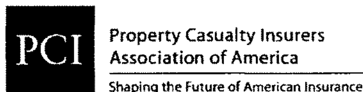

Financial Obligation Insurance: Systemic Risk Differences

Financial obligation insurance can be thought of as the transfer of payment risk on a financial obligation from the creditor or investor to an insurer. Financial guaranty insurance, mortgage insurance, some types of credit insurance, credit default swaps, and similar payment risk transfers are all examples of financial obligation insurance (FOI). FOI products typically involve a transfer of risk from the banking (credit) marketplace or the securities (capital) marketplace to the insurance marketplace. FOI transfers only the risk of payment failure, as opposed to a traditional banking product involving lending or loan servicing or a securities product involving investment returns.

Financial obligation insurance products are similar to traditional property/casualty products in that they provide indemnification for losses in accordance with the specific requirements and conditions of an insurance contract. However, they are a different and distinct marketplace. Traditional property/casualty products indemnify a person or organization for losses that result from either the damaging, destruction or loss of use of their property; or the result of a claim of liability by someone seeking financial damages. Financial obligation insurance indemnifies losses arising from negative credit or payment events.

Many FOI products are not regulated as insurance, such as credit default swaps, even though they function in the financial marketplace in a manner similar to financial insurance. Even FOI products that are regulated by the states as insurance are often treated as a special class of risk. For example, many states prohibit financial guaranty and mortgage insurers from writing any other line of insurance business. In addition, most states exclude financial guaranty, mortgage guaranty and credit insurance from their state guarantee funds. It is interesting to note that while credit default swaps, total return swaps, some collateral debt obligation securities, and similar derivative structured finance risk transfers are functionally insurance products, they have no capital reserving requirements and are relatively unregulated and lack the equivalent statutorily mandated transparency.

PCI believes that it is appropriate for federal and state regulators to continue to recognize and treat separately the distinct systemic risk characteristics of financial obligation insurance from traditional property/casualty products. However, FOI products have varying degrees of systemic risk profile and many state regulated financial obligation insurance products have been protected by strict solvency standards and oversight, particularly in contrast to federally regulated or unregulated risk transfer equivalents. Furthermore, many small and large insurers offer financial obligations insurance products, including on an incidental basis, in amounts that do not generate significant amounts of systemic risk.

There are a number of mechanisms that can be used to transfer credit risk on a variety of financial instruments. The most commonly used are credit default swaps and financial insurance. Financial insurance includes financial guaranty insurance, mortgage guaranty insurance and credit insurance. All of these mechanisms present some degree of systemic risk. Credit default

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swaps and financial guaranty insurance present a high degree systemic risk potential, mortgage guaranty insurance has less systemic risk attributes and credit insurance poses low systemic risk.

Credit Default Swaps (CDS)

Although not currently regulated as an insurance product, the issuance of CDS was a significant growth area for most financial guaranty monoline insurers. The NAIC Financial Guaranty Insurance Model Act defines a CDS as an agreement using the credit derivative definitions of the International Swaps and Derivatives Association in which a party agrees to compensate another party in the event of a payment default by, insolvency of, or other adverse credit event with respect to the issuer of a specified security or other obligation. In effect, the seller of a CDS will pay the buyer of that CDS any interest or principal payments defaulted on by the issuer of the covered debt security, because of an adverse credit event, during the time period covered by the CDS. Despite being equivalent to financial guaranty insurance (and generally perceived as insurance in the marketplace), credit default swaps are not regulated by state insurance departments or any other financial regulator and not covered by state guaranty funds. The total worldwide market for credit default swaps has been estimated at approximately $55 trillion in notional value at mid-year 2008. The notional value of a CDS is the face amount of the security that is used to calculate payments made on that instrument. The amount is called notional because it is not generally the amount that will change hands.

The extremely limited transparency of the unregulated CDS market creates a high degree of systemic risk by limiting the ability to monitor the CDS exposure among market participants or to quantify the impact of certain negative events (e.g., credit rating downgrades) on the sellers of CDS. This lack of transparency also limits the ability to establish standards for capital adequacy and liquidity to provide some measure of stability in the financial system.

The Securities and Exchange Commission (SEC) has discussed the need to create a credit default swap electronic exchange to increase liquidity, transparency, and pricing efficiency in the CDS marketplace. A CDS electronic exchange could also provide regulators with information to analyze and quantify the systemic impact of CDS and to develop other approaches to protect the integrity of the markets and its participants. Currently, two groups, IntercontinentalExchange and CME, have announced they have the technical ability to convert CDS into regulated exchange futures and to support their trading on an electronic platform. In addition, the SEC has asked for elimination of the "swap exclusion" in current law that prohibits it from regulating over-the-counter CDS.

Financial Guaranty Insurance

Financial guaranty insurance means a surety bond, or, when issued by an insurer, an indemnity contract under which a loss is paid upon proof that the financial loss has occurred as a result of any of the following events:

- Failure of any obligor on or issuer of any debt instrument or other monetary obligation to pay when due, principal, interest, premium, dividend or purchase price of or on, or other

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amounts due or payable with respect to, the instrument or obligation, when the failure is the result of a financial default or insolvency.

- Changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products;
- Changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or
- Other events which an individual state's commissioner may determine are substantially similar to any of the above.

Although financial guarantees are insurance because they provide protection against specific identified losses, there are significant differences between financial guaranty insurance and other property and casualty coverages.

- Financial guaranty insurers generally cannot write other lines of insurance; because of this limitation they are called monolines.
- Financial guaranty insurance is covered under the property and casualty guaranty funds in only 14 states.
- Financial guaranty insurance has historically been written on a "no-loss" or "remote loss" underwriting standard, focused on insured municipal bonds, which have historically low loss rates.
- In recent years, many financial guaranty insurers sought to increase growth by insuring structured products such as collateralized debt obligations of various asset backed securities and by issuing credit default swaps, greatly increasing their systemic risk profile.
- The financial guaranty risks underwritten by monolines are much more correlated with economic conditions and other systemic vulnerabilities than the risks written by multiline property casualty insurers.
- In some instances financial guaranty monolines held invested assets that were directly correlated to the structured products they were insuring.
- Financial guaranty insurance issued by monoline financial guaranty insurance corporations is excluded from the definition of property and casualty insurance by the Terrorism Risk Insurance Act.

A few companies that are not monolines write very small amounts of financial guaranty insurance along with the rest of their business. These companies pose insignificant systemic risk, and should not be subject to systemic risk regulation.

Mortgage Guaranty Insurance

Mortgage guaranty insurance provides coverage for the mortgagee (usually a financial institution) in the event that a mortgage holder defaults on a loan. It is also called private mortgage insurance (PMI). Mortgage insurers, like financial guaranty insurers, also operate on a monoline basis. Mortgage insurers, under current regulation, are capitalized to handle catastrophic mortgage related claims, may not be associated with high risk non-traditional

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activities, and must invest in assets without correlation risk to residential mortgages. While significantly less at risk than financial guaranty insurers, mortgage guaranty insurers do present some lesser amount of systemic risk as the residential real estate markets continue to experience significant deleveraging. As home values drop below outstanding mortgage balances and general economic conditions deteriorate mortgage defaults continue to increase. Michigan is the only state that provides property and casualty insurance guaranty fund coverage for mortgage guaranty insurance. In addition, private mortgage insurance is excluded from the definition of property/casualty insurance by the Terrorism Risk Insurance Act.

Credit Insurance

Commercial credit insurance can be purchased by businesses or other providers of goods and services extending credit, for indemnification of losses or damages resulting from the nonpayment of amounts owed to them for goods and services provided in the normal course of their business. Personal credit insurance can also be purchased as either single interest or dual interest. Single interest credit insurance protects the creditor's interest in the collateral securing a debtor's credit transaction. Dual interest credit insurance protects both the creditor's and the debtor's interest in the collateral securing the debtor's credit transaction. Credit insurance, like mortgage guaranty insurance, has a significantly lower systemic risk exposure than financial guaranty insurance. However, like mortgage guaranty insurance, at least some systemic risk exposure may exist. Credit insurance is covered by state guaranty funds only in Illinois, Kansas, Maryland and Michigan.

Reinsurance

Any reinsurance put in place on financial obligation insurance coverages would assume similar systemic risk characteristics as the underlying coverages.

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Insurance Line Systemic Risk Grouping

* excluding Life and Accident/Health insurance products

High Systemic Risk

Financial Guaranty

An insurance policy, or an indemnity contract (when issued by an insurer), or similar guaranty types under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnitee as a result of failure to perform a financial obligation; a change in interest rates; a change in currency exchange rates; or, a change in the value of specific assets, commodities or financial indices. These contracts usually involve sophisticated insureds, and therefore rates may be exempt from general statutory standards.

Less Systemic Risk

Mortgage Guaranty

Coverage for the mortgagee (usually a financial institution) in the event that a mortgage holder defaults on a loan; also called private mortgage insurance (PMI).

Low Systemic Risk

Credit

Commercial – Various coverages purchased by manufacturers, merchants, educational institutions, or other providers of goods and services extending credit, for indemnification of losses or damages resulting from the nonpayment of debts owed to them for goods or services provided in the normal course of their business.
Personal - Personal property credit may be either "single interest" or "dual interest". Single interest means insurance that protects only the creditor's interest in the collateral securing a debtor's credit transaction. Dual interest (also commonly referred to as "limited dual interest") means insurance that protects the creditor's and the debtor's interest in the collateral securing the debtor's credit transaction. Examples include, but are not limited to, Placed Home, Placed Auto, Personal Property, Credit Involuntary Unemployment and Personal GAP Insurance.

Surety

A three-party agreement where the insurer agrees to pay a second party (the obligee) or make complete an obligation in response to the default, acts, or omissions of a third party (the principal or obligor). Contractors are often required to purchase surety bonds if they are working on public projects. The surety company becomes responsible for carrying out the work or paying for the loss up to the bond "penalty" if the contractor fails to perform.

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Insurance Line Systemic Risk Grouping

No Significant Systemic Risk

Accident and Health	Coverage for accidental injury, accidental death, and related health expenses. Benefits will pay for preventative services, medical expenses and catastrophic care.
Aircraft	Coverage for aircraft (hull) and their contents; aircraft owners' and aircraft manufacturers' liability to passengers, airports and other third parties.
Allied Lines	Property insurance that is usually bought in conjunction with fire insurance; it includes wind, water damage and vandalism coverage.
Boiler and Machinery	Coverage for the failure of boilers, machinery and other electrical equipment (e.g., air conditioners, heating, electrical, telephone and computer systems). Benefits include (i) property of the insured, which has been directly damaged by the accident; (ii) costs of temporary repairs and expediting expenses; and (iii) liability for damage to the property of others. Coverage also includes inspection of the equipment.
Burglary and Theft	Coverage for property taken or destroyed by break-in and entering the insured's premises (commercial or personal); burglary or theft; forgery or counterfeiting; fraud; and off-premises exposure. Includes Fidelity and Surety coverage written as part of a Crime and Fidelity program.
Commercial Auto	Coverage for motor vehicles owned by a business engaged in commerce that protects the insured against financial loss because of legal liability for motor vehicle related injuries, or damage to the property of others caused by accidents arising out of the ownership, maintenance, use, or care-custody & control of a motor vehicle. Examples include business auto (Auto Liability, PIP, MP, UM/UIM, Specified Causes of Loss, Comprehensive, and Collision); garage policies (Garage Liability, Garagekeepers Legal Liability, PIP, MP, UM/UIM, Specified Causes of Loss, Comprehensive, and Collision) and truckers policies (coverage for persons or organizations engaged in the business of transporting property by auto for hire, including coverage of the specialized liability exposure created by trailer interchange agreements).
Commercial Multiple Peril	The policy packages two or more insurance coverages protecting an enterprise from various property and liability risk exposures. Frequently includes fire, allied lines, various other coverages (e.g., difference in conditions) and liability coverage. Such coverages would be included in other annual statement lines, if written individually. Examples of CMP policies include builders risk, business owners (BOP), e-commerce, and commercial farm and ranch.
Crop	Coverage protecting the insured against loss or damage to crops from a variety of perils, including but not limited to fire, lightening, loss of revenue, tornado, windstorm, hail, flood, rain, or damage by insects.
Earthquake	Coverage for building and contents losses resulting from a sudden trembling or shaking of the earth, including that caused by volcanic eruption. A special policy or endorsement is available because earthquakes are not covered by standard homeowners or most business policies.

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Insurance Line Systemic Risk Grouping

Farmowners	Farmowners insurance sold for personal, family or household purposes. This package policy is similar to a homeowners policy, in that it has been developed for farms and ranches and includes both property and liability coverage for personal and business losses. Coverage includes farm dwellings and their contents, barns, stables, other farm structures and farm inland marine, such as mobile equipment and livestock.
Fidelity	A bond or policy covering an employer's loss resulting from an employee's dishonest act (e.g., loss of cash, securities, valuables, etc.)
Fire	Coverage protecting property against losses caused by a fire or lightning that is usually included in homeowners or commercial multiple peril policies.
Flood	Basic flood insurance is provided by the federal government (the NFIP) and sold through private companies and agents. Private insurers also provide excess flood policies and may cover flood damage under the comprehensive portion of an auto insurance policy.
Homeowners	The typical homeowners insurance policy covers the house, the garage and other structures on the property, as well as personal possessions inside the house such as furniture, appliances and clothing, against a wide variety of perils including windstorms, fire and theft. Homeowners insurance also covers additional living expenses which reimburses the policyholder for the extra cost of living elsewhere while the house is being restored after a disaster. The liability portion of the policy covers the homeowner for accidental injuries caused to third parties and/or their property. Coverage for flood and earthquake damage is excluded and may be purchased separately. This applies similarly to condos, renters/tenants and mobile homes at a fixed location.
Inland Marine	Coverage for property that may be in transit by all forms of land and air transportation, held by a bailee, at a fixed location, or movable goods that are often at different locations (e.g., off-road construction equipment), or scheduled property (e.g., Homeowners Personal Property Floater). These lines also include instrumentalities of transportation and communication, such as bridges, tunnels, piers, wharves, docks, pipelines, power and phone lines, and radio and television towers. Also includes policies for electronic data processing equipment/software, pet insurance, animal mortality, event cancellation and travel coverage.
Medical Malpractice	Insurance coverage protecting a licensed health care provider or health care facility against legal liability resulting from the death or injury of any person due to the insured's misconduct, negligence, or incompetence, in rendering or failure to render professional services.
Ocean Marine	Coverage for ocean and inland water transportation exposures; goods or cargoes, ships or hulls, earnings, piracy, the jettisoning of cargo to save the property of others, and liability.
Other Liability	Coverage protecting the insured against legal liability resulting from negligence, carelessness, or a failure to act resulting in property damage or personal injury to others. Examples include liability coverage for commercial general liability, completed operations, contractual liability, day care centers, D&O, E&O, elevator/escalator, employers liability, liquor liability, municipal liability, environmental pollution liability, Internet liability, etc.

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Other Lines of Business	Coverage not described under previous lines of insurance, such as service contracts and title insurance.
Personal Auto	Coverage for privately owned motor vehicles and trailers for use on public roads not owned or used for commercial purposes including the following, singularly or in any combination: Auto Liability, Personal Injury Protection (PIP), Medical Payments (MP), Uninsured/Underinsured (UM/UIM); Specified Causes of Loss, Comprehensive, and Collision. Also includes motorcycle and recreational vehicles (RV).
Products Liability	Coverage for losses or injuries caused by defect or malfunction of the product.
Surplus Lines	Property/casualty insurance coverage that isn't available from state-licensed/admitted insurers must be purchased from a non-admitted carrier (surplus lines insurer). Examples include risks of an unusual nature that require greater flexibility in policy terms and conditions than exist in standard forms or where the highest rates allowed by state regulators are considered inadequate by admitted companies.
Workers' Compensation	Insurance that covers an employer's liability for injuries, disability or death to persons in their employment, without regard to fault, as prescribed by state or federal workers' compensation laws and other statutes. Coverage may include payments for medical care, physical rehabilitation, and lost wages.

Reinsurance – The systemic risk exposure generally follows the level associated with the line of coverage generating the risk being ceded. This can change based upon the allocated capital driven-underwriting capacity of the respective reinsurance market.

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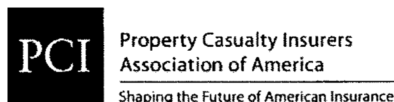

Information Sharing Proposal

Needs

- Increase oversight of holding companies by promoting cross-industry information sharing between and among various financial services overseers, both nationally and internationally, to detect potential problems earlier and help avoid another meltdown.
- Increase coordination of oversight efforts to prevent and detect financial fraud, both domestically and internationally.

Holding Company Solvency Information Sharing

- Require the Presidential Working Group (PWG) on financial markets to develop and implement a plan for information sharing coordination with international overseers regarding holding company solvency and potential threats to cross-border market stability in a manner that:
    - does not exceed the scope of domestic information sharing activities;
    - protects the confidentiality and privileges of both the overseer and the subject companies;
    - clearly designates a lead holding company overseer and its responsibilities, and is preemptive with respect to duplicative information requests;
    - is based on cost-benefit analysis, so that the benefits of the information outweigh the collection costs; and
    - is limited to currently reported group level financial information related to solvency, such as capital levels and off-balance sheet or significant cross-affiliate obligations.
- Direct the overseers, pursuant to the PWG plan, to establish regular information sharing protocols and transfers with other domestic and foreign overseers, consistent with the above objectives, so that the lead overseer of a holding company collects and redistributes to the other relevant financial overseers appropriate information on the holding company's solvency.

Antifraud Network Act (summary of key provisions as passed the House in 2001)

- Require the financial overseers to establish an automated system for sharing antifraud information, primarily to cross-check public disciplinary information for background checks on key individuals and companies.
- Create a confidentiality supervisory information privilege – anything collected by a financial overseer related to its supervisory role can only be publicly disclosed with the permission of the originating overseer.
- Ensure that any existing confidentiality protections follow the information.
- Provide limited legal immunity to overseers for good faith actions within the scope of duty.

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- Create a streamlined agent background check: requiring the FBI to do fingerprint background checks on insurance professionals and the NAIC to act as a clearing house that all states could rely on each record check for a year.

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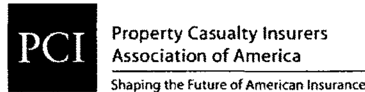

Regulatory Distinctions between Solvency and Systemic Risk Regulation

- Solvency measures whether a company has enough capital to meet its obligations. Solvency regulation is focused on (1) ensuring a financial company has enough capital to fulfill its promises and (2) limiting individual consumers' losses from failed financial companies. In insurance, it protects the policyholder; in banking, the deposit holder; and in securities, the investor. Each financial industry has certain solvency requirements that reduce the likelihood a financial company will fail to fulfill its promise, and a consumer protection fund (GF, FDIC, SIPC) that limits certain consumer losses from such failures. Solvency regulation is currently conducted by the functional regulators separately in each marketplace.

- Systemic risk measures the likelihood and the degree that a company's activities will negatively affect the larger economy, requiring federal intervention to mitigate the effects. Systemic risk regulation is focused on protecting the economy from major failures of mostly holding companies.

- While solvency regulation focuses on individual financial consumers within each marketplace (micro), systemic risk regulation focuses on limiting the spread of failure risks from one market segment to other industries and the global economy (macro). Solvency regulation is conducted by the primary functional regulator for each subsidiary. Systemic risk regulation is conducted by consolidated umbrella supervisors.

- The Gramm-Leach-Bliley Act (GLBA) created limited umbrella systemic risk regulation for financial holding companies (FHC). Insurance and securities activities can be conducted in the same holding company as banking only if the depository subsidiaries are well managed and capitalized and meet certain credit-rating thresholds. According to the Federal Reserve Board (FRB), which oversees FHC regulation, it supervises the consolidated organization, monitoring "the systemic risks posed by [FHCs]", while the OCC, FDIC, OTS, SEC, and state insurance regulators (the primary regulators) regulate each holding company subsidiary. The FRB oversees overall FHC risk-taking to judge how the parts and the whole may affect affiliated banks to avoid bank failures creating systemic risks to the economy.

- In theory, the FRB shares information with the primary regulators to protect against systemic risks while avoiding duplicative or excessive burdens. GLBA's "Fed-lite" provisions allow the FRB to examine and require reports from the FHC parent, but generally not the functionally regulated subsidiaries. FHCs that fail to meet FRB risk standards must enter into an agreement to correct the deficiencies. If not corrected within 180 days, FHCs may be required to divest all banking subsidiaries.

- There are several critical gaps in the current GLBA systemic risk oversight laws. GLBA focused FRB oversight on protecting banks from insurance/securities risks and resulting systemic risks from banks to the economy. However it did not address systemic risks flowing

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from non-bank subsidiaries to the economy, nor does GLBA allow FRB oversight of holding companies without banks (such as thrift, insurance, or investment bank holding companies). The FRB's risk management practices oversight may also need to be strengthened, to better account for broader market instability, liquidity risks, and enterprise risk-management.

- Solvency and systemic risk regulation are separate oversight regimes with distinct goals, standards, and remedies. Solvency regulation in each industry is being reexamined by functional regulators. However, the major vulnerability that allowed the current crisis and that needs to be quickly addressed to prevent its reoccurrence is a lack of broader systemic risk regulation beyond the limited GLBA/FRB/FHC construct. Fixing GLBA's systemic risk regulation deficiencies can be easily enacted and implemented, using current models, without requiring changes in solvency regulation or responsibilities.

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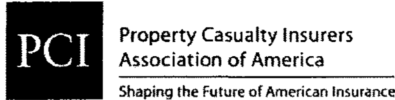

Systemic Risk Defined

"Systemic risk" refers to the likelihood and degree of negative consequences to the larger body.

With respect to federal financial regulation, the systemic risk of a financial institution is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects.

How to Measure Systemic Risk

Too Big to Fail: The traditional analysis for assessing the risk of required government intervention is the "Too Big to Fail" Test (TBTF). TBTF can be measured in terms of an institution's size relative to the national and international marketplace, market share concentration (using the Herfindahl-Hirschman Index for example), and competitive barriers to entry or how easily a product can be substituted. While there are large companies in most financial marketplace segments, the national insurance marketplace is spread among thousands of companies, and the barriers to entry in a business where capital is the primary input are relatively minor. The policies of one homeowners' insurer can be relatively easily substituted for another or picked up by a state residual market provider, with limits on the underwriting fluidity primarily stemming from state-by-state regulatory impediments, such as limits on pricing and capital mobility. There are arguably either no or extremely few insurers that are TBTF in the U.S. marketplace.

Too Interconnected to Fail: A more useful systemic risk measure than a traditional TBTF test is a "Too Interconnected to Fail" (TICTF) assessment. An intuitive TICTF analysis has been at the heart of most recent federal financial emergency relief decisions. TICTF is a measure of the likelihood and amount of medium-term net negative impact to the larger economy of an institution's failure to be able to conduct its ongoing business. The impact is measured not just on the institution's products and activities, but also the economic multiplier of all other commercial activities dependent specifically on that institution. It is also dependent on how correlated an institution's business is with other systemic risks.

Property/casualty (P/C) insurance companies, other than in a few specialized segments noted below, present relatively low systemic risk because they generate relatively little counterparty risk and their liabilities are generally independent of economic cycles or other potential systemic failures. With respect to liabilities, P/C products tend to be mandatory with inelastic demand, so revenues are less affected by other systemic risks. Recessions or 3rd party failures do not significantly increase workers' injuries, auto accidents, or house fires. Insurance contracts are not typically subject to further hedging or risk arbitrage (unlike mortgage underwriting or financial guarantees that may be subjected to numerous cycles of securitization and further third party financial guarantees or risk betting). While some portions of primary risks are passed on to reinsurers, the risks are not further multiplied or leveraged, and the primary company almost always remains obliged on and retains a portion of the underlying risk. With respect to assets, p/c insurers don't hold other people's money, so there is no vulnerability to a "run on the bank," and they only underwrite based on their own assets (unlike depository institutions, investment funds, or retirement accounts) with less leveraging statutorily allowed than for other insurance or financial companies. Ultimately, while the economy is highly dependent on the p/c industry, the industry's risks are independent and relatively walled off from other systemic impairments.

Examples: Even a very large auto insurer poses very little systemic risk to the larger economy. Few commercial third parties rely on a specific auto insurer's policies that would suffer immediate

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economic losses or decline, other than the insurer's direct investors. Policyholders would be largely protected by existing state guaranty funds, third party accident claimants would be similarly protected through such funds (as well as under their uninsured motorist coverage), and new business could be switched relatively easily to other providers or a state residual market provider. The insurer's contracts with its agents and other suppliers would migrate quickly to new underwriters, and the beneficiaries of its investments would similarly migrate over a relatively short period of time. The insurer's failure would be relatively independent from a larger economic cycle or downturn – its investment portfolio is required to be relatively conservative and unleveraged, and its auto losses would be relatively uncorrelated with any economic cycles or systemic risk waves. Unlike banks and securities firms, a property-casualty insurer failure would not cause a run on the industry since the products are essentially mandatory and overall demand is relatively inelastic. While the failure of a large auto insurer would be undesirable, and perhaps even cause a short period of transitory disruption in a local auto insurance marketplace, the negative economic consequences to the larger economy would be relatively limited – primarily transition costs and any net losses of the specific company.

Exceptions: A small number of p/c insurance market segments present a different systemic risk vulnerability. For example, the credit downgrading of a small number of bond insurers (and unregulated investment companies offering equivalent financial guarantee products) last year played a role in the trillions of dollars of third party credit default swaps that are still being unwound. That deleveraging process has triggered a domino affect of other negative economic consequences throughout the globe, including freezing numerous capital markets that have limited general consumer and commercial financing. A few very large state owned/run insurance funds may also present slightly higher systemic risk, particularly for natural catastrophe exposure, since they tend to be severely underpriced, underfunded, and most likely to require additional capital after events that would cause competing state budgetary impairments and needs. Mortgage insurance is more correlated with economic cycles and susceptible to further 3rd party leveraging, although the companies are still subject to strict leveraging and investment limits, rely on their own capital, and sell a product that is essentially mandatory and thus less elastic in demand. Surety insurance can also be susceptible to economic cycles, although it has not presented a systemic risk in the current economic cycle. Reinsurance has a slightly different risk profile than primary insurance, but is similarly uncorrelated to other systemic risks and the negative effects of reinsurance failures are mostly confined to the insurance industry.

AIG

It should be noted that AIG was not "Too Big to Fail", but ultimately received unusual federal assistance because it was "Too Interconnected to Fail". AIG's *insurance* units were mostly engaged in underwriting coverages that other insurers would be able to assume over a relatively short period of time. Almost all of AIG's subsidiaries have continued to successfully operate except for AIGFP, an *unregulated* entity engaged in financial guarantees and derivatives activities. AIGFP, however, was involved in hundreds of billions of dollars of risk swaps that were relied upon and further highly leveraged by numerous 2nd and 3rd parties. The credit downgrading of AIG because of the liabilities of AIGFP, and its inability to raise sufficient additional offsetting capital, set off a series of 2nd and 3rd party adjustments that continued to ripple through the economy with deleterious consequences until the federal government stepped in with an additional backstop. This made AIGFP, and thus the AIG thrift holding company as a whole, TICTF. While AIG's insurance operations are large, they did not generate the same level of systemic risk. The economy, after a short period of market transition, would be better able to adjust to a severe impairment of AIG's insurance subsidiaries than its non-insurance operations. AIG did suffer write downs from its securities lending business, which involved borrowed assets from its life (but not property-casualty) insurance subsidiaries, but these losses were much less in scope than the AIGFP exposure.

For more information, please go to: www.pciaa.net/reg-reform.

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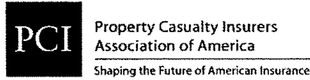

Systemic Risk Oversight Proposal

Systemic Risk Definition (abbreviated)	The systemic risk of a financial institution is the likelihood and the degree that the institution's activities will negatively affect the larger economy such that unusual and extreme federal intervention would be required to ameliorate the effects. "Too Interconnected to Fail" (TICTF) is the appropriate measure of the likelihood and amount of medium-term net negative impact to the larger economy of an institution's failure to be able to conduct its ongoing business. The impact is measured not just on the institution's products and activities, but also the economic multiplier of all other commercial activities dependent specifically on that institution. It is also dependent on how correlated an institution's business is with other systemic risks.
Overseer	The Federal Reserve Board should be the systemic risk overseer. It has the appropriate institutional culture, mission, and expertise. However, the FRB's systemic risk oversight should be completely separate from its other bank holding company oversight powers.
Oversight Jurisdiction	Any institution engaged in financial activities that present a significant systemic risk. Also any institution engaged in financial activities that chooses to submit to federal systemic risk oversight (e.g., typically for international equivalency treatment).
Oversight Powers	Authority to require: (1) Appropriate transparency and disclosure to overseers for all entities within the regulatory jurisdiction. (2) Coordination with other US and international overseers. (3) Risk management for systemic risk for specific entities whose financial activities present a significant systemic risk. Systemic risk oversight should not include: • Solvency oversight for individual companies. • Business conduct oversight (licensing, market conduct, product approval). • Duplicative disclosure or transparency information requirements. • General federal compliance (with privacy standards, etc.). • Other elements of bank holding company oversight.

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Oversight of Risk Management	Systemic risk oversight standards might consist of: • Overseeing holding company capital standards and group risk management. • Monitoring of affiliate transactions and significant off-balance sheet obligations. • Collecting and sharing information related to group systemic risk and holding company solvency. • Requiring coordination of examinations and visits regarding systemic risk as appropriate. • Eliminating duplicative oversight of holding companies.
Authority to coordinate with international oversight	Greater global financial harmonization is necessary to prevent global regulatory arbitrage. The FRB should coordinate systemic risk standards within its jurisdiction with international overseers after a full public review, including an examination of the effects on small companies. The overseer should not delegate oversight, and should retain the ability to provide exceptions or withdraw its deferral or mutual recognition as necessary.

For more information, please go to: www.pciaa.net/reg-reform.

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TESTIMONY OF
T. TIMOTHY RYAN, JR.
PRESIDENT AND CEO OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
OF THE
COMMITTEE ON FINANCIAL SERVICES

HEARING ON PERSPECTIVES ON SYSTEMIC RISK

MARCH 5, 2009

Introduction

Chairman Kanjorski, Ranking Member Garrett, members of the Subcommittee:

My name is Tim Ryan and I am President and CEO of the Securities Industry and Financial Markets Association ("SIFMA").[1] Thank you for your invitation to testify at this important hearing. The purpose of my testimony will be to detail SIFMA's views on a financial markets stability regulator, including the mission, purpose, powers and duties of such a regulator.

While I am speaking on behalf of SIFMA today, from 1990 to 1993 I served as Director of the Office of Thrift Supervision, with responsibility for

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

regulatory oversight of the nation's approximately 2,000 thrifts. During that time, I also was a principal manager of the clean-up effort following the savings and loan debacle of the 1980s. That experience gave me an acute appreciation for the importance of effective regulation and the challenges we face as we work through the current crisis.

As we all know, financial markets across the globe have experienced severe dislocations in the last several months. Congress has aggressively responded to these challenges in the United States by passing sweeping legislation, including the Emergency Economic Stabilization Act of 2008 (the "EESA"), the Housing and Economic Recovery Act of 2008, and the American Recovery and Reinvestment Act of 2009. Congress has rightly recognized, however, that addressing the immediate crisis is only half the battle. Improvements can be made to our current regulatory model for financial services which can help us avoid such crises in the future. We recognize that this is a moment in our history where such efforts are essential.

In attempting to address the challenges affecting our system, we need to recognize that financial markets are now global in nature. Individual U.S. and non-U.S. banks, securities firms, insurance companies, hedge funds and other financial institutions operate in all major markets around the world. Non-U.S. financial institutions operate in our financial markets. Investors all over the world invest in markets everywhere either directly or through financial intermediaries. As a result, we need a global approach to financial regulatory reform. It does not

make sense to regulate markets as though they are insulated from the outside world.

International coordination on systemic issues will be critical to avoid cross-border regulatory arbitrage. We need to consider the extraterritorial consequences that our financial regulatory reform will have on other markets, as well as the possibility that any particular regulatory reform, unless coupled with a coordinated global approach, could give rise to disparate regulatory treatment as among U.S. and foreign markets, or create incentives to move U.S. jobs and businesses off-shore.

We also need to carefully watch the extraterritorial consequences of other major non-U.S. regulators or regions on U.S. domestic markets and financial institutions. Close cooperation among policymakers on an international basis will therefore play an important part in effectively addressing systemic risk and other challenges affecting the financial system. Good places to start would be the G-20, the Financial Stability Forum and the de Larosière Group.

SIFMA stands ready to be a constructive voice in this critically important public policy dialogue – in the U.S. and abroad – to restore confidence in the global financial system. Our members understand the value that a well-designed and implemented regulatory system brings to minimizing systemic risk. We believe that a global effort is required to develop such a regulatory system with common principles that limit regulatory arbitrage between and among nations.

Financial Markets Stability Regulator

Systemic risk[2] has been at the heart of the current financial crisis. We at SIFMA have therefore devoted considerable time and resources to thinking about systemic risk, and what can be done to identify it, minimize it, maintain financial stability and resolve a financial crisis in the future. A regulatory reform committee of our members has met regularly in recent months to consider these issues, and to develop a workable proposal to address them. We have sponsored roundtable discussions with former regulators, financial regulatory lawyers and our members, as well as other experts, policymakers and stakeholders. In short, we have brought together some of the best and the brightest to try to develop solutions to the issues that have been exposed by the financial crisis and the challenges facing our financial regulatory architecture.

We support the proposal to establish a financial markets stability regulator

Through this process, we have identified a number of questions and trade-offs that will confront policymakers in trying to mitigate systemic risk. Although our members continue to consider this issue, there seems to be consensus that we need a financial markets stability regulator as a first step in addressing the challenges facing our overall financial regulatory structure. The G30, in its report on financial reform, supports a central body with the task of promoting and maintaining financial stability, and the Treasury, in its blueprint, also has

[2] While there is no single, commonly-accepted definition of systemic risk, we think of "systemic risk" as the risk of a systemwide financial crisis characterized by a significant risk of the contemporaneous failure of a substantial number of financial institutions or of financial institutions or a financial market controlling a significant amount of financial resources that could result in a severe contraction of credit in the U.S. or have other serious adverse effects on economic conditions or financial stability.

supported a market stability regulator. We also believe, as a second step, that we must work to rationalize the broader financial regulatory framework to eliminate regulatory gaps and imbalances that contribute to systemic risk.

We are realistic in what we believe a financial markets stability regulator can accomplish. We do not believe that a financial markets stability regulator will be the cure all and end all. It will not be able to identify the causes or prevent the occurrence of all financial crises in the future. But at present, no single regulator (or collection of coordinated regulators) has the authority or the resources to collect information system-wide or to use that information to take corrective action across all financial institutions and markets regardless of charter. We believe that a single, accountable financial markets stability regulator will improve upon the current system.

Mission of the Financial Markets Stability Regulator

While our position on the mission of the financial markets stability regulator is still evolving, we currently believe that its mission should consist of mitigating systemic risk, maintaining financial stability and addressing any financial crisis. It should have authority over all financial institutions and markets, regardless of charter, functional regulator or unregulated status. In carrying out its duties, the financial markets stability regulator should coordinate with the relevant functional regulators, as well as the President's Working Group, as applicable, in order to avoid duplicative or conflicting regulation and supervision. It should also coordinate with regulators responsible for systemic risk in other countries. It should have the authority to gather information from all financial institutions and

markets, make uniform regulations related to systemic risk that are binding on all and act as a lender of last resort to all. It should probably have a more direct role in supervising systemically important financial groups, including the power to conduct examinations, take prompt corrective action and appoint or act as the receiver or conservator of such systemically important groups. These more direct powers would end if a financial group were no longer systemically important.

Powers and Duties

There are many issues to consider in determining what the powers and duties should be of the financial markets stability regulator. We have identified and analyzed a number of them that we enumerate below.

1. Scope of Authority

The first issue to consider is the scope of authority of the new regulator. To be effective, the authority should probably extend to all financial institutions, markets, products and services. The new regulator should also probably have more direct supervisory power over systemically important financial institutions or groups.

You might want to consider defining certain kinds of institutions, markets, products or services as financial. Such categories should probably include currently unregulated financial institutions, such as hedge funds, private equity funds or others, in addition to regulated financial institutions, such as banks, savings associations, other depository institutions, securities brokers or dealers, insurance companies, securities clearing agencies, derivatives clearing organizations, payment system operators, investment companies, investment

advisers, commodity pool operators, commodity trading advisors or futures commission merchants. You might define markets broadly to include securities or futures markets, over-the-counter financial markets, electronic communications networks and alternative trading systems. You might also consider whether to give the financial markets stability regulator discretionary authority to declare other entities, markets, products or services to be financial or to exempt any financial institutions, markets, products or services from coverage, and what limits to put on those discretionary authorities.

You might also want to consider taking a similar approach to defining what constitutes a systemically important financial institution or group. Certain types of entities might be defined as systemically important, including primary dealers, securities clearing agencies, derivatives clearing organizations and payment system operators. You might also want to consider whether to give the financial markets stability regulator discretionary authority to declare any other financial institutions to be systemically important, and what limits to put on that authority. You might also want to consider whether the financial markets stability regulator should have discretionary authority to determine that an institution that was once designated as systemically important should no longer be classified that way if it is no longer systemically important.

One difficult issue is what to do with systemically important financial institutions that are not currently subject to any federal functional regulation, such as insurance companies and hedge funds. We do not believe that the financial markets stability regulator should become a functional regulator of such

institutions. Instead, the financial markets stability regulator should focus on systemic issues. If insurance companies and hedge funds are to be subject to federal functional regulation, this might be done through an optional federal charter in the case of insurance companies and the SEC in the case of hedge funds.

2. Level Playing Field

In defining the powers and duties of the financial markets stability regulator, it will be important to maintain a level playing field between systemically important and other financial institutions. If systemically important financial groups are regulated more heavily than other financial institutions, this will perpetuate or create new opportunities for regulatory arbitrage. Any activities that are regulated more heavily when conducted by a systemically important institution will simply migrate to the relatively less regulated institutions or flow off-shore. Instead of reducing overall risk in the system, this approach would simply shift risk from one group to another. On the other hand, systemically important financial groups could be perceived to benefit from a "too big or too complex to fail" policy, which could result in a funding or other advantage over other financial institutions and an unacceptable level of moral hazard. Any legislation creating a financial markets stability regulator should try to be as neutral as possible between the two groups.

3. Information Gathering

You might consider giving the financial markets stability regulator the authority to gather information from all U.S. financial institutions and markets in

order to identify systemic risk and maintain financial stability. You might also consider whether this authority should apply to all financial institutions, regardless of charter, and regardless of whether they are currently functionally regulated or not. The financial markets stability regulator will need information necessary to form and maintain a picture of the overall systemic risks in the U.S. financial system.

4. Uniform Systemic Risk Rules

While some commentators have suggested that the regulatory powers of the financial markets stability regulator be focused exclusively on systemically important financial groups, we believe this would be a mistake. If the authority of the financial markets stability regulator is limited to systemically important financial groups, any efforts to identify and control systemic risk will simply result in shifting the risky activities to other financial institutions or off-shore rather than taking it out of the system or controlling it. Also, the financial markets stability regulator may identify sectors of the market where individual entities are not systemically important, but which entities in the aggregate can have a significant impact on systemic risk. You should therefore consider giving the financial markets stability regulator the authority to make uniform rules, where applicable, for any class of similarly situated financial institutions, markets, products or services to the extent necessary to reduce systemic risk and promote financial stability.

If you do, you should also consider whether to require the financial markets stability regulator to consult with the relevant federal functional

regulators. The goal of such uniform systemic risk rules should not be to unduly burden smaller institutions that would be otherwise only be tangentially touched by the financial markets stability regulator. You might also consider giving a nonexclusive list of examples where the financial stability regulator has authority, such as:

- capital or liquidity rules for any class of similarly situated financial institutions, and
- risk management and transparency requirements.

5. Information Sharing

The financial markets stability regulator will need to coordinate with the relevant federal functional regulators in order to do its job properly. You should consider imposing an obligation on all functional regulators to share supervisory information with the financial markets stability regulator. It is difficult to see how the financial markets stability regulator will be able to do its job properly unless it has access to supervisory information gathered by all relevant functional regulators.

6. Confidential Supervisory Information

Some of the information gathered by the financial markets stability regulator, especially from otherwise unregulated financial institutions such as hedge funds or private equity funds, may not otherwise be publicly disclosed and may be confidential and proprietary. Such information should be treated as confidential supervisory information and therefore protected by statute against disclosure or loss of privilege, except to the extent it forms part of industry-wide

data. Congress might consider reviewing the statutory protections of such information to determine whether they need to be strengthened. Otherwise, there could be legitimate and serious resistance to the financial stability regulator's information gathering powers from some financial institutions.

Similarly, all confidential supervisory information shared among federal regulators should have the same statutory protection. Such information should not lose some or all of its protection because a functional regulator shares it with the financial markets stability regulator, or vice versa. You should consider reviewing the statutory protections governing confidential supervisory information to make sure they are all sufficiently protective.

7. Accountability

Given the scope of authority the financial markets stability regulator might have, it will be important to hold the financial markets stability regulator accountable for implementing its mission. The Congress should consider a robust reporting regime for the financial markets stability regulator including, at a minimum, annual reports to Congress. The financial markets stability regulator might report on (1) the risks to the U.S. financial system, (2) the regulatory measures being taken or that will be taken to address such risks, (3) the costs and benefits of such measures, (4) any adverse effects from such measures on market discipline, and (5) the steps being taken to minimize moral hazard and maximize the benefits of market discipline.

8. International Coordination

International coordination on systemic issues will be critical to avoid cross-border regulatory arbitrage. You should consider giving the financial markets stability a mandate to coordinate with any foreign or international body of regulators on systemic risk issues. The G30 report, for example, strongly encourages enhancing existing mechanisms for international regulatory and supervisory coordination.

9. Technology Platform

Because no U.S. regulator currently has the technology platform necessary to gather, aggregate and mine all the data that might be gathered by the financial markets stability regulator, you should consider giving the financial markets stability regulator a mandate to develop a plan to aggregate the data that currently resides at the different regulated industry utilities or otherwise build the systems necessary to achieve its goals.

10. Enforcement Authority

The financial markets stability regulator will not be able to carry out its mission effectively if it does not have the authority to enforce its rules or orders. Consequently, you should consider giving it enforcement authority similar to what the Federal Reserve has over bank holding companies, including the power to take formal and informal supervisory action against any financial institution or market. The financial markets stability regulator should generally be required to coordinate or defer to any relevant federal functional regulators in bringing enforcement action against any financial institution or market, other than a

systemically important financial institution. But you should consider whether to give it override authority with respect to the enforcement of any rule, regulation or order made to reduce systemic risk or promote financial stability if it is not being adequately enforced by the relevant federal functional regulator.

11. Lender of Last Resort

Section 13(3) of the Federal Reserve Act has been the Federal Reserve's tool of choice in providing liquidity and other financial assistance to financial institutions and the market during the current financial crisis. That has been its source of authority for its emergency liquidity facility to primary dealers, its rescue of AIG, the Commercial Paper Funding Facility, the Term Asset-Backed Securities Loan Facility (TALF), its credit support for Fannie and Freddie, its participation in the troubled asset guarantee programs, and most of its other emergency actions during the financial crisis. It would probably be useful to analyze whether Section 13(3) needs to be updated or modernized in any way in light of the lessons learned during the current financial crisis.

12. Consolidated Supervision and Examination Authority

The rest of the issues relate solely to systemically important financial institutions. The financial markets stability regulator is likely to argue that it requires direct consolidated supervisory authority over systemically important financial institutions in order to do its job effectively. You might therefore consider whether to give it the authority to be the consolidated supervisor of systemically important financial groups, much the way the Federal Reserve is currently the consolidated supervisor of bank holding company groups. You

might also consider whether this authority should be exclusive at the group level. It may be unfair to subject a systemically important financial group to duplicative and overlapping consolidated supervision. This would not affect the functional regulation of any financial institution within the group, which would remain subject to functional regulation by its federal functional regulator. Although the financial markets stability regulator would ordinarily coordinate with or defer to the functional regulator of any financial institution within the group, you should consider whether the financial markets stability regulator should have the authority to override any such functional regulator on systemic risk issues.

13. Prompt Corrective Action

The federal banking agencies currently have the authority to take a wide variety of correction actions well before an insured bank becomes insolvent. This gives the banking agencies the flexibility to address issues before they turn into a crisis. While having authority is not the same as using it, you might nevertheless consider giving the financial stability regulator similar authority to take prompt corrective action with respect to any systemically important financial institution or group if certain events occur, such as becoming undercapitalized, being in an unsafe or unsound condition or engaging in an unsafe or unsound practice. The trigger events and permissible actions could be modeled on those contained in Section 38 of the Federal Deposit Insurance Act.

14. Resolution Powers

One of the most important gaps exposed during the current financial crisis was the lack of federal resolution powers for systemically important financial institutions or groups. The Federal Deposit Insurance Corporation ("FDIC") has broad powers to act as a conservator or receiver of a failed or severely troubled bank. These powers include the ability to control the process, to repudiate burdensome contracts, to transfer certain assets and liabilities to a bridge bank, and to enter into loss-sharing and other financial assistance arrangements designed to maximize the value of the failed institution to the system. This is the power the FDIC used to resolve WaMu, IndyMac and other thrifts. The Federal Housing Finance Authority ("FHFA") exercised similar powers when it placed Fannie and Freddie into conservatorship.

No similar resolution power was available to the government to resolve Lehman Brothers or AIG. Lehman Brothers was allowed to fail largely because no one was willing to step in to acquire Lehman Brothers before it filed for bankruptcy. AIG was rescued initially with a use of the Federal Reserve's authority under Section 13(3) of the Federal Reserve Act and subsequently by money from the Troubled Asset Relief Program ("TARP").

The Bankruptcy Code or state insurance insolvency codes may not give the government sufficient control over the resolution of systemically important financial institutions and groups. Instead, you might consider giving the financial markets stability regulator the authority to appoint itself or another federal regulatory agency (including the FDIC) as the conservator or receiver of any

systemically important financial institution or group. If you do, you might also consider giving it resolution powers similar to those contained in Sections 11 and 13 of the Federal Reserve Act.

15. Emergency Financial Assistance

Another important gap in the system exposed by the financial crisis is the lack of any regulator with the power to provide emergency financial assistance to any systemically important financial institution or group in order to prevent systemic risk. The FDIC has the power to provide such assistance to banks, but its power does not extend to financial institutions generally or even to bank holding companies. Moreover, it is generally precluded from providing such "open bank" assistance unless it would be less costly to the deposit insurance fund than closing the bank or if necessary to prevent systemic risk. But the FDIC has been very reluctant to expose the deposit insurance fund even to prevent systemic risk. In fact, but for the short-lived assistance promised in the Citi-Wachovia transaction, the FDIC has not agreed to provide any open bank assistance since 1992.

According to public reports, this has created a certain amount of tension among some of the federal agencies during the financial crisis. The agencies most concerned about systemic risk have not always had clear authority or sufficient resources to provide emergency assistance. The agency that did – the FDIC – has been very reluctant to provide it. If Congress decides to create a financial markets stability regulator and give it resolution powers, it might also consider giving it clear authority over the decision whether to provide emergency financial assistance to prevent a systemic crisis. There should be some limits on the

exercise of that power to make sure it does not create moral hazard. One proposal might be to require the financial markets stability regulator to consult with the Secretary of the Treasury and the President, before providing emergency financial assistance to a systemically important financial institution.

There are a number of options for who might be the financial markets stability regulator

There are a number of options for who might be the financial markets stability regulator. One option is to create a new independent federal agency, possibly within Treasury. Another option is a panel of regulators such as the President's Working Group. Yet another option is to make the Federal Reserve the financial markets stability regulator.

Each of these options has advantages and disadvantages. Whichever option is selected, the financial markets stability regulator should have the right balance between accountability to and independence from the political process. It needs to have credibility in the markets and with regulators in other countries. It should have the tools necessary to identify systemic risk, take prompt action to prevent a financial crisis and resolve a financial crisis if it occurs. To be truly effective, the financial markets stability regulator would need to have the power to act as the lender of last resort or to provide emergency financial assistance to the markets, and to have prompt corrective action and resolution powers over failed or failing financial institutions that are systemically important.

A new federal agency could be singularly focused on the critical mission of financial stability. It could be structured to avoid conflicts between its role as financial markets stability regulator and other roles such as that of monetary

policy authority. It would likely be more accountable to Congress and less independent than the Federal Reserve. But a new regulatory agency would require a large new budgetary appropriation to staff and fund its activities, as well as substantial time to establish, become fully functional and become credible domestically and internationally. Indeed, this entire process could take several years. There are risks in delaying an effective financial markets stability regulator for too long. Finally, a new regulator might not be given enough independence from the political process to provide confidence to the market.

A panel of regulators such as the President's Working Group might bring together more collective expertise than either a new regulator or the Federal Reserve. But issues of coordination and collective accountability are a concern. This model has the potential to perpetuate the risk of continued gaps, duplication, inefficiency and waste compared to a single oversight body.

Unlike a new regulatory agency, the Federal Reserve already has a window into the overall U.S. and global markets. It has an experienced staff and the ability to expand its resources with revenues from its open market activities. It has a long tradition of independence, giving it essential credibility with the markets. It also has strong credibility with regulators around the world with which the financial markets stability regulator would need to coordinate. Its tool kit includes many of the tools that we believe are essential for the financial markets stability regulator. For example, it already has the ability to act as the lender of last resort and to provide emergency financial assistance during a financial crisis. These tools probably need to be modernized in light of the lessons learned from

the financial crisis, but the Federal Reserve already has them. The Federal Reserve also has experience and a credible track record using these tools responsibly and sparingly. Finally, expanding the Federal Reserve's powers to include those of a financial markets stability regulator could be done relatively quickly and would result in a single regulator being accountable for systemic risk across all financial institutions and markets.

The principal arguments against the Federal Reserve boil down to fears about the concentration of too much power and responsibility in the Federal Reserve and concerns about its independence in conducting monetary policy. In addition, the Federal Reserve would still need to coordinate with the functional regulators unless it is also going to take over their powers, which may not be feasible or desirable. Some critics also point out that the Federal Reserve has not been blameless in failing to identify and take corrective action against systemic risk in time to prevent the current financial crisis.

Conclusion

Recent challenges have strained the notion that U.S. markets are the most efficient, liquid and well-regulated markets in the world. They have highlighted the necessity of a fundamental review of our regulatory system. In light of the essential role that the financial markets play in U.S. and global economic growth and job creation, regulatory and legislative efforts should support the rejuvenation of the financial services sector.

SIFMA strongly supports these efforts and commits to be a constructive participant in the process. SIFMA stands ready to assist the Committee as it

considers systemic risk and the proposal to create a new federal regulator to be responsible for identifying and controlling systemic risk. We are confident that through our collective efforts, we have the capacity to emerge from this crisis with stronger and more modern regulatory oversight that will not only prepare us for the challenges facing financial firms today and in the future, but help support renewed economic growth and job creation.

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:
"Perspectives on Systemic Risk"

Thursday, March 5, 2009

Therese M. Vaughan, Ph.D.
Chief Executive Officer
National Association of Insurance Commissioners

Testimony of Therese M. Vaughan, Ph.D.
Chief Executive Officer
National Association of Insurance Commissioners

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for inviting me to testify before the Subcommittee on perspectives on systemic risk.

My name is Therese Vaughan. I am the Chief Executive Officer of the National Association of Insurance Commissioners (NAIC). Prior to joining the NAIC, I was a Professor of Insurance and Actuarial Science at Drake University where I focused on the management and regulation of financial institutions. I also served as the Iowa Insurance Commissioner from 1994 to 2004, and NAIC president in 2002. I am pleased to be here today to discuss the NAIC's activities in the area of regulatory modernization and financial stability regulation, and to offer our assistance and expertise as the Committee tackles the enormous challenge of developing legislative solutions to the current financial crisis.

Identifying Systemic Risk

Sustained stability in the financial sector requires seasoned regulators with the authority, expertise and resources to fulfill their responsibilities, and a commitment among all financial regulators to work collaboratively to construct a system-wide view of the financial sector. The current financial crisis illustrates the interconnectedness of our financial system, and the need to strengthen the interconnectedness of our regulatory system.

"Systemic risk" has become the moniker of choice in most current descriptions of potential threats to the economy. However, this is a term whose meaning has evolved over time. Early on in the discussion, the term "systemic risk" was essentially synonymous with "too big to fail." While the size, scope, or leverage of an organization can be contributing factors to whether it poses systemic risk, these criteria alone are too simplistic a characterization. There is a growing appreciation that the legislative and regulatory structure that has allowed for innovation and synergies between and among financial institutions and their subsidiaries has also created significant interconnectedness and linkages where capital and risk can flow. At the moment, I

would argue that the greatest systemic risk facing our economy is a lack of confidence of the American people in our financial system.

The Government Accountability Office (GAO) in a recent report defines systemic risk as "the risk that an event could broadly affect the entire financial system rather than just one or a few institutions." We would agree. In our view, an entity poses systemic risk when that entity's activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it.

The nature of the insurance market and its regulatory structure make the possibility of systemic risk originating in the industry less than in other financial industries. In general, the insurance industry is more likely to be the recipient of systemic risk from other economic agents rather than the driving force that creates systemic risk.

There are several possible ways to look at systemic risk as it relates to the insurance industry. Among the issues to consider are whether systemic risk exists within a single insurer and the insurance industry as a whole, and whether systemic risk elsewhere in the economy could materially harm the insurance industry.

In terms of the size of individual firms, insurance markets in general are quite competitive and well functioning. Though large writers exist in certain lines and in some states, these insurers do not seem to qualify as "too big to fail." If an individual insurer were to fail, even an insurer with dominant market share, state guaranty funds would protect existing policyholders of the failed insurer by paying out claims. Other insurers would step forward in the marketplace to write the business left by the failing insurer. State residual markets are also available to write business. There may be short-term dislocations in the marketplace, but a major failure of an insurer will generally not create systemic risk within the insurance market or other elements of the overall economy. That is not to say that no stress would be felt by the market or consumers, but state regulations dealing with guaranty funds help alleviate the pain by protecting policyholders. In a competitive market, inefficient or unproductive firms are allowed to fail so that capital may find its way to more productive uses. In forming state guaranty funds, state regulators have considered the unique situation of an insurance policy being a future contract and the possible adverse effect on consumers.

Risks in insurance are different from bank risks for three reasons. First, insurers tend to be less leveraged than banks. This enables them to withstand financial stresses to a greater extent. In addition, strict rules on assets make insurers less vulnerable to declines in assets. Even in a situation that puts stress on policyholders and a line of business, it is unlikely that that strain will cascade to other areas of the economy.

Second, insurers tend to have liabilities that are different from those of banks. That is, the payment of the liabilities is generally independent of economic cycles. This makes a "run" on insurance companies unlikely compared to the situation with banks. Although annuity writers may experience a form of "run" by investors, it will likely be tempered by the existence of surrender fees. In an economic downturn, there will be some loss in demand for insurance policies, but in general, demand is relatively inelastic among insurers. That means cash flow is more likely to stay positive for insurance companies.

Third, and related to their unique liabilities, insurers tend to have a longer time horizon. They do not have to sell assets on a regular basis to meet short-term demands.

An insurance business having special interconnectedness to capital markets may be capable of generating systemic risk, however. The financial and mortgage guaranty lines have been stressed because of their coverage of mortgage-related securities. Those losses have negatively affected the availability of public sector and mortgage loan financing. The resulting situation has created a ripple effect where internal insurance losses resulting from a poor housing environment continue to further negatively impact the housing and mortgage sectors.

As has been well documented, large complex financial institutions with insurance operations have produced systemic risks within the economy. The insurance businesses in these holding companies have thus far been adequately protected by state insurance regulations. Nonetheless, the public may not differentiate between the instability in the holding companies and the relative stability of the insurance obligations, thus having the potential to create a flight by policyholders away from the insurance company.

Systemic risks originating in other parts of the overall economy, which in turn affect the insurance industry, are real. A collapse of the stock market (to a greater degree than what we have recently seen) or the bond market would have a dire effect on insurance companies and

could lead to insurance company failures. A collapse of the dollar and rampant inflation would increase claims costs for property and casualty insurers. A mixture of high inflation and a declining economy (stagflation) and low investment returns could create a perfect storm for all aspects of the economy. No system of regulation, no matter how good, can ensure that insolvencies will not occur in an extreme tail event. What it can do is protect consumers when that event occurs.

Promoting Financial Stability

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. We caution, however, that our willingness to collaborate should not be misconstrued as simple acquiescence to federal preemption. Under our supervision, insurance companies have weathered these extraordinary economic times relatively well while coping with catastrophic storms and a challenging marketplace. Our conservative solvency standards and accounting guidance have been validated by these events, and the record of state insurance regulation proves that we have earned an equal seat at the table.

In addition to consideration of financial stability or systemic risk regulation, Congress should also consider regulatory safeguards and imposing greater transparency in the capital markets so that financial products or interactions that pose systemic risk can be identified. The magnitude of the credit default swap (CDS) market illustrates this reality.

Principles for Systemic Risk Regulation

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. We have developed a series of principles for systemic risk regulation, as it relates to insurance, that we believe must be incorporated into any comprehensive systemic risk system. Our principles recognize that greater collaboration among financial services regulators is needed while securing and maintaining existing expertise through preservation of the principle of functional regulation.

1. Primary Role for States in Insurance Regulation

Any framework established to regulate financial stability must integrate, but not displace, the successful state-based system of insurance regulation. The nation's insurance markets represent an island of relative stability in an otherwise chaotic and troubled financial sea, and that is due to the strong solvency protections implemented and enforced by the states.

Consumer access to state-based, local regulatory officials must be maintained as part of any systemic risk regulatory system that is established. That local access, which exists in the current system of state insurance regulation, is the bulwark of consumer protection. State insurance regulators are on the front lines in resolving approximately three million consumer inquiries and complaints every year and that daily attention to the needs of individuals and businesses must be maintained in any reform effort. While state insurance regulators are concerned that insurers are profitable and provide a reasonable return for investors, the focus of insurance regulation is protection of policyholders and claimants. It is the forward-looking nature of insurance that compels regulators to make sure that sufficient funds are available to respond to consumers' needs when they arise.

A federal financial stability regulatory scheme must provide for sharing of information and formal collaboration among all financial regulators. Appropriate information sharing authority and confidentiality protocols should be established among all federal and state financial services regulators, and with law enforcement. This will ensure that all financial services regulators are on equal footing in access to needed information, and will help mitigate regulatory arbitrage.

2. Formalization of Regulatory Cooperation and Communication

Federal financial stability regulation should ensure effective coordination, collaboration and communication among the various and relevant state and federal financial regulators, and should ensure such coordination among all such regulators in the United States. Formal structures should be enhanced or introduced to provide a forum for all financial regulators to consult about emerging issues and trends, allowing early identification and action on issues potentially affecting the larger economy.

In consultation with functional regulators, any financial stability regulator should develop best practices for systemic risk management. Preservation of "functional regulation" should be a fundamental goal of federal financial stability regulation. Financial stability regulation, as it relates to insurance, can only be stronger with the added expertise of the 13,000 people working in state and territorial insurance departments.

3. Group Supervision of Holding Companies

Preemption of functional regulatory authority, if ever appropriate or necessary, should be limited to extraordinary circumstances that present a material risk to the continued solvency of the holding company (or "enterprise") or threaten the stability of a financial system. In considering the systemic risk posed by large institutions or holding company structures, the concept of "supervisory colleges" should be used to understand the risks within the holding company structure. Such "colleges" should consist of functional regulators from each financial services sector represented within institutions or holding company structures deemed to pose systemic risk.

Federal financial stability regulation must operate in a transparent, accountable and collaborative manner, and should defer to the functional regulator in proposing, recommending or requiring any action related to a regulated entity's capital, reserves or solvency. The health of one company within the holding company structure should not be compromised simply for the benefit of another company within another sector of the holding company. Decisions affecting an entity's finances can affect millions of policyholders and consumers. Accordingly, they require the greatest care and expertise.

Where state insurance regulation is concerned specifically, preemption of state regulatory authority should take place, if at all, only under limited circumstances where there is material risk to the financial system, only to the extent necessary to meet obligations to policyholders and claimants, and only where state regulatory authority to act has been exhausted. Preemption should never occur for its own sake. There is great benefit to having multiple sets of eyes looking at an institution, such as exists with the current state-based insurance regulatory system. Preempting – and putting a single federal regulator in charge – would take away the crucial failsafe of allowing real and potential oversights by one regulator to be spotted and corrected by others.

Systemic Risk in Insurance

Insurance companies are more often the receivers or conduit of risk than the creators – the assumption of risk, after all, is their fundamental business. The same is true of systemic risk, which provides ample motivation for us to want to close regulatory gaps to encourage greater financial stability. Insurers' exposure to systemic risk typically flows from linkages to the capital markets. A classic example is AIG, where the unregulated credit default swap (CDS) transactions impaired the holding company, resulting in a downgrade which has threatened policyholders' confidence in the otherwise stable insurance subsidiaries. AIG's insurance companies were also directly exposed to systemic risk through securities lending partnerships with other financial institutions. This activity resulted in a liquidity crunch when a massive deterioration in the value of traditionally conservative, fixed income securities resulted in AIG's counterparties all attempting to exit the marketplace at roughly the same time. No company or regulator operates so conservatively as to withstand such a "run on the bank" scenario, but financial stability regulation can ensure that such scenarios are identified and mitigated before they become systemic.

Insurance can also illustrate the difference between systemic risk and the risk of large failures. Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant. For example, if the largest auto insurer in the U.S. fails, its policyholders can be quickly absorbed by other insurers, and they are backed up further by the state guaranty fund system. This scenario does not pose systemic risk – as the impact is isolated, does not ripple to other financial sectors and does not require extraordinary intervention to mitigate. Any system of financial stability regulation should focus on truly systemic risk, and not create redundant mechanisms for dealing with isolated disruptions.

Conclusion

The NAIC is a full partner with Congress and the Administration in seeking ways to improve the financial regulatory system and promoting financial stability. The state-based insurance regulatory system is one of critical checks and balances, where the perils of a single point of failure and omnipotent decision making are eliminated. We have a long history of consumer protection, conservative solvency oversight, and market stability, so any system of financial stability regulation can, and must, build on this proven regime.

Thank you for the opportunity to testify, and I would be happy to answer your questions.

United States Government Accountability Office

GAO

Testimony
Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

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SYSTEMIC RISK

Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps

Statement of Orice M. Williams, Director
Financial Markets and Community Investment

GAO-09-397T

Highlights

Highlights of GAO-09-397T, a testimony to Congressional Requesters

Why GAO Did This Study

The U.S. financial system is more prone to systemic risk today because (1) the current U.S. financial regulatory system is not designed to adequately oversee today's large and interconnected financial institutions, (2) not all financial activities and institutions fall under the direct purview of financial regulators, and (3) market innovations have led to the creation of new and sometimes complex products that were not envisioned as the current regulatory system developed. Credit default swaps (CDS) are one of the products that have assumed a key role in financial markets.

My statement will discuss (1) the extent to which U.S. financial regulators and the UK regulator oversee CDS, (2) risks and challenges that CDS present to the stability of financial markets and institutions and similar concerns that other products may pose, and (3) the recent steps that financial regulators and the industry have taken to address risks pose by CDS and similar efforts that may be warranted for other financial products. GAO reviewed research studies and congressional testimonies. We interviewed financial regulators and a variety of financial market participants.

In January 2009, GAO designated the financial regulatory system as a high-risk area in need of congressional attention. Issues involving systemic risk regulation in general and CDS in particular should be considered as part of that effort.

View GAO-09-397T or key components. For more information, contact Orice M. Williams at (202) 512-8678 or williamso@gao.gov.

March 2009

SYSTEMIC RISK

Regulatory Oversight and Recent Initiatives to Address Risks Posed by Credit Default Swaps

What GAO Found

The current regulatory structure for CDS does not provide any one regulator with authority over all participants in the CDS market, making it difficult to monitor and manage potential systemic risk. Federal oversight of CDS trading and monitoring of the CDS market are largely conducted through the banking regulators' safety and soundness oversight of supervised banks that act as CDS dealers. The Securities and Exchange Commission and the Commodity Futures Trading Commission lack the authority to regulate CDS broadly as financial products. Regulators have sought to address potential systemic risks arising from CDS activities mainly through collaborative efforts with other supervisors and key market participants. However, the extent to which regulators routinely monitor the CDS activity of unregulated market participants is unclear. The Financial Services Authority in the United Kingdom has authority over most CDS products and can collect information about the CDS market, but it has pursued most of its regulatory efforts in collaboration with U.S. regulators.

CDS pose a number of risks to institutions and markets, many of which are not unique. These include counterparty credit, operational, concentration, and jump-to-default risks. Market participants and observers noted that CDS referencing asset-backed securities (ABS) and collateralized debt obligations (CDOs), particularly those related to mortgages, currently pose greater risks to institutions and markets than other types of CDS. Other risks and challenges from CDS relate to the lack of transparency in CDS markets, the potential for manipulation related to the use of CDS as a price discovery mechanism, and the use of CDS for speculative purposes. Regulators and market participants noted that over-the-counter (OTC) derivatives, to varying degrees, may pose some similar risks and a few identified equity derivatives as the OTC derivatives that were most similar to CDS.

Financial regulators and market participants have initiated several efforts to mitigate these risks. These efforts target primarily operational and counterparty credit risks and include improving the operational infrastructure of CDS markets, creating a clearinghouse or central counterparty process to clear CDS trades, and establishing a central trade registry for CDS. If effectively implemented and sustained, these initiatives could begin to address some of the risks noted. But the effectiveness of these recent initiatives could be limited because participation is voluntary and regulators lack the authority to require all market participants to report their trades to a repository. Moreover, customized and highly structured CDS, which can include CDS with complex reference entities that may present additional risks, generally lack the standardization necessary for centralized clearing. Other ideas to reform CDS markets, such as mandatory clearing or limiting some types of trades, have important limitations that would need to be addressed. Finally, many participants and observers agreed that OTC derivatives other than CDS generally share some of the same risks and could benefit from similar efforts to mitigate their impact.

Chairman Kanjorski and Members of the Subcommittee:

I appreciate the opportunity to participate in the hearing today to broadly discuss systemic risk and in particular the systemic risk posed by credit default swaps (CDS) and other over-the-counter (OTC) derivatives. As you well know, there is no single definition for systemic risk. Traditionally, systemic risk was viewed as the risk that the failure of one large institution would cause other institutions to fail. This micro-level definition is one way to think about systemic risk. Recent events have illustrated a more macro-level definition: the risk that an event could broadly affect the financial system rather than just one or a few institutions. In our January 2009 report on the U.S. financial regulatory system, we pointed out that the current regulatory system was not designed to adequately oversee today's large and interconnected financial institutions, whose activities pose new risks to the institutions themselves and systemic risk to the broader financial system.[1] We also noted that not all financial activities and institutions fall under the direct purview of financial regulators and that market innovations had led to the creation of new and sometimes complex products whose complexity and substantial role in the financial system was not envisioned as the current regulatory system developed. Credit default swaps are one of the products that have assumed a key role in financial markets. They are being used by financial institutions that are subject to varying degrees of regulation, and the market for CDS is largely unregulated in the United States.

My statement today focuses on the results of prior work and our recent review of CDS and the risks that they and other OTC derivatives pose to the financial system (initiated at the request of Ranking Member Bachus and Chairman Kanjorski). Specifically, I will discuss (1) the extent to which U.S. financial regulators and the UK regulator oversee CDS, (2) risks and challenges that CDS present to the stability of financial markets and institutions and similar concerns that other products may pose, and (3) the recent steps that financial regulators and the industry have taken to address risks posed by CDS and whether similar efforts may be warranted for other financial products.

[1]GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

To achieve our objectives, we analyzed publicly available reports, congressional testimonies, and other documents issued by international financial organizations, academics, financial regulators, industry groups, and market participants. We also corresponded with the New York State Insurance Department, the UK Financial Services Authority (FSA), and two clearinghouses. We interviewed staff from the Board of Governors of the Federal Reserve System (FRS), Commodity Futures Trading Commission (CFTC), Federal Reserve Bank of New York (FRBNY), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), President's Working Group on Financial Markets (PWG), and the Securities and Exchange Commission (SEC). Finally, we spoke with representatives of three CDS dealer banks, a credit rating agency, an industry trade group, five hedge funds, a large provider of derivatives trade and settlement services, and a large provider of CDS pricing and valuation services, as well as speaking with two industry observers. We provided a summary of our findings to the FRS, OCC, OTS, and SEC, and this statement was based on those summaries and incorporates their comments as appropriate.

We conducted our work from October 2008 to February 2009 in accordance with all sections of GAO's Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained and the analysis conducted provide a reasonable basis for our findings and conclusions.

Summary

The current regulatory structure for CDS and other OTC derivatives does not provide any one regulator with the authority over all market participants, making potential systemic risk hard to monitor and manage. In the United States, federal oversight of CDS trading is largely conducted through the banking regulators' safety and soundness oversight of the supervised banks that act as dealers in the market. Unlike equities or futures markets that are regulated by SEC and CFTC respectively, CDS are not regulated broadly as financial products because SEC and CFTC lack authority to do so. Federal financial regulators, namely the banking regulators, generally monitor activity in the CDS market through information obtained from their supervised entities, but comprehensive and consistent data on the overall market have not been readily available. Regulators have sought to address potential systemic threats arising from CDS activities mainly through collaborative efforts with other U.S. and foreign supervisors and key market participants. However, the extent to

which regulators routinely monitored the CDS activity of unregulated market participants is unclear. While U.S. federal financial regulators do not have authority over CDS as a product, in the United Kingdom, FSA has authority over most CDS products and can collect information on those products. Despite this broader authority, FSA has pursued most of its regulatory efforts in collaboration with U.S. regulators.

CDS pose a number of risks, including

- **Counterparty credit risk**—the risk to each party in an OTC derivatives contract that the other party will not perform the contractual obligations.
- **Operational risk**—the potential for losses that could occur from human errors or failures of systems or controls.
- **Concentration risk**—the potential for loss when a financial institution establishes a large net exposure in similar types of CDS.
- **Jump-to-default risk**—the risk that the sudden onset of a credit event will cause an abrupt change in a firm's CDS exposure.

Market participants pointed out that the degree of risk associated with CDS can vary depending on (1) the type of CDS, (2) the reference entity for the CDS, and (3) how the CDS is used. Market participants and observers noted that CDS referencing asset-backed securities (ABS) and collateralized debt obligations (CDOs), particularly those related to mortgages, currently pose greater risks to institutions and markets than other types of CDS. Other risks and challenges from CDS relate to the lack of transparency in CDS markets, the potential for manipulation related to the use of CDS as a price discovery mechanism, and the use of CDS for speculative purposes. It is also important to note that many of these risks are not unique to CDS. Regulators and market participants noted that OTC derivatives may share some similar types of risks as CDS, but the degree of risk can vary. Equity derivatives were identified as the OTC derivatives that were most similar to CDS in terms of the risks and challenges that they presented.

Recognizing the threat that CDS and other OTC derivatives could pose to the financial system, regulators and market participants have initiated several efforts to address certain risks posed by CDS. These efforts have primarily targeted operational and counterparty credit risks and include improving the operational infrastructure of CDS markets, creating a clearinghouse or central counterparty process to clear CDS trades, and establishing a central trade registry for CDS. If effectively implemented and sustained, these initiatives have the potential to begin to address some

of the risks related to the use of CDS and other OTC derivatives. However, the effectiveness of these recent initiatives could be limited because participation is voluntary and regulators lack the authority to require all market participants to report their trades to a repository. Moreover, the more customized and highly structured CDS, which can include CDS on complex reference entities (e.g., ABS and CDOs) that may present additional risks to institutions and financial markets, generally lack the standardization necessary for centralized clearing. As a result, individual institutions' management of CDS risks remains critical to these institutions' safety and soundness. Similarly, management of counterparty credit risk is critical to any future central clearinghouse, which would concentrate exposure to CDS and could pose systemic risk. Other ideas to reform CDS markets, such as mandatory clearing or limiting some types of CDS trades, have important limitations or challenges that would also have to be addressed. Many participants and observers agreed that OTC derivatives other than CDS generally share some of the same types of risks, although to varying degrees, and could benefit from similar efforts to mitigate their impact.

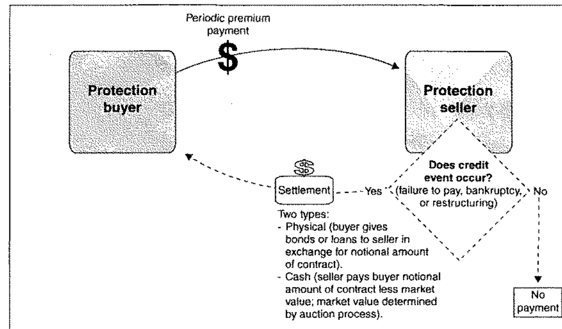
Background

As originally designed, CDS are bilateral contracts that are sold over the counter and transfer credit risks from one party to another. The seller, who is offering credit protection, agrees, in return for a periodic fee, to compensate the buyer, who is purchasing it, if a specified credit event, such as default, occurs (see fig. 1). There are three standard types of CDS contracts, depending on the underlying reference entity.

- A single-name CDS is based on a single reference entity such as a bond, institution, or sovereign entity.
- A multi-name CDS references more than one corporate or sovereign entity and can be divided into those that reference at least 2 but not more that 10 entities and those that reference more than 10 entities.
- An index CDS is based on an index that may include 100 or more corporate entities.

The contract term often ranges from 1 to 10 years, with most standard CDS contracts having a 5-year duration.

Figure 1: Overview of a CDS Contract



Source: GAO.

Participants in the CDS market include commercial banks, broker dealers, hedge funds, asset managers, pension funds, insurance and financial guaranty firms, and corporations. CDS can provide a number of benefits, such as giving some market participants another tool to manage credit risk. They also are a way to replicate an investment in a debt instrument such as a bond. However, in 2008, as the United States and the world faced one of the worst financial crises in history, some market observers identified CDS as one of several financial products they believed had contributed to the overall tightening in the credit markets following the bankruptcy of Lehman Brothers and the near-collapse of American International Group (AIG), which was a major CDS seller. Although authoritative information about the actual size of the market is generally not available, some have estimated the amount of outstanding contracts—as measured by the notional amount of the CDS contracts—at over $50 trillion in 2008. However, more recent figures place the notional amount at around $28 trillion, in part reflecting trade compression efforts. These market events and the estimated size of the CDS market have raised concerns about the risks that CDS and similar financial products may pose to the stability of the financial system. Furthermore, questions have been raised about the current level and structure of oversight of CDS and their impact on the financial system. In the last 3 years, CDS market participants and financial regulators have been taking actions to help

mitigate various risks and challenges related to CDS activities, with a particular focus on the market's infrastructure.

CDS Oversight Highlights the Challenges of an Outdated Regulatory System

In the United States, federal financial oversight of CDS is limited. Banks, whose activities as CDS dealers account for a large percentage of CDS trading, are subject to safety and soundness oversight by banking regulators. Bank regulators therefore have the authority to act on their concerns about the extent to which a banking organization's CDS trading affects the health of the bank. However, oversight of banks acting as dealers does not directly extend into the CDS product market itself. In addition, federal financial market regulators—primarily SEC and CFTC—are generally limited or restricted in their ability to oversee CDS broadly as a product because they lack statutory authority. SEC has antifraud and antimanipulation authority over CDS, but it may face challenges in enforcing this authority because of statutory restrictions on its rule-making ability. Federal financial regulators have sought to address potential systemic threats arising from CDS activities mainly through collaborative efforts with other supervisors and key market participants. While U.S. federal financial regulators do not have authority over CDS as a product, in the United Kingdom, which has a CDS market comparable in size to the U.S. market, FSA has authority over most CDS products. However, its regulatory efforts have generally been pursued in collaboration with U.S. regulators.

Federal Regulation of CDS Generally Focuses on the Activities of Dealer Banks

Federal banking regulators can oversee the CDS activity of the financial institutions they supervise. These regulators' oversight captures most CDS activity because banks act as dealers in the majority of transactions. All of the major CDS dealers are commercial banks or subsidiaries of bank or financial holding companies that are subject to regulation by U.S. or foreign holding company regulators.[2] Also, bank regulators have some authority to review the effect of a bank's relations with an affiliate on the health of the bank. However, bank regulators do not regulate the CDS markets. Moreover, bank regulators generally do not differentiate CDS from other types of credit derivatives in their supervision of institutions, because most credit derivatives volume is comprised of CDS. Regulators

[2]Some CDS activities are conducted at these banks' broker-dealer subsidiaries, which are subject to SEC oversight.

focus their oversight on institutions' derivatives portfolios regardless of their structure.

Banking regulators' oversight of CDS activity is largely limited to activity that is deemed to pose risks to the safety and soundness of the institutions they regulate. Accordingly, federal banking regulators generally oversee dealer banks in the U.S. mainly as part of their ongoing examination programs. However, as we reported in 2008, some regulators continued to be concerned about the counterparty credit risk created when regulated financial institutions transacted with entities that were less regulated, such as hedge funds, because these activities could be a primary channel for potential systemic risk.[3]

FRS officials explained that when examiners identified an increasing use of credit derivatives at certain regulated banks, they expanded the scope of their examinations to include a review of risks arising from the banks' trading of these products. These exams generally were broad in scope, although occasionally they focused on CDS, and assessed the products' financial risk and the way banks monitored and managed that risk. According to officials, some of the examination findings included concerns related to management of counterparty credit risk, including collateral practices, risk management systems, models for risk identification, and governance issues.

OCC officials explained that, as the prudential regulator of the large dealer banks, its on-site examiners conducted ongoing risk-focused examinations of the more complex banking activities, which could include CDS transactions. OCC targets its risk-focused examinations using risks or trends that it notices across banks. According to OCC officials, its on-site examiners monitor derivatives activity daily in the large dealer banks and look for trends and exceptions in the banks' information to gauge risk. For example, they may examine new counterparties that have not gone through an internal counterparty review process. OCC also conducts a quarterly analysis of the derivatives market using call report data submitted by all insured U.S. commercial banks to evaluate risks from trading activities, including CDS, in the national banking system. However, this oversight does not provide a clear snapshot of potential

[3]GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*, GAO-08-200 (Washington, D.C.: Jan. 24, 2008).

concentrations of risk in participants outside of national banks. Similarly, FRBNY collects data from OTC derivatives dealers that participate in an FRBNY-led initiative to improve the operational infrastructure for CDS, including information on operational metrics such as confirmation backlogs and transaction volumes but not on CDS exposures.

Under consolidated supervision, some subsidiaries of holding companies that engage in CDS activities may not receive the same degree of monitoring as regulated entities receive from their prudential supervisors. OCC officials explained that, while most CDS activity is conducted in banking entities because CDS trading is a permissible bank activity, some derivatives activity is conducted in nonbank subsidiaries of holding companies. OCC, like other federal bank regulators, has authority to review how a bank's relations with an affiliate (specifically, an affiliate that is not a subsidiary of the bank) affects the health of the bank. However, OCC supervises the bank, not the affiliate. In such cases, OCC officials said that they would collaborate with FRS to examine activity in the other nonbank subsidiaries if they deemed it necessary.

Similarly, even though SEC oversees broker-dealers, the agency does not regulate the CDS markets they deal in. Until September 2008, SEC provided oversight of major investment bank conglomerates at the consolidated level through its Consolidated Supervised Entity (CSE) program.[4] According to SEC officials, investment banks generally conducted CDS transactions in subsidiaries not registered as U.S. broker-dealers, and therefore SEC did not have an ongoing on-site examination program for these entities. Rather, the CSE program monitored information aggregated at the holding company level that included the activities of these affiliates, including their CDS transactions. According to SEC, a significant part of the CSE supervision program was dedicated to monitoring and assessing market and credit risk exposures arising from trading and dealing activities. The CSE program conducted targeted exams related to three specific projects—reviews of liquidity pools, price verification of commercial real estate, and management of counterparty exposures—which SEC officials explained could include CDS activities but did not have CDS as a specific focus.

[4]The investment bank conglomerates formerly regulated under SEC's CSE program are now supervised at the consolidated level as bank holding companies. The CSE program no longer exists, although SEC continues to oversee these firms' registered broker-dealer subsidiaries.

Similarly, OTS is responsible for overseeing thrift holding companies through its consolidated supervision program. These entities include AIG, GE Capital Services, Morgan Stanley, and American Express Company, which are large global conglomerates with many subsidiaries. OTS does not conduct ongoing on-site examinations of all unregulated subsidiaries. OTS officials explained that the agency monitored the holding companies' enterprisewide risk-management practices to determine how the companies identified and managed risk and supplemented this monitoring with limited on-site visits of unregulated subsidiaries as it deemed necessary. For example, when AIG's external auditor identified internal control problems with AIG Financial Products, a nonthrift subsidiary that was active in the CDS market and ultimately identified as posing a systemic risk to the financial system because of its role in the market, OTS examined its operations. However, OTS officials told us that thrifts generally have engaged in limited CDS activities.

Federal financial regulators generally supplement data from their supervised entities or other information they collect with data from sources such as the International Swaps and Derivatives Association, Inc. (ISDA), the Bank for International Settlements, the British Bankers Association, and the rating agency Fitch to compare their banks to the larger universe of market participants. More recently, information has been available to regulators from the industry's central trade repository, the Trade Information Warehouse (TIW).

CDS Are Not Generally Regulated As a Product, Making Monitoring Their Role in the Market a Challenge

Federal market regulators—SEC and CFTC— do not have authority to regulate the CDS markets directly. With respect to CDS trading, their authorities are limited or restricted. In 1999, the PWG unanimously urged Congress to adopt recommendations aimed at mitigating certain legal uncertainties related to OTC derivatives. One recommendation was to exclude from oversight certain bilateral transactions between sophisticated counterparties and eliminating impediments to clearing OTC derivatives. A CDS is this type of transaction. Congress largely adopted the PWG recommendations when it passed the Commodity Futures Modernization Act of 2000 (CFMA). As a result, the Commodity Exchange Act (CEA) was amended to exclude the OTC CDS market from the regulatory and enforcement jurisdiction of CFTC. Federal securities laws also exclude CDS from SEC oversight, although SEC retains antifraud enforcement authority.

SEC's authority over CDS activity conducted outside of a registered broker-dealer is generally limited to enforcing antifraud provisions,

including prohibitions against insider trading. These provisions apply because CDS generally are considered security-based swap agreements under CFMA. However, because SEC is generally statutorily prohibited under current law from promulgating record-keeping or reporting rules regarding CDS trading in the OTC market outside of a registered broker-dealer, its ability to enforce its authority is difficult. However, in the past 3 years SEC has initiated a number of CDS-related enforcement cases for alleged violations of its antifraud prohibitions, including cases involving market manipulation, insider trading, fraudulent valuation, and financial reporting. More recently, in September 2008 SEC initiated an investigation into possible market manipulation involving CDS. In connection with the investigation, SEC announced that it would require certain hedge fund managers and other entities with CDS positions to disclose those positions to SEC and provide other information under oath. According to SEC, depending on the results the investigation may lead to more specific policy recommendations regarding CDS.

SEC officials indicated that investigations of OTC CDS transactions have been far more difficult and time-consuming than those involving exchange-traded equities and options because of the prohibition on requiring recording keeping and reporting for CDS. The lack of clear and sufficient record-keeping and reporting requirements for CDS transactions has resulted in incomplete and inconsistent information being provided when requested, according to SEC officials. The officials said that this restriction had made it more difficult to investigate and take effective action against fraud and manipulation in the CDS market than in other markets SEC oversaw. In October 2008, the SEC Chairman requested that Congress remove the CFMA restrictions on SEC's rulemaking authority with respect to CDS. The current Chairwoman has indicted that she supports removal of these restrictions as well.

Federal Regulators' Approach to Monitoring Systemic Risk from CDS Has Hinged on Collaborative Efforts

Federal financial regulators have sought to address potential systemic threats arising from CDS activities mainly through collaborative efforts with other supervisors and market participants. According to federal financial regulators, they address potential systemic risks by working closely with each other and international regulators to exchange information and coordinate the supervision of regulated market participants that could pose systemic risks to the financial system. Some of these collaborative forums include the PWG, the Senior Supervisors Group, the Basel Committee on Banking Supervision, the Financial Stability Forum, and the Joint Forum. However, it is unclear to what

extent the activities of unregulated subsidiaries or other unregulated market participants were also being reviewed as part of these initiatives.

FRS officials indicated that, in carrying out its responsibilities for conducting monetary policy and maintaining the stability of the financial system, the Federal Reserve monitored markets and concentrations of risk through data analysis and direct contact with market participants. According to FRS officials, in supervising banks and bank holding companies they focused on CDS activity as it pertained to institutional stability. FRS ensures that the appropriate infrastructure is in place so that the system can absorb "shocks." FRS officials explained that, by ensuring that important market participants could avoid the most adverse impacts from these shocks—such as through counterparty credit risk management—systemic risk could be mitigated.

Over the last several years, FRS has identified opportunities to increase the market's resiliency to systemic shocks related to CDS—for example, by implementing a market process for settling CDS contracts, reducing the notional amounts of outstanding contracts, and improving the operational infrastructure of the CDS market in collaboration with other supervisors. For example, since September 2005 financial regulators in the U.S. and Europe have collaborated with the industry to improve the operational infrastructure of the CDS market and to improve counterparty risk management practices. However, some market participants and observers noted that the current regulatory structure did not enable any one regulator to monitor all market participants and assess potential systemic risks from CDS and other types of complex products.

In the United Kingdom, FSA Generally Has Broader Authority Than U.S. Regulators Collectively

While U.S. regulators do not have authority over CDS as a product, in the United Kingdom, where available evidence suggests CDS volume is comparable to that in the United States, FSA has authority over most CDS products. FSA officials explained that most CDS-related regulatory efforts have been pursued in collaboration with U.S. regulators, such as the effort to improve the operational infrastructure for CDS that was led by FRBNY and the Senior Supervisors Group's effort to enhance risk management practices. FSA officials also explained that, more recently, it had been monitoring all aspects of OTC infrastructure and industry commitments, including central clearing for CDS, credit event settlement, collateral management processes, trade compression, and position transparency. Much of this monitoring is conducted through data collected directly from regulated firms.

The New York State Insurance Supervisor Has a Role in Overseeing Insurers' CDS Activities

The New York State insurance supervisor also has authority to oversee certain aspects of insurers' OTC derivatives activities, including CDS transactions. According to the New York State Insurance Department, it has regulated the use of derivatives by insurance companies, including CDS, since the late 1990s. The Department is the primary regulator for most U.S. financial guaranty insurers (FGIs), which are also known as bond insurers. According to the Department, aside from FGIs few insurance companies buy or sell CDS because New York state law generally prohibits insurers from significantly leveraging their portfolios. Insurance companies generally use CDS for hedging credit risk and for investment purposes. According to department officials, in its role as regulator for FGIs the department ensures that insurance companies maintain consistent underwriting criteria and adequate reserves for these activities. Under New York law, insurers must file detailed disclosures about their derivatives transactions in their quarterly and annual statements. Also, prior to engaging in any derivatives activity insurers must file a derivatives use plan that documents their ability to manage derivatives transactions. According to department officials, the department has requested detailed information from FGIs and engages in ongoing dialogue with them concerning insurance contracts referencing CDS.

However, if an insurance company uses subsidiaries that are not affiliated with the insurance company, oversight may be limited. For example, the superintendent of the New York State Insurance Department testified that it did not oversee the activities of AIG Financial Products because AIG Financial Products was not affiliated with the insurance companies the department regulates.

Risks and Challenges Presented by CDS and Other Financial Products

Risks to financial institutions and markets from CDS include counterparty credit risk, operational risk, concentration risk, and jump-to-default risk. However, market participants suggested that the degree of risk associated with CDS varied depending on (1) the type of CDS, (2) the reference entity for the CDS, and (3) how the CDS was used. More specifically, CDS referencing ABS and CDOs, particularly those related to mortgages, were identified as posing greater risks to institutions and markets than other types of CDS. Other risks and challenges include the lack of transparency in CDS markets, the potential for manipulation related to the use of CDS as a mechanism for price discovery, and the use of CDS for speculative purposes. Regulators and market participants noted that some OTC derivatives may share similar risks. However, the degree of risk can vary substantially by product type. Equity derivatives specifically were

identified as the OTC derivatives that were most similar to CDS in terms of the risks and challenges that they presented.

Overview of the Risks and Challenges Posed by CDS

The main risks from CDS include counterparty credit risk, operational risk, concentration risk, and jump-to-default risk. In simple terms, counterparty credit risk is the risk to each party in an OTC derivatives contract that the other party will not fulfill the obligations of the contract. In addition to potentially not receiving contractual payments, a purchaser of CDS whose counterparty fails would suddenly be left without protection and could either have to replace the CDS contract at current, higher market values or go without protection. Banks and other financial institutions that have large derivatives exposures use a variety of techniques to limit, forecast, and manage their counterparty risk, including margin and collateral posting requirements.

However, regulators, market participants, and observers identified several challenges in managing CDS counterparty credit risk. First, although margin and collateral posting serve as a primary means of mitigating the risk of loss if a counterparty does not perform on its contractual obligations, calculating margin and collateral amounts can be difficult because of the challenges associated with determining the actual amount of counterparty exposure and the value of the reference asset. Specifically, it may be difficult for market participants to agree on the valuation of CDS contracts on ABS and CDOs. Second, margining practices are not standardized and vary depending on the counterparty. For example, market participants and observers suggested that institutions with high credit ratings, for which exposures were considered to pose little credit risk, were not initially required to post collateral. These firms included bond insurers and AIG Financial Products, a noninsurance subsidiary of AIG. However, when some of these institutions' ratings were downgraded, the institutions had difficulty meeting collateral calls. Third, the CDS market lacks comprehensive requirements for managing counterparty credit risk. More specifically, the bilateral collateral and margin requirements for OTC derivatives do not take into account the counterparty credit risk that each trade imposes on the rest of the system, allowing systemically important exposures to build up without sufficient capital to mitigate associated risks.

The second type of risk that I would like to discuss is operational risk. This is the risk that losses could occur from human errors or failures of systems or controls. With CDS, there are several operational steps that are required to process trades, such as trade confirmation, which were not

automated until recently and thus created backlogs in the system. In a report issued in 2007, we reported that these backlogs were largely due to a decentralized paper-based system and the assignment of trades to new parties without notifying the original dealer—a process known as novation.[5] For instance, in September 2005, some 63 percent of trade confirmations (or 97,650) of the 14 largest credit derivatives dealers had been outstanding for more than 30 days. These large backlogs of unconfirmed trades increased dealers' operational risk, because having unconfirmed trades could allow errors to go undetected that might subsequently lead to losses and other problems. Potential problems also existed in the operational infrastructure surrounding physical settlement, novation, and valuation of CDS.

The third type of risk, concentration risk, refers to the potential for loss when a financial institution establishes a large net exposure in similar types of CDS. For example, AIG presented concentration risk because it sold a significant amount of CDS protection on related reference entities without also holding offsetting positions and did not sufficiently manage this risk. This risk tends to be greater for dealers that sell CDS protection because no margin and collateral requirements exist to ensure that the selling firm will be able to meet its potential obligations. Also, the potential exposures are greater and more uncertain than the fixed premium payments of a purchaser of CDS protection. Additionally, if a market participant decides to hold a large concentrated position, it could experience significant losses if a credit event occurred for one or more reference entities. But concentration risk can create problems for market participants even without a credit event involving the reference entity. For example, a market participant may face obligations to post collateral on a large net exposure of CDS if its financial condition changes, potentially resulting in financial distress for the dealer. AIG is the most recent example of this problem. When its credit rating was downgraded, the contracts required that it post collateral, contributing to the company's liquidity crisis.

Market participants suggested that the degree of risk from concentrated net exposures was tied to the nature of the reference entity or obligation. For example, a concentrated position in CDS on mortgage-related CDOs

[5]GAO, *Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, but Were Successfully Addressed after Joint Regulatory Action*, GAO-07-716 (Washington, D.C.: June13, 2007).

may present more risk than CDS on a highly-rated corporation or U.S. government bonds. Further, concentration risks at one firm may also present challenges to other market participants and the financial system. According to a regulator and an observer, the lack of clear information on the net CDS exposures of market participants makes informed decisions about risk management difficult, a situation that becomes increasingly problematic when a credit event occurs. A regulator also testified that because the CDS market was interconnected, the default of one major participant increased the market and operational risks faced by more distant financial market participants and impacted their financial health. The near-collapse of AIG illustrates the risk from large exposures to CDS.

Finally, jump-to-default risk, as it relates to the CDS market, is the risk that the sudden onset of a credit event for the reference entity can create an abrupt change in a firm's CDS exposure. Such a credit event can result in large swings in the value of the CDS and the need to post large and increasing amounts of collateral and ultimately fund the settlement payment on the contact. The default of a reference entity could put capital strain on the CDS seller from increased collateral and payment obligations to settle the contract. For example, because CDS generally are not funded at initiation, a CDS seller may not have provided sufficient collateral to cover the settlement obligations.

CDS Can Also Pose a Number of Other Risks and Challenges

Other risks and challenges from CDS identified by market participants, observers, and regulators include a lack of transparency in the CDS market, the potential for manipulation related to the use of CDS as a price discovery mechanism, and the use of CDS for speculative purposes. According to some regulators, market participants, and observers, limited transparency or disclosure of CDS market activity may have resulted in the overestimation of risk in the market. Such a lack of transparency may have compounded market uncertainty about participants' overall risk exposures, the concentration of exposures, and the market value of contracts. For example, as mentioned previously at least one regulator and an observer suggested that it was unclear how the bankruptcy of Lehman Brothers would affect market participants, and this uncertainty contributed to a deterioration of market confidence. More specifically, it was reported that up to $400 billion of CDS could be affected, but the Depository Trust and Clearing Corporation (DTCC) later stated that its trade registry contained $72 billion of CDS on Lehman, and this amount was reduced to about $21 billion in payments after bilateral netting. Some market participants suggested that concerns about transparency were even more prevalent with customized CDS products because the contracts

were not standardized and their prices were determined using estimates rather than prices from actual transactions.

Some regulators and an industry observer suggested the potential existed for market participants to manipulate these prices to profit in other markets that CDS prices might influence, such as the equity market, and that the lack of transparency could contribute to this risk. CDS price information is used by some market participants as an indicator of a company's financial health. Market participants use spreads on CDS contracts to gauge the financial health and creditworthiness of a firm. However, two regulators and an industry observer suggested that it was unclear whether CDS prices accurately reflected creditworthiness because the market was largely unregulated and the quality of data is questionable in an opaque market. According to testimony by an SEC official in October and November 2008, the lack of transparency in the CDS market also created the potential for fraud, in part because the reporting and disclosure of trade information to the SEC was limited. More specifically, the official testified that a few CDS trades in a relatively low-volume or thin market could increase the price of the CDS, suggesting that an entity's debt was viewed by the market as weak. Because market participants may use CDS as one of the factors in valuing equities, this type of pricing could adversely impact a reference entity's share price. One market observer we spoke with offered the following hypothetical example: if the CDS price moves up and the equity price moves down, an investor could profit from holding a short position in the equity by buying protection in the CDS market. The SEC official testified that a mandatory system of record keeping and reporting of all CDS trades to SEC should be used to guard against the threat of misinformation and fraud by making it easier to investigate these types of allegations. However, another regulator suggested that the price discovery role was not a unique role to CDS and that exchange-traded derivatives such as foreign exchange and interest rate derivatives also served a price discovery function.

Another challenge identified by regulators and market participants was the frequent use of CDS for speculative purposes, an issue that has raised some concerns among some regulators and industry observers. Some have suggested that the practice should be banned or in some way restricted. However, other regulators and market participants disagree and note that speculators in the CDS market provide liquidity to the market and facilitate hedging. Many of the concerns stem from uncovered or "naked" CDS positions, or the use of CDS for speculative purposes when a party to a CDS contract does not own the underlying reference entity or obligation. Because uncovered CDS can be used to profit from price changes, some

observers view their function as speculation rather than risk transfer or risk reduction. For example, one regulatory official stated that these transactions might create risks, because speculative users of CDS have different incentives than other market participants. In addition, one regulator stated that when participants used CDS for speculative purposes, there was no direct transfer or swap of risk. Instead, the transaction creates risk from which the participant aims to profit. Market participants also noted that the risks associated with CDS did not stem from their use for speculation but from a failure to manage the risks, particularly CDS of ABS. Market participants and an observer also explained that a restriction on uncovered CDS would create a market bias in favor of protection buyers, because it is easier for them to hold a covered position. This bias could impact the liquidity of the market, because trading would be confined to those with an exposure to the referenced entity. Finally, market participants noted that firms used CDS to manage risks from many economic exposures in addition to risks such as counterparty credit exposures that arise from holding the underlying reference obligation.

A Number of Other OTC Derivatives Pose Similar Risks and Challenges

In addition to CDS, we also explored whether other products posed similar risks and challenges. Regulators and market participants identified a number of other OTC derivatives that presented similar risks and challenges, such as counterparty credit risk and operational risk. These OTC derivative products include interest rate, foreign exchange, and commodity derivatives. While the types of risk may be similar, the degree of risk can vary. However, equity derivatives specifically were identified as the OTC derivatives that are most similar to CDS in terms of the risks and challenges that they presented. OTC equity derivatives, such as equity swaps and options, were said to be similar to CDS because of the potential for abrupt shifts in exposure, a lack of transparency, and the ability to customize the product. Nevertheless, according to regulators and industry observers, the CDS market differs from other OTC derivatives markets because it poses greater risks due to the potential for greater increases in payment obligations and larger impacts from life-cycle events such as those associated with jump-to-default risk.

Regulators and the Industry Have Undertaken a Number of Initiatives Recently to Address Risks Posed By CDS and Other Financial Products

Financial regulators and the industry have initiated several efforts to begin addressing some of the most important risks posed by CDS and similar products, particularly operational and counterparty credit risks. These efforts include improving the operational infrastructure of CDS markets, implementing a clearinghouse or central counterparty to clear CDS trades, and establishing a central trade registry for CDS. If implemented effectively and sustained, the recent initiatives could begin to address some of the risks related to the use of CDS. However, their effectiveness will likely be constrained by two factors. First, participation in a clearinghouse and central trade registry is generally voluntary. And second, the efforts would not include the more customized and highly structured CDS that can include CDS on complex reference entities that may pose significant risks to institutions and financial markets. A number of other reforms to the CDS market have surfaced but face challenges. These include mandatory clearing or restricting CDS trades. Finally, OTC derivatives that share some of the risks related to CDS could benefit from similar efforts to mitigate their impact.

Actions Associated with Managing Risks Related to CDS Have Focused on Three Areas

Financial regulators and market participants have recently taken steps to try to address risks posed by CDS. The efforts have focused on three main areas: (1) operational and infrastructure improvements, (2) creation of a central trade repository, and (3) development of clearinghouses to clear CDS contracts.

Operational and Infrastructure Improvements

Regulators and industry members have cooperated since 2005 on four projects to identify and address operational risks posed by CDS. In addition to managing operational risks from CDS, several of these efforts should assist participants in managing counterparty credit risks in general.

- First, the industry has worked to reduce the backlog of CDS processing events, including unconfirmed trades. In 2005, a joint regulatory initiative involving U.S. and foreign regulators directed major CDS dealers to reduce the backlog of unconfirmed trades and address the underlying causes of these backlogs. In response, market participants increased the use of electronic confirmation platforms. Since November 2006, most CDS trades are confirmed electronically through an automated confirmation system known as Deriv/Serv. By increasing automation and requiring endusers to obtain counterparty consent before assigning trades, dealers were able to significantly reduce the number of total confirmations outstanding. As a result of these efforts

to improve trade processing, many participants view the CDS market as the most automated among OTC derivatives.

- Second, the industry has sought to improve novation, the process whereby a party to a CDS trade transfers, or assigns, an existing CDS obligation to a new entity. In 2005, the joint regulatory initiative suggested that the novation process had contributed to the large backlog of unconfirmed trades, because the assignment of trades to new parties often occurred without the consent of the original counterparty. In such cases, a party to a CDS contract might not be aware of the identity of its new counterparty, possibly increasing operational and counterparty credit risks. To streamline the novation process, ISDA introduced a novation protocol in 2005 that required counterparty consent before assigning a trade. However, until recently parties to the novation communicated using phone and e-mail, both of which can be inaccurate and inefficient. More recently, the industry has committed to processing all novation consents for eligible trades through electronic platforms.

- Third, the industry has attempted to reduce the amount of outstanding trades via "portfolio compression." In 2008, a Federal Reserve initiative resulted in a working group of dealers and investors that collaborated with the industry trade group ISDA to pursue portfolio compression of CDS trades. The process involves terminating an existing group of similar trades and replacing them with fewer "replacement trades" that have the same risk profiles and cash flows as the initial portfolio, and thus eliminating economically redundant trades. According to FRBNY, the compression of CDS trades results in lower outstanding notional amounts and helps to reduce counterparty credit exposures and operational risk. By the end of October 2008, FRBNY reported that trade compression efforts had reduced the notional amount of outstanding CDS by more than one-third.

- Finally, the industry has taken steps to implement a cash settlement protocol for CDS contracts. CDS contracts traditionally used physical settlement that required a protection buyer to deliver the reference obligation in order to receive payment. Because many CDS are uncovered, the protection buyer would have to buy the underlying referenced entity to deliver, potentially causing buyers to bid up prices and limiting the profits from protection and speculation. To address this concern, ISDA developed protocols to facilitate cash settlement of CDS contracts. The cash settlement protocols rely on auctions to determine a single price for defaulted reference obligations that is then used to calculate payout amounts to be paid at settlement. This process

has been used to settle CDS contracts involved in recent credit events, including Lehman Brothers, Washington Mutual, Fannie Mae, and Freddie Mac.

Creation of a Central Trade Repository Illustrates the Limits of a Voluntary System

In November 2006, DTCC created the TIW to serve as the industry's central registry for CDS. TIW contains an electronic record of most CDS trades, and DTCC and market participants plan to increase its coverage. In addition to placing most new trades in TIW, CDS dealers and other market participants also plan to submit existing and eligible CDS trades to TIW.

TIW helps to address operational risks and transparency concerns related to the CDS market. For example, according to DTCC, it helps mitigate operational risk by reducing errors in reporting, increases transparency by maintaining up-to-date contract information, promotes the accuracy of CDS-related information, and simplifies the management of credit events. TIW also facilitates operational improvements such as automated life-cycle processing by interacting with electronic platforms for derivatives trades such as Deriv/Serv.

Additionally, TIW should assist regulators in monitoring and managing concentration risk from CDS. Although regulators can receive CDS-related information from their regulated entities, no regulator has the ability to receive this information from all market participants, and no single comprehensive source of data on the CDS market exists. However, a central trade repository that contains information on all CDS trades will allow regulators to monitor large positions of market participants and identify large and concentrated positions that may warrant additional attention. TIW also has helped to address some concerns about CDS market transparency by providing aggregate information on CDS trades. The information includes gross and net notional values for contracts on the top 1,000 underlying CDS single-name reference entities and all indexes and is updated weekly.

Despite the important benefits provided by TIW, several factors limit its usefulness as a tool to monitor the overall market. First, TIW does not include all CDS trades, particularly those that cannot be confirmed electronically. For example, TIW cannot fully capture all customized trades, such as CDS referencing ABS and CDOs, including those related to mortgages. While DTCC officials believed that TIW includes a large portion of CDS trades, they noted that they could not be certain because the size and composition of the entire market remain unknown. Second, TIW currently has no regulatory oversight to ensure the quality of the data,

and regulators lack the authority to require that all trades be included in TIW, particularly those of nonbanks.

Clearinghouses May Offer Some Benefits, but Some CDS May Be Too Customized for Clearing

A clearinghouse can reduce risks associated with CDS, including counterparty credit risks, operational risks, and concentration risks, while also improving transparency. A clearinghouse acts as an intermediary to ensure the performance of the contracts that it clears. For CDS, market participants would continue to execute trades as bilateral OTC contracts. However, once registered with the clearinghouse the CDS trade would be separated into two contracts, with the clearinghouse serving as the counterparty in each trade. That is, the clearinghouse would have a separate contractual arrangement with both counterparties of the original CDS contract and serve as the seller to the initial buyer and the buyer to the initial seller. In this way, a clearinghouse would assume the counterparty credit risk for all of the contracts that it cleared.

If a clearinghouse is well-designed and its risks are prudently managed, it can limit counterparty credit risk by absorbing counterparty defaults and preventing transmission of their impacts to other market participants. Clearinghouses are designed with various risk controls and financial resources to help ensure that they can absorb counterparty failures and other financial losses. For example, clearinghouses impose standard margin requirements and mark positions to market on a daily basis. They also have other financial safeguards that typically include capital requirements, guaranty funds, backup credit lines, and the ability to call on capital from member firms, which often are large financial institutions.

A clearinghouse also can help to standardize margin and collateral requirements. It can impose more robust risk controls on market participants and assist in the reduction of CDS exposures through multilateral netting of trades. In doing so, it would facilitate the compression of market participants' exposures across positions and similar CDS products, thereby reducing the capital needed to post margin and collateral.

A clearinghouse also can help to address operational and concentration risks and improve CDS transparency. Market participants suggested that a clearinghouse would help to centralize market information and could facilitate the processing of CDS trades on electronic platforms. It can also help limit concentration risk through standardized requirements for margin collateral that may help reduce the leverage imbedded in CDS contracts and thus place limits on a firm's ability to amass a large net exposure selling CDS. Finally, according to some regulators and

prospective clearinghouses, a clearinghouse could improve CDS transparency by releasing information on open interest, end-of-day prices, and trade volumes.

However, like the other options for improving the CDS market, only certain standardized trades would be cleared by a clearinghouse, and market participants would decide which trades to submit for clearing. A clearinghouse can only clear trades with a sufficient level of standardization because the more customized the contract, the greater the risk management and operational challenges associated with clearing it. Initially, the proposed clearinghouses will clear standard-index CDS and some highly traded single-name corporate CDS. Regulators and market participants suggested that risks from more complex and structured CDS would have to be addressed outside of clearinghouses. One market participant volunteered that it would not be opposed to collateral requirements for CDS that were not cleared through a clearinghouse. Further, because clearing is voluntary, it is unclear what portion of CDS will be cleared and whether this volume will be sufficient to support the clearinghouses.

Regulators and market participants suggested that robust risk management practices were critical for clearinghouses because clearinghouses concentrated counterparty credit and operational risk and CDS presented unique risks. Failure to sufficiently manage these risks could threaten the stability of financial markets and major institutions if a clearinghouse were to fail. In addition, if jump-to-default risk is not sufficiently managed through margin requirements and other methods, it has the potential to create significant losses for the clearinghouses. According to market participants, the jump-to-default risk posed by CDS makes determining sufficient margin requirements difficult. If a required level of margin is considered too high, whether justified or not, market participants may be less likely to use the clearinghouse.

Although several groups have announced plans to create clearinghouses for CDS, none of the groups currently are clearing trades. First, as part of their efforts over the past year to improve the CDS market, FRBNY and several other regulators encouraged the industry to introduce central clearing of CDS contracts. The industry previously had begun moving toward the creation of a clearinghouse, and in July 2008, after FRBNY encouraged firms to develop clearinghouse proposals, several major

dealers committed to launching a clearinghouse by December 2008. None are currently operational, however.[6] At least four groups have developed clearinghouse options for CDS, two in the United States (IntercontinentalExchange and CME Group) and two in Europe (LIFFE and Eurex Clearing). LIFFE opened for clearing in December 2008 but has had virtually no business as of February 2009.

Market participants and regulators identified advantages and disadvantages associated with having multiple clearinghouses clear CDS contracts. Some regulators noted that there could be advantages to having multiple clearinghouses at the early stages of development, particularly related to competition in designing and developing them. In addition, one market participant noted that with multiple clearinghouses the concentration of risk could be spread across multiple platforms. However, market participants suggested that having multiple clearing houses raised concerns about regulatory consistency in terms of setting standards and monitoring, especially for those in the U.S. and internationally. Market participants also indicated that multiple clearinghouses would create inefficiencies and remove some of the advantages gained from multilateral netting, because no single clearinghouse would enjoy the benefit of a complete portfolio of CDS. Moreover, participants would have to post collateral in multiple venues.

Under current law, a clearing organization for CDS—or other OTC derivatives—must be regulated, but any of several regulators may provide that oversight.[7] FRS, CFTC, and SEC all have played a role in establishing a clearinghouse, including reviewing proposals seeking regulatory approval. CME is registered as a derivatives clearing organization with CFTC. ICE has established its clearinghouse in a subsidiary FRS member bank—ICE Trust. LIFFE is regulated by FSA, and Eurex is overseen by the German Federal Financial Supervisory Authority.

SEC has determined that the act of clearing CDS through a clearinghouse may result in the contracts being considered securities subject to the securities laws. To facilitate the clearing and settlement of CDS by

[6]The U.S.-based clearinghouses are still awaiting regulatory approval.

[7]Section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991, as added by CFMA, requires that a multilateral clearing organization for OTC derivatives be (1) either a bank subject to federal supervision, (2) registered with CFTC or SEC, or (3) supervised by an approved foreign financial regulator.

clearinghouses, SEC issued an interim final rule on temporary and conditional exemptions in January 2009. SEC stated that the conditions of these exemptions would allow the agency to oversee the development of the centrally cleared CDS market and CDS exchanges and to take additional action as necessary. SEC has determined that LIFFE has met the conditions for the temporary exemptions from registration under the securities laws. The exemption expires in September 2009, at which time SEC officials believe they will be better situated to evaluate how these exemptions apply to the cleared CDS market.

Given the overlapping jurisdiction and lack of regulatory clarity, FRS, CFTC, and SEC have signed a memorandum of understanding to ensure that each regulator applies similar standards across the different clearinghouse efforts. According to the regulators, the purpose of the memorandum is to foster cooperation and coordination of their respective approvals, ongoing supervision, and oversight of clearinghouses for CDS. Moreover, some said that the memorandum would help to prevent an individual regulator from taking a softer approach in its monitoring and oversight of required standards for clearinghouses, which could encourage more participants to use the less rigorously regulated clearinghouse. However, another regulator suggested that the memorandum still might not guarantee consistent application of clearinghouse standards and requirements, because each regulator had a different mission and approach to regulation.

Market participants identified several disadvantages related to the current state of oversight for clearinghouses. Some market participants suggested that there had been a lack of clarity and certainty regarding oversight of clearinghouses because of the involvement of multiple regulators. As noted, some market participants questioned whether consistent standards and oversight would be applied across clearinghouses. Market participants and one regulator noted the importance of coordinating oversight internationally to ensure consistent global standards and mitigate the potential for regulatory arbitrage. Finally, some market participants suggested that having multiple regulators for a clearinghouse created the potential for regulatory overlap and related inefficiencies.

Other Ideas to Manage CDS Risks

Market observers and others have proposed other ideas to address concerns related to CDS, including (1) mandatory clearing, (2) mandatory exchange trading, (3) a ban on uncovered CDS, and (4) mandatory reporting of CDS trades. While these proposals would address some

perceived problems with CDS markets, sources we interviewed identified important limitations and challenges for each of them.

- Mandatory clearing would ensure that CDS contracts benefited from the advantages of a clearinghouse, but regulators, market participants, and market observers explained that highly customized CDS would be impossible to clear because they lack the needed standardization.
- Mandatory exchange trading could offer improved price transparency and the benefits of clearing. But some market observers indicated that some CDS that were illiquid could not support an exchange and that the standardization of contracts would limit CDS' risk management benefits.
- Banning or otherwise restricting uncovered CDS could limit activity that some observers believe contributed to the recent distress of financial institutions, yet proponents of uncovered CDS argue that banning these contracts would severely limit market liquidity and eliminate a valuable tool for hedging credit risk.
- Finally, some regulators and market observers believe that mandatory reporting of CDS trades to a central registry would increase transparency and provide greater certainty that information on all CDS was being captured in one place. However, some market participants suggested that detailed reporting of CDS trades should be limited to regulators so that positions were not exposed publicly, and some participants explained that a similar reporting system for bond markets had had adverse consequences that stifled that market.

Other OTC Derivatives May Benefit from Similar Efforts

Regulators and the industry have initiated efforts to improve the operational infrastructure of OTC derivatives in general. However, each product has unique challenges because of differences in market maturity, volumes, and users, among other things. Despite these unique challenges, regulators, market participants, and observers told us that OTC derivatives, generally shared similar risks, such as operational and counterparty credit risks, and would benefit from initiatives to address those risks. As part of their efforts to improve the operational infrastructure of OTC derivatives markets, market participants have identified seven high-level goals:

- Global use of clearinghouse processing and clearing,
- Continuing portfolio compression efforts,

- Electronic processing of eligible trades (targets of the effort include equity, interest rate, and foreign exchange derivatives),
- Elimination of material confirmation backlogs,
- Risk mitigation for paper trades that are not electronically processed,
- Streamlined trade life-cycle management, and
- Central settlement for eligible transactions.

Some other OTC derivatives may also benefit from reductions in the amount of outstanding trades through portfolio compression efforts. FRBNY officials stated that they are looking at other OTC derivatives that had a critical mass of outstanding trades to determine whether they would benefit from compression. To the extent that further regulatory actions are explored for other OTC derivatives, regulators must consider the risks and characteristics of each class of OTC derivatives before taking additional actions.

In closing, I would like to provide some final thoughts. While CDS have received much attention recently, the rapid growth in this type of OTC derivative more generally illustrates the emergence of increasingly complex products that have raised regulatory concerns about systemic risk. Bank regulators may have some insights into the activities of their supervised banks that act as derivatives dealers, but CDS, like OTC derivatives in general, are not regulated products, and the transactions are generally not subject to regulation by SEC, CFTC, or any other U.S. financial regulator. Thus, CDS and other OTC derivatives are not subject to the disclosure and other requirements that are in place for most securities and exchange-traded futures products. Although recent initiatives by regulators and industry have the potential to address some of the risks from CDS, these efforts are largely voluntary and do not include all CDS contracts. In addition, the lack of consistent and standardized margin and collateral practices continue to make managing counterparty credit risk and concentration risk difficult and may allow systemically important exposures to accumulate without adequate collateral to mitigate associated risks. This area is a critical one and must be addressed going forward.

The gaps in the regulatory oversight structure of and regulations governing financial products such as CDS allowed these derivatives to grow

unconstrained, and little analysis was done on the potential systemic risk created by their use. Regulators of major CDS dealers may have had some insights into the CDS market based on their oversight of these entities, but they had limited oversight of nonbank market participants, such as hedge funds, or subsidiaries of others like AIG, whose CDS activities partly caused its financial difficulties. This fact clearly demonstrates that risks to the financial system and even the broader economy can result from institutions that exist within the spectrum of supervised entities. Further, the use of CDS creates interconnections among these entities, such that the failure of any one counterparty can have widespread implications regardless of its size. AIG Financial Products, which had not been closely regulated, was a relatively small subsidiary of a large global insurance company. Yet the volume and nature of its CDS business made it such a large counterparty that its difficulty in meeting its CDS obligations not only threatened the stability of AIG but of the entire financial system as well.

Finally, I would briefly like to mention what the current issues involving CDS have taught us about systemic risk and our current regulatory system. The current system of regulation lacks broad authority to monitor, oversee, and reduce risks to the financial system that are posed by entities and products that are not fully regulated, such as hedge funds, unregulated subsidiaries of regulated institutions, and other non-bank financial institutions. The absence of such authority may be a limitation in identifying, monitoring, and managing potential risks related to concentrated CDS exposures taken by any market participant. Regardless of the ultimate structure of the financial regulatory system, a systemwide focus is vitally important. The inability of the regulators to monitor activities across the market and take appropriate action to mitigate them has contributed to the current crisis and the regulators' inability to effectively address its fallout. Any regulator tasked with a systemwide focus would need broad authority to gather and disclose appropriate information, collaborate with other regulators on rule making, and take corrective action as necessary in the interest of overall financial market stability, regardless of the type of financial product or market participant.

Staff Contact and Acknowledgments

For further information about this testimony, please contact Orice M. Williams on (202) 512-8678 or at williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Karen Tremba, Assistant Director; Kevin Averyt, Nadine Garrick, Akiko Ohnuma, Paul Thompson, and Robert Pollard.

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AMERICAN ACADEMY *of* ACTUARIES

Testimony Concerning Regulation of Systemic Risk in the Financial Services Industry

Submitted for the Record
By James Rech, Vice President, Risk Management and Financial Reporting Council
of the American Academy of Actuaries

U.S. House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

March 5, 2009

Chairman Kanjorski, Ranking Member Garrett, and distinguished Members of the Subcommittee:

The Risk Management & Financial Reporting Council of the American Academy of Actuaries[1] appreciates the opportunity to provide its perspective on how to better "prevent private sector activities from putting at risk the stability of the U.S. economy." The time has come for a financial regulator focused on systemic risk. We support the establishment of a governmental systemic risk regulator that can effectively provide oversight of financial risks and protection to the public providing that it incorporates the following principles and concepts.

Systemic risk is an issue within the insurance industry. Some of the systemic risks to insurance systems are regulated by limitations on leverage. Regulatory controls include a combination of external structures (government-sponsored guarantee funds and catastrophe pools) and internal requirements (regulatory audits, actuarial opinions subject to standards of practice, solvency metrics, asset allocation, loss reserve and minimum capital requirements). We think there are valuable "lessons learned" from insurance regulation that can inform the debate over creation of a systemic risk regulator.

The viability of the insurance sector rests on the perception that insurers can and will meet their promises. While there are many complexities of insurance and financial risk, there is a straightforward process for regulating those risks. It begins with understanding and defining risks, measuring those risks over time, and linking the possible measurement outcomes to effective actions. Actuaries are key players in this process, because of the extensive experience the profession has in dealing with risk management and solvency issues involving public and private insurance systems within the financial services industry.

[1] The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

1850 M Street NW Suite 300 Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948 www.actuary.org

We have witnessed unparalleled new threats to our financial security as is highlighted by American International Group (AIG) and its unregulated and uncontrolled venture into Credit Default Swaps (CDS). Since these financial guarantees were made outside of AIG's insurance subsidiaries, they reportedly escaped insurance regulatory oversight. Our Risk Management and Solvency Committee recently submitted testimony to the National Council of Insurance Legislators on the subject of CDS that is attached for your information. The concepts expressed there should be useful in developing a regulatory structure for CDS as well as other financial products with insurance-like features.

To illustrate an example relevant to today's financial crisis, we note that in 1990 Congress amended The National Housing Act of 1934 to require the Secretary of Housing & Urban Development to conduct an annual independent actuarial study and analysis of the Mutual Mortgage Insurance fund and to report annually to Congress on the financial status of the fund. This fund had assets of over $25 billion at the end of Fiscal Year 2007 and currently insures over $400 billion in FHA residential mortgage loans. The recent Fiscal Year 2008 actuarial report indicates that the Mutual Mortgage Insurance Fund will continue to exceed the mandated minimum capital ratio and is not forecasting the kind of bailout needed to support other guarantees of residential mortgages.

In summary, actuarial solvency and risk concepts will be useful in approaching how to structure the role of the Systemic Risk Regulator. We would welcome the opportunity to discuss with the committee the key concepts and elements that we believe are needed for the effective oversight and monitoring of systemic risk.

Signed by,

James Rech
Vice President
Risk Management and Financial Reporting Council
American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

Risk Management and Solvency Committee of the American Academy of Actuaries[1]
Testimony to NCOIL – January 24, 2009

Actuarial Principles, Risk Management Principles, and Insurance Principles for the Solvency & Risk Management of Credit Default Swaps (CDS) - Why and How?

Actuaries recognize that there are acute public policy issues around the financial security provided by the CDS market and there is a need for oversight of the accumulation of risk by the individual counterparties who are providing financial protection. It is our experience that these issues are similar to the risk protection provided by insurance in terms of specific capital requirements needed to back-up the contract's promise to pay when the covered event, default, occurs.

We are not advocating what authorities or entities necessarily need to regulate the CDS market. However, we do not see how a future CDS market can be expected to avoid collapse in a credit crisis without some form of effective solvency requirements and risk management oversight. The example provided by insurance regulation, with its capital requirements, solvency regulation and legislated authority in the event of insolvency is certainly one that has much to recommend as a sound basis for any financial security system that is designed to protect the public.

I. Challenge of CDS and Fitting Risk to Appropriate Oversight & Regulation
The failure of entities in the CDS market to provide sufficient backing for their guarantees demonstrates that increased awareness is needed from market participants and regulators about the implications of the following crucial distinction:

> When does the market function as a price discovery mechanism versus when does the market provide price guarantees for which specific financial backing, in terms of capital and risk management, is needed to minimize failures from systemic risk issues?

We think this important distinction will help improve the dialogue on solutions beyond the traditional concern of debating whether something is insurance or a financial product. The following discussion in this section focuses on many of the characteristics and similarities that can be seen in the CDS and insurance markets as well as the diverse "labels" that have been applied:

a. CDS exhibit certain risk characteristics that are similar, with respect to counterparty solvency risk, to what we observe in certain insurance and financial guarantee products. Typically, CDS represent a product that more closely resembles *forward agreements* rather than *futures instruments*:
   - Over the counter, not exchange transactions
   - Heterogeneous, not homogeneous contract terms
   - Illiquid rather than liquid markets

b. Addressing the solvency issues for the CDS market could be accomplished in a number of ways, but it seems clear that the current oversight of the CDS market has failed to provide an acceptable level of financial security to the public. The insurance regulatory model has many characteristics around

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protecting the solvency of the market that could provide an excellent starting point for effective oversight of the CDS market.
By analogy, insurance carriers (insurance risk "Intermediaries") assume and cede financial instruments that behave like illiquid, heterogeneous put contracts. Since Swaps exhibit similar risk characteristics, Swap Dealers (SWAP intermediaries) create, in effect, similar solvency obligations to the Swap participant (the "public"). This is of increased importance in the Swap Markets since Swap Dealers, rather than Swap Brokers, predominate in the Swap distribution system.

c. A typical dictionary definition for insurance states a definition as "coverage by contract whereby one party undertakes to indemnify or guarantee another against loss by a specified contingency or peril". While under commonly understood usage, this may mean that all insurance contracts meet this definition, it does not mean that all contracts meeting this definition are considered contracts of insurance especially since we recognize that meeting a generally understood definition of insurance is not meant to take precedence over a legal definition. Legally, statutes have been drafted to define insurance for the purposes of the specific regulation. However, state statutes have also addressed other products which are often considered financial in nature (such as private mortgage insurance, financial guarantee insurance, and long durational contracts such as home warranty and automobile warranty) and have indicated that they should be regulated based on the same principles as have been applied to insurance.

d. Pricing for loan defaults and credit downgrades often uses similar approaches to those used for pricing of insurance products. The "actuarial method" is a common methodology for evaluating credit risk, based on a frequency/severity method, i.e., the probability of default multiplied by the loss given default. Actuaries have commonly used such methods to evaluate pricing and reserving for private mortgage insurance, financial guarantees, warranties and long duration contracts.

II. Risk Requirements for a Sound Market – There is a long history of actuarial and risk management expertise in the development of methodologies to address the solvency needs for a market of contracts with significant solvency risk characteristics. Some examples include:

a. An actuarial methodology based on identifying and quantifying the amount to mature an obligation plus a risk charge for the guarantee.
b. Recent advances include the application of Conditional Tail Expectation (CTE) combined with scenario testing to estimate the impact of potential unknown and uncertain risks. This approach enables an understanding as to what could happen, how it will impact the organization and how the organization may need to limit risk given a better understanding of those risks. Basel II and IAIS (banking and insurance regulators) are beginning to advocate such approaches. These approaches may provide a better understanding of the CDS risks by providing greater detailed quantification affecting solvency requirements.
c. Stress/sensitivity testing of the assumptions affecting capital adequacy as part of appropriate actuarial, risk management and insurance regulatory practices.
d. Product design should also be included as a risk management approach for CDS. Just as options have moved to established exchanges to minimize counterparty risk, CDS may also require future product design changes.
e. The Asset Valuation Reserve (AVR) concept, developed almost 30 years ago, is an insurance regulatory requirement that establishes provisions for the credit risk associated with an insurer's invested assets.

IV. Additional discussion item - Identifying when a market of financial products needs a financial backstop to protect the public in the event of an extensive market collapse, and determining whether a solvency framework, similar to what exists for the insurance market, provides a model to achieve effective protection for the public.

CDS pricing assumes no arbitrage opportunities and therefore assumes that market pricing reflects current market conditions. For financial soundness, however, the issue seems to be whether CDS intermediaries should come under a solvency framework that combines current mark-to-market transparency with longer term security, including technical elements such as contingency reserves and risk-based capital

requirements. With a CDS market dominated by Swap intermediaries (dealers), public policy concerns would suggest the identification of sound solvency frameworks for those intermediaries. Public confidence in the insurance industry has been achieved through the interaction among legislators, regulators, insurer management, underwriters, accountants, actuaries, etc. Similar approaches could be developed to advance the financial soundness of CDS intermediaries.

Summary

A market that takes on the risk of backing a credit default via CDS will need to apply solvency and risk management principles if there is a need to provide a measure of security to those who depend on such a market to perform adequately. These principles are well established for the insurance industry and could serve as a model for the CDS market. Actuaries have been involved for many years in recommending and developing sound solvency requirements, particularly for insurance markets, to ensure that adequate capital is required and that sound underwriting, system design and risk management requirements are in place. Should you wish more information on any of these concepts as you move forward, please feel free to call upon the Risk Management and Solvency Committee of the American Academy of Actuaries.

Frank Keating
President & Chief Executive Officer

March 3, 2009

Dear Member of Congress,

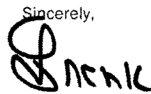
On behalf of the ACLI and its 340 member companies, I would like to share with you information that we believe is essential as you consider how to best address the economic crisis and systemic risks in the financial market. While the current focus has appropriately been on the problems in the banking sector, policymakers must also consider the systemic role that life insurance companies play in the economy.

Life insurers are the single largest source of corporate bond financing in the U.S., with over $5 trillion in assets. We provide retirement and financial security to 75 million American families, holding nearly 22% of all private employer-provided retirement assets. A major interruption in the industry could have far reaching ramifications for a significant source of capital in the financial markets, and could even threaten the financial security of the individuals who rely on the industry's products. As a state regulated industry, we are often out of sight, out of mind. However, life insurers must not be overlooked as Congress addresses the issue of systemic risks and the financial services market.

Included with this letter are additional details on the industry's place in the economy, as well as recent articles from the *Wall Street Journal* and the *New York Times* that highlight some of these issues.

Please feel free to contact me or my staff if you have any questions. We stand ready to be a resource and partner as you undertake this important effort to prevent future financial crisis.

Sincerely,



Frank Keating

American Council of Life Insurers
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Life Insurers and Systemic Risk

A healthy economy is dependent on all facets of the financial services sector being sound. At a time when federal policymakers are discussing and implementing programs to ensure that the banking segment of the financial system is secure and functions as necessary for the nation to succeed, policymakers need to better understand the systemic role life insurance companies play in the economy.

It is imperative for policymakers to recognize that the life insurance industry is systemically significant not simply in the U.S., but to international markets as well. The facts supporting this position are numerous. Congress must take these facts into consideration as it considers implementing regulatory reform and new oversight to address systemic risk in all segments of the U.S. financial services industry.

Investment Holdings and Lending

- At the end of 2007 the industry held over $5 trillion in total assets.
- Those $5 trillion + of industry assets are distributed among all segments of our economy, as 38% are in corporate bonds, 33% are in stocks, 11% are in government bonds, 6% are in commercial mortgages, and 12% are in a variety of other assets.
- Life insurers are the single largest source of corporate bond financing.
- Life insurers hold approximately 22% of all private employer-provided retirement assets

Employment and Premium Income

- Insurance companies employ about 2.2 million people as direct employees and as agents and brokers.
- Life insurers annual revenue from premiums alone was $600 billion in 2007, an amount equivalent to 4.4% of US GDP.

Concentration of Assets

- The top 25 life insurer fleets control about 80% of industry assets.
- The top 35 life insurer fleets control 86% of industry assets.

Policyholders and Coverage

- 75 million American families (nearly 70% of households) depend on life insurance industry products to protect their financial and retirement security.
- This coverage is obtained individually and through employee benefit programs, making life insurers indispensible to a cost effective and efficient way to deliver benefit programs to Americans.
- There is $20 trillion of life insurance coverage in force today.
- Life insurers hold $2.6 trillion in annuity reserves to help Americans plan for a secure retirement.

Benefits Paid by Life Insurers in 2007

- $58 billion to life insurance beneficiaries;
- $72 billion in annuity payments;
- $15.7 billion in disability income insurance benefits; and
- $7.2 billion in long-term care insurance benefits.

Examples of Actions by International Insurance Regulators in Response to the Worldwide Economic Crisis

Nation	Date	Action
Canada	December 24, 2008	Relaxation of capital requirements for variable annuities and other products
Germany	October 20, 2008	Establishment of financial market stabilization fund for financial institutions including insurers
Hong Kong	December 18, 2008	Relaxation of the interpretation of valuation regulations
India	December 2008	Cut solvency margins for various ULIP products
Indonesia	October 2008	Changes to Accounting Standards to provide more flexibility on valuation of investments
Japan	October 2008	Increased flexibility of accounting rules
Korea	April 2009 (filing)	Adopt RBC to replace % asset approach
Mexico	December 18, 2008 December 29, 2008	Change in credit measures Change in valuation criteria
Malaysia	November 2008 April 2009 (filing)	Central bank provides liquidity facility Increased flexibility of accounting rules
Netherlands	October 2008 November 2008	13 billion Euro cash injection to banks and insurers Central Bank (also supervisory authority) grants pension funds extension on submitting recovery plans
Taiwan	October 2008	Increased flexibility of accounting rules; adjustment of RBC to ease burden on insurers
UK	November 2008	Flexibility in the assumption made in the calculation of reserves

The New York Times

March 3, 2009
DEALBOOK

The Case for Saving A.I.G., by A.I.G.

By ANDREW ROSS SORKIN

Inside the corridors of power in Washington, a 21-page document has been getting a lot of attention. It is marked confidential and titled "A.I.G.: Is the Risk Systemic?"

The report, prepared for regulators by the American International Group, examines the economic apocalypse that would follow if A.I.G. failed.

This document may help explain why the federal government just rescued the insurance giant for the fourth time in six months — and why the government was willing to spend $30 billion more of taxpayers' money for very little return. The government, which owns nearly 80 percent of A.I.G., not only did not take more equity in A.I.G., but it also converted its preferred shares, which paid a 10 percent dividend, into shares that don't pay a dividend at all.

"Systemic risk" is a phrase often used to describe the domino effect of one business's failure on the rest of the economy. We saw the dangers of systemic risk in action when Lehman Brothers failed in September. And we've heard a lot from Detroit automobile executives about the systemic risk they say the nation would face should General Motors teeter.

But those failures look like summer thundershowers compared with the financial hurricane that a collapse of A.I.G. would represent, according to the document, which was presented to Treasury Secretary Timothy F. Geithner and Lawrence H. Summers, head of the National Economic Council, in recent weeks.

One of the biggest worries, besides the considerable collateral damage to the banking system, is a risk that most people aren't talking about, perhaps because it's too scary. This one is probably easier to understand than any kind of financial chicanery: the dangers lurking below A.I.G.'s seemingly stable, highly regulated life insurance business. In the United States, A.I.G. has more than 375 million policies with a face value of $19 trillion.

If policyholders lost faith in A.I.G. and rushed to cash in their policies all at once, the entire insurance industry could falter.

"A 'run on the bank' in the life and retirement business would have sweeping impacts across the economy in the U.S.," according to the A.I.G. document. "In countries around the world with higher savings rates than in the U.S., the failure of insurance companies would be a catastrophe."

Even though A.I.G.'s insurance business is regulated by states, there probably would not be enough money to pay out to consumers from what's known as a guarantee fund. Other regulated insurance companies, which have been weakened by credit losses, would be required to pay money into the fund to cover the shortfall, weakening them further and in some cases bankrupting them.

Some would have to sell more and more of the bonds in their portfolios to honor their obligations to the scared-off policyholders. And that would freeze up the bond markets again, because life insurance companies to a very great extent are the bond markets. They buy more corporate debt than any other institutions.

David E. Wood, a partner at the law firm Anderson Kill Wood & Bender, takes the possibility of a bankruptcy one step further. "Given the number of states in which A.I.G. is domiciled or in which it issued large numbers of policies, the net effect may be regulatory gridlock and high administrative expenses, delaying payment and decreasing the funds available to pay claims."

What's worse, if A.I.G. failed, many people would be unable to obtain the same insurance from a competitor for the same price. In fact, many people would probably be shut out. "Some life-policy holders

may no longer be insurable at commensurate rates or as a result of adverse health situations since the purchase of the original policy," the document said.

How we got here is a well-worn tale that others have detailed extensively: A.I.G. used its triple-A rating from the insurance part of its business to run a huge casino that then overwhelmed the entire business.

"It's an interesting structure where you have an insurance company that works really well and on top of it is a holding company and the holding company's biggest asset is this huge hedge fund," Edward M. Liddy, who became A.I.G.'s chief executive last fall, told me, sitting in the conference room adjacent to his office, which was once the den of Maurice R. Greenberg, A.I.G.'s former patriarch. "It just doesn't make any sense to me."

The problem is that the casino has infected the rest of the business. That's why the structure of the government's deal is actually quite clever.

First, Mr. Geithner appears to have decided that he can't be punitive — a reversal from the deal he helped shape in September while at the Federal Reserve Bank of New York, which nearly wiped out shareholders and added a huge cost to A.I.G. to do business. Indeed, it was all those added costs, in part, that forced the multiple restructurings because A.I.G. couldn't afford to make the payments. The new deal makes it more likely A.I.G. can afford to stay in business.

Of course, there seems to be a slight disconnect: at one moment Mr. Geithner appears to be toeing a populist line when it comes to executive pay and corporate aircraft, and at another, he is generous about spending tax dollars without an immediate return. The good news is that he's taking a more long-term, holistic approach — and he's setting up A.I.G. for a much-needed breakup down the road. (The deal calls for two units of A.I.G. — American International Assurance and the American Life Insurance Company — to be owned directly by taxpayers.)

The bad news is that he had every right to press to own 100 percent of A.I.G., and he didn't take it.

The markets, of course, didn't react well to all this maneuvering, as investors cashed out of their shares on Monday, sending stocks to their lowest levels since 1997. Let's just hope people don't start cashing out their life insurance policies, too.

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ANNUITIES

Annuity Math Anxiety

Consumers wonder if they are exposed to more risk as some insurers get regulatory relief in calculating their reserves

By Leslie Scism

WHILE THE biggest financial headlines over the past few months have focused on bailing out banks and other businesses with taxpayer money, many owners of annuities and life insurance are following another rescue attempt, with some bewilderment: efforts by insurers to get tens of billions of dollars in relief from state insurance regulators.

The insurers are asking states not for cash, but rather for rule changes that could spare them from having to set aside billions of additional dollars to show they can make good on their obligations to consumers. Some measures would reduce the reserves that insurers are required to hold against expected future expenses, and others would expand what they can count as capital.

What many consumers are wondering is this: Would the changes come at their expense? Annuities and insurance policies represent a substantial part of many families' financial security, and customers are concerned about any maneuver that puts those policies at risk, even if only slightly.

And consumers have another question, too: Do the insurers actually need the relief?

Here's a summary of events: Last November, as the stock market was headed toward a low point of the year and debt markets were virtually frozen, the American Council of Life Insurers, or ACLI, a trade group, asked an organization of state regulators, the National Association of Insurance Commissioners, or NAIC, to ease nine particular rules, all in place to protect policyholders. The ACLI maintained that the industry needed an easing in time for insurers' annual financial filings for calendar year 2008 because, with markets in turmoil, raising new capital might not be possible at a reasonable cost.

Though insurers are regulated by states, the NAIC sets financial standards that states generally follow. The NAIC assigned a team of technical experts to review the proposals, and by January the team had cleared six of them, with some modifications.

Then, amid mounting opposition from consumer groups and independent watchdogs, the NAIC's executive committee on Jan. 29 nixed the package, saying the ACLI hadn't made its case for rushed action. The vote coincided with an upturn in both stock and bond markets.

Over the past month, as the stock market resumed sliding, some of the nation's biggest insurers—including **Allstate Corp.**, **Hartford Financial Services Group** Inc. and **Lincoln National** Corp.—won permission from their state regulators for some of the easing that the NAIC rejected. Under state-based regulation, states have the ability to grant exceptions to the rules, and have done so occasionally over the years. Insurers' filings for 2008 are due today in most states, and dozens of additional exceptions are expected to surface.

Here's what you need to know as events continue to unfold:

Let's start with the bottom line: Is this aid going to hurt consumers?

First, some terminology. Insurers set up reserves to back their obligations, and they keep ample additional sums of money on hand in case reserves fall short. This additional money is their capital, or net worth. Insurers hold the bulk of their reserves and capital in investment-grade corporate bonds and mortgage-backed securities.

"The proposals will lower the level of reserves and other dollars that today protect America's consumers," the Consumer Federation of America and the Center for Economic Justice wrote in comments filed with the NAIC on Jan. 27. "This approach will pull the wool over the eyes of millions of Americans holding life and annuity contracts," by making the insurers' capital bases appear plumper than they otherwise would.

But the ACLI disputes that the changes would put consumers at peril. The rules at issue, it says, are overly conservative—and in one instance all it asked was to begin using early a new rule that was set to kick in later in 2009. In a December report, Moody's Investors Service agreed in part, noting there is an economic cost to insurers "to maintain the very conservative 'redundant' regulatory reserves required" for some policies.

The ACLI also contends the conservatism could boomerang to hurt consumers: If reported capital levels decline, it could cause some people to hastily cancel policies, with adverse financial consequences, while they also could end up hurt if insurers raise new money on punishing terms.

Much of the critics' displeasure has been over the NAIC's fast-tracking of the proposals. "It is disturbing that the NAIC has made no showing of what constitutes 'redundant' or 'excess' reserves overall," the two consumer groups wrote. They added that the current economic upheaval may well be undermining the industry's long-standing conservatism "in completely unknown ways."

In rejecting the ACLI proposals, the NAIC said some of them had merit, and promised that their future consideration would follow the group's "open, transparent and deliberative process."

How many insurers have asked for and gotten relief?

We don't know that yet. To help the public better monitor what's going on, the NAIC says it will assemble data from the disclosures that insurers are required to make in their 2008 state filings.

Some requests have surfaced as publicly traded insurers responded to questions from analysts in fourth-quarter conference calls or in filings with the Securities and Exchange Commission. One of the biggest requests, and most detailed explanations, came from Hartford. In a Feb. 12 SEC filing, it said Connecticut regulators had approved its use of two items that the NAIC technical experts had cleared, with relief totaling $987 million. Hartford said this boosted the capital base of its life-insurance units by about 20%, to $6.05 billion, as of Dec. 31.

In Illinois, Allstate said it obtained $1.61 billion in relief for two units; that represents about 12% of their capital. Philadelphia-based Lincoln won approval from regulators in Indiana, where a big unit is based, for easing it said totals about $300 million.

Some non-publicly traded insurers also have obtained relief, including **Nationwide Mutual Insurance** Co., **Northwestern Mutual Life Insurance** Co. and

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Pacific Life Insurance Co. So far, it appears to be mostly life insurers asking for breaks, but some of Allstate's and Nationwide's relief went to car-insurance units.

Why are life insurers harder hit than other insurers?

Insurers of various types have suffered capital-depleting losses in their investment portfolios. Many of the losses have come from bonds and preferred stock of troubled financial firms like Lehman Brothers and Fannie Mae, as well as mortgage-backed securities. Life insurers tend to own longer-term, and thus riskier, bonds than property-casualty insurers, to match policies that aren't payable for years into the future; property-casualty insurers tend to own larger proportions of short-term, very easily traded securities, as customers file claims at any time.

Also, the market's slide has been punishing for some life insurers that are big issuers of variable annuities. These insurers are collecting substantially less in fees tied to money under management, and their liability has soared for the minimum-return guarantees of these retirement-income products. The insurers are subject to reserve and capital requirements to show they can make good on the guarantees.

Are the life insurers seeking help in serious trouble?

The shares of many publicly traded insurers scream that there are problems: Some are down 90% since last spring. Dividends have been slashed.

The major ratings firms have the life-insurance industry on negative outlook, meaning more downgrades than upgrades are expected in coming months. The first wave took place just after the insurers posted big losses for the fourth quarter. "Given the disarray in the credit and capital markets, most insurers' financial flexibility has decreased in the past six months," Standard & Poor's said Thursday, announcing downgrades at 10 companies. With the economy continuing to worsen, insurers' investment portfolios "could experience unprecedented stress in the next 12-18 months," it said.

Still, at least for now, most big insurers remain in categories signifying "strong" financial health. For their part, many insurers say they have ample capital to honor all obligations, but with capital-raising opportunities limited, they felt it prudent to obtain the easing. Northwestern, a triple-A-rated insurer, says some rules are "unduly conservative," so the relief it obtained gives people "a clearer sense of our financial strength." Some say they acted to stay on a level playing field with rivals who obtained relief.

Exactly what kind of relief have insurers sought?

Hartford and Pacific Life, top sellers of variable annuities, obtained relief tied to the calculation of reserves for their minimum-return guarantees. As Hartford noted in its filing, the existing rule ignores some fees paid by annuity owners that can offset the guarantees' ultimate cost. The relief will allow the insurers to factor in a wider range of the fees.

Many insurers—including Allstate, Hartford, Lincoln, Nationwide, Northwestern, **Principal Financial Group** Inc. and U.S. units of **Aviva PLC** and **ING Groep** NV—won permission for more-generous treatment of "deferred tax assets" in calculating their capital. These are credits that a company aims to use to offset future taxes. They have value to the extent that the insurer generates a profit in the future and can actually put them to use.

As the NAIC debated, some regulators argued against expanding their use, saying that projecting profits is tough in normal times and perhaps impossible in the current turmoil. The companies, on the other hand, say expanded use provides a more-accurate picture of their financial position.

Ohio National Financial Services won permission to use updated mortality policies in setting up insurance reserves as well as deferred-tax assets, among other items. It says the changes are "helpful, but not material to our company."

So what's a consumer to do?

The proliferation of relief efforts means that consumers need to be on guard when reviewing financial data on insurers' Web sites and at the NAIC's Consumer Information Source service, says Brendan Bridgeland of the Center for Insurance Research.

The NAIC says it's looking into how it can alert users of its service. As for insurers, mutually owned Northwestern, for one, says it will post a news release about the rule easings it is employing. Officials at several publicly traded insurers note that they generally don't highlight statutory-accounting figures; instead, their Web sites point to SEC filings. Those filings are based on a generally less-conservative type of accounting.

Many consumers rely on ratings firms' assessments of insurers, and the big firms say they are factoring relief items into their analysis. For instance, if two insurers both report "risk-based-capital ratios" of 400%, but one is using rule easings to avoid a decline to 325%, "we would say that company is more weakly capitalized than the other, all other things being equal," says Robert Riegel, a Moody's managing director.

Statement for the Record

of the

National Association of Mutual Insurance Companies

to the

Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee

House Financial Services Committee

hearing on

Perspectives on Systemic Risk

March 5, 2009

The National Association of Mutual Insurance Companies ("NAMIC") is pleased to offer comments to the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee on systemic risk.

Founded in 1895, NAMIC is the largest full-service national trade association serving the property/casualty insurance industry with more than 1,400 member companies that underwrite more than 40 percent of the property/casualty insurance premium in the United States. NAMIC members are small farm mutual companies, state and regional insurance companies, risk retention groups, national writers, and international writers and are distinguishable by not only their size, but their diversity in business models and markets.

NAMIC supports a reformed national system of state-based insurance regulation. NAMIC believes that oversight and supervision of systemic risk must complement, rather than duplicate or supplant, the existing regulatory structure. Similarly, NAMIC urges Congress to focus on the products, activities, and market-oriented events and developments posing systemic risk. This is in contrast to an approach that would publicly identify and regulate "systemically significant institutions" based on size or perceived importance. The property/casualty industry is highly competitive, well capitalized, and poses little systemic risk. Congress should resist efforts, no matter how well intentioned, that would disrupt one of the well functioning bedrocks of our financial structure.

Systemic Risk

Traditional financial risk has focused on risks *within* the financial system; systemic risk focuses on risks *to* the financial system. Systemic risk refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components. The precise meaning of systemic risk, however, is ambiguous; it means different things to different people, but must not be used to define the downturns resulting from normal market fluctuations.

Some define systemic risk as the probability that the failure of one financial market participant to meet its contractual obligations will cause other participants to default on their obligations, leading to a chain of defaults that spreads throughout the entire financial system, and eventually to the nonfinancial economy generally. This conception of systemic risk is likened to the risk of a chain reaction of falling interconnected dominoes.

Others conceive of systemic risk as the risk of a major external event, or "macro shock," that produces nearly simultaneous, large, adverse effects on most or all of the financial system (rather than just one or a few institutions) such that the entire economy is adversely affected. In this conception of systemic risk, the threat to the system is a market-oriented crisis rather than an institution-oriented crisis. Market-oriented crises

tend to begin with a large change—usually a decline—in the price of a particular asset; the change then becomes self-sustaining over time.

The domino theory definition has little relevance to the current situation as the crisis was not caused by a single institution producing a contagion effect that spread to otherwise healthy interconnected institutions. The macro-shock definition comes much closer to describing what has happened.

Investors around the world suddenly realized that certain types of asset-backed securities and credit derivatives might not have been as safe as their ratings implied because of their (often hidden) exposure to risky subprime mortgages. This sudden realization among investors was the large external shock that led to systemic failure, as the market for asset-backed securities suddenly dried up and intermediaries holding these securities were forced to sell them at distressed prices, leading to massive write-downs and the freezing of the world's credit markets.

Inasmuch as the current crisis was caused not by the risky behavior of a single institution or even a small group of institutions, but rather by an exogenous event—a shock to the system—it is difficult to imagine how similar crises could be avoided in the future by focusing regulation on particular institutions that are presumed *ex ante* by regulators to be systemically significant, as opposed to potentially significant events in the market.

Such market-oriented events, it must be noted, could come from any number of sources. In the present crisis, while public attention has focused on the spectacular deterioration of certain large financial institutions, it was a common shock that led to their demise - a rapidly deflating housing bubble combined with a failure on the part of investors, intermediaries, and rating agencies to accurately assess subprime mortgage risk. That failure was facilitated in part by the growth of the "originate to distribute" model of mortgage lending, which served to create a disconnect between the ultimate bearer of risk and the initiator of credit, thus reducing the incentive to understand and monitor risk.

Future crises are likely to arise from other types of asset bubbles, or other instances of widespread failure by market participants in evaluating certain types of risk. Past financial crises also suggest that market-oriented systemic risk is of greater concern than risk associated with supposedly systemically significant institutions. For example, the 1987 stock market crash was not precipitated by any particular institution or group of institutions, nor was it the proximate cause of the failure of any large bank. Instead, it was a market-oriented crisis that was viewed— at the time and since — as an event with potentially systemic consequences that warranted official sector intervention. In addition to the 1987 stock market crash, examples of such crises might include the widening of interest rate spreads and decline in liquidity following the collapse of Long-Term Capital Management in 1998 and the collapse of the junk bond market in 1989-90.

Creating a systemic risk regulator focused on particular institutions designated as systemically significant would do little to prevent a recurrence of the type of market-oriented systemic breakdown that has led to the current crisis, and which is likely to be the cause of future crises. Moreover, such an approach could have harmful side effects, particularly for the property/casualty insurance industry and its consumers if certain property/casualty insurance companies are deemed systemically significant and are regulated as such.

The majority of the entities under scrutiny for systemic risk are regulated by one or more federal or state regulators. The underlying operations of these entities are complex and regulatory supervision requires a high level of expertise in the specific business. As such, it is imperative that any regulatory model coordinate and complement the existing supervisory bodies.

Systemic Risk in the Insurance Industry

In the wake of problems facing the financial services industry, there have been calls for the creation of a federal or international systemic risk regulatory body. As a trade association that represents property/casualty insurers, NAMIC's primary concern is the potential impact of institution-oriented systemic risk regulation on our member companies and the consumers they serve.

The six primary factors that affect the probability that a financial institution will create or facilitate systemic risk are *leverage, liquidity, correlation, concentration, sensitivities, and connectedness.*

- **Leverage**

  Very few property/casualty insurers use commercial paper, short-term debt or other leverage instruments in their capital structures, a fact that makes them less vulnerable than highly leveraged institutions when financial markets collapse. Because of their basic business model (explained more fully below) and strict capital requirements imposed by state regulators, property/casualty insurers are much more heavily capitalized, in terms of their asset-to-liabilities ratios, than banks and hedge funds. For these reasons alone, the banking system's perennial moral hazard of being "too big to fail" has no equivalent in the insurance industry. This, of course, is a completely different model than the banking world where leverage is a central component of the enterprise.

- **Liquidity**

  Unlike most other types of financial institutions, the nature of the products that property/casualty insurers provide makes them inherently less vulnerable to disintermediation risk. While banks are exposed to the risk that customer

withdrawals can exceed available liquidity, the risk of a liquidity shortfall is minimal for insurance companies. Insurance companies are financed by premiums paid in advance, and payments are subject to the occurrence of insured events. Insurance policies are also in force for a contracted period of time, the terms of which are agreed to by both parties. If an insurance customer cancels a policy before the end of the contract, the premium is refunded on a pro rata basis and coverage is canceled. Whereas bank liabilities are short-term and assets are long-term, the converse is true of insurance, which has liquid assets but longer-term liabilities. Thus, for both business and regulatory reasons property/casualty insurers carry a liquid investment portfolio. As long as the insurance company has built up reserves and its investments are calibrated to match the statistically anticipated claims payments, there is no liquidity risk and no possibility of a "run on the bank" scenario.

- **Correlation**

  Property/casualty insurers use underwriting tools specifically designed to identify and control certain types of correlation, including market concentration, in order to control catastrophe and underwriting exposures. Identifying and managing risks are at the core of insurance; these tools allow insurers to accurately price and underwrite risk. The side benefit of rigorous underwriting is a reduction in systemic risk exposure.

  It is also important to note the difference between asset backed securities and other derivative products, where the underlying risk is financial or market (such as credit, price, interest rate, or exchange rate), and property/casualty insurance, where the underlying risk is a real event, such as an automobile accident, fire, or theft. While the former risks are likely to be correlated, in that they will be affected by similar cyclical economic or financial factors, the latter are largely individual, non-cyclical, idiosyncratic risks. Banking risks are often highly correlated, particularly in economic downturns. Traditional insurance, in contrast, pools uncorrelated, idiosyncratic risks, and is not subject to systemic crises in the same way as banks.

- **Connectedness/Sensitivities/Concentration**

  Property/casualty insurers manage concentrations of investments and have regulatory limitations on both the type and concentrations of the assets in which they invest. These realities have the effect of reducing the property/casualty insurance industry's connectedness and sensitivity to the actions and conditions of other sectors of the financial services industry.

  The one possible exception to this rule is the small subset of monoline financial guaranty insurers that offer specialized products such as bond and mortgage insurance. Because financial guaranty insurance is by definition directly connected

to financial products, it is conceivable that these specialty insurers could play a role in propagating systemic risk.

The aberrant business model of financial guaranty insurers, however, hardly provides justification for subjecting mainstream property/casualty insurers to systemic risk regulation. While property/casualty insurers, like virtually all investors, have suffered investment losses, no financial contagion has spread throughout the industry or to other financial markets. Even where a property/casualty insurer is held by a holding company that also holds other types of financial services companies, regulatory restrictions designed to protect policyholders operate to "ring-fence" the property/casualty insurer's capital and protect it from incursions caused by any problems of the other subsidiaries.

Unlike lightly regulated financial institutions such as investment banks and hedge funds, most of the obligations of property/casualty insurers are protected by the insurance guaranty fund system. This nationwide system, which is financed by the property/casualty insurers of each state, reduces the systemic impact of any failing property/casualty insurer by providing most customers or claimants assurance that the insurer's obligations will be satisfied on a timely basis.

Risk Regulation in the Property/Casualty Insurance Industry

Insurers are subject to strict financial and market regulation by the states. State statues give insurance regulators authority to supervise and regulate the financial condition of insurers licensed to do business in their state and to review market practices. Almost all states have adopted, either through statute or regulation, the financial regulation requirements in the National Association of Insurance Commissioners ("NAIC") Financial Accreditation Standards program, including the NAIC's annual and quarterly financial statements, accounting manual, auditing and actuarial requirements, risk-based capital and examination model laws. Accounting standards for insurers are significantly more conservative than other financial institutions. Statutory Accounting Principles ("SAP") focus on solvency and as a general rule recognize liabilities earlier and/or at a higher value and recognize assets later and/or at a lower value than traditional General Accepted Accounting Principles ("GAAP").

In addition to more conservative accounting standards, insurers must maintain minimum levels of capital and surplus. In the early 1990's the NAIC developed a system that prescribes capital requirements corresponding to the level of risk of the company's various activities. The risk-based capital ("RBC") formulas apply separate charges for an insurer's asset risk in affiliates, asset risk in other investments, credit risk, underwriting risk, and business risk and each formula recognizes the correlation between various types of risk. The Risk-Based Capital Model Law also establishes levels of required company and/or regulatory action, ranging from the company corrective action to regulator termination of the entity. While the RBC system is

intended to prescribe minimum capital levels, it also functions as an early warning system.

In addition, the state regulators participate in the NAIC Financial Analysis Working Group. This group of regulators and NAIC staff focus on the financial condition of nationally significant insurers. This process, which is confidential, provides regulatory peer review of the actions domiciliary regulators take to improve the financial condition of larger insurers.

The failure of the financial services divisions of American International Group ("AIG") has caused some commentators to question the adequacy of insurance regulation. However, it is imperative to note that the financial and regulatory failures of AIG occurred outside the state-regulated insurance divisions. AIG is a holding company with around 200 corporate affiliates, about 71 of which are life and property/casualty insurance companies. The insurance units are well capitalized, properly regulated and highly rated. The insurance assets remain solvent and valuable and are serving as the primary assets used as collateral for the government's massive investment. The credit default swap and derivatives transactions were not insurance and were effectuated outside the insurance divisions by the holding company in the financial products divisions. The holding company was regulated by the federal Office of Thrift Supervision.

Potential Consequences of Institution-Oriented Systemic Risk Regulation

Systemic risk regulation and oversight focused on particular institutions based on size, nature of business or perceived significance may well miss market-oriented events and trends that are the true sources of systemic risk. Some commentators have suggested that systemic risk regulation should focus on particular financial institutions that are considered to be "systemically significant." While the criteria for determining which companies are systemically significant are unclear at this point, most proponents of this approach seem to have in mind companies that are thought to be "too big to fail" or "too interconnected to fail."

The act of publicly identifying and regulating "systemically significant institutions" is likely to have unintended negative consequences, particularly if property/casualty insurance companies are among the institutions designated as systemically significant. If an insurance company is deemed systemically significant, investors and consumers will see it as an official declaration that the company will not be allowed to fail. This is because the whole purpose of regulating systemically important insurers is to prevent them from failing, since their failure would have an adverse systemic impact on the financial system or the economy generally.

It seems quite likely that insurers designated as systemically important would gain a competitive advantage over other insurers. Companies carrying the official "systemically significant" designation would be able to attract more customers and

investment capital than their rivals, thanks to the perception that "systemically significant" insurers will be backed by the federal government. Moreover, the implicit guarantee of a government bailout for systemically significant insurers would create a moral hazard that could manifest itself in regulatory arbitrage, a strategy of identifying and exploiting loopholes in the systemic risk regulatory apparatus that would enable the company to engage in riskier (but potentially more profitable) underwriting or investment practices.

To counteract the moral hazard produced by the "systemically significant" designation, the systemic risk regulator might err on the side of caution by preventing systemically significant insurers from engaging in any business practice that, in its view, could even remotely contribute to systemic risk. Overly restrictive regulation of this kind could decrease the availability of insurance coverage while increasing its cost.

While systemic risk poses economic costs, so does regulation. The costs, both direct and indirect, of a systemic regulatory system could be high and care must be taken to avoid situations in which the costs outweigh the benefits. In addition to the direct costs of additional regulation, Congress must be wary of the moral hazard and disruption of the efficient evolution of markets which can result from inappropriate regulatory intervention.

Effective Systemic Risk Regulation

NAMIC believes that regulators should work to identify, monitor, and address systemic risk. However, a systemic risk regulator should complement existing regulatory resources. Furthermore, NAMIC does not believe that the business or legal characterization of any institutions should be used as a basis for assessing systemic risk. Oversight and regulation of systemic risk should focus on the impact of products or transactions used by financial intermediaries.

Attempting to define and regulate "systemically significant institutions" on the basis of size, business line, or legal classification – such as including all property/casualty insurers - would do little to prevent future financial crises. Indeed, a regime of systemic risk regulation that is institution-oriented rather than focused on specific financial products and services could divert attention and resources from where they are most needed, while at the same time producing distortions in insurance markets that would be harmful to consumers.

The next crisis will likely arise from a set of circumstances quite different from those that produced the current crisis. However, at this time there is no evidence that the property/casualty insurance industry contributes any substantial amount of systemic risk to the global financial system. A new systemic risk regulator should not be tasked with supervising property/casualty insurers that are arbitrarily presumed to be "systemically significant." Instead, any new systemic regulatory system should be given the flexibility to adapt to changing developments in the marketplace, and to anticipate events that

could potentially cause a cataclysmic shock to the financial system and the broader economy.

NAMIC member companies understand that federal policymakers must have better information about the insurance industry, and confidence in the financial health of property/casualty insurers. To that end, NAMIC has supported the creation of a federal Office of Insurance Information. That measure, coupled with effective systemic risk regulation, could accomplish important policy objectives that are not currently being met.

Conclusion

NAMIC supports a strong, transparent, market economy. We encourage the Subcommittee to fully explore all options for addressing the various challenges, including systemic risk, confronting the nation's economy. As the Subcommittee and Congress evaluate solutions, NAMIC, on behalf of our member companies and their customers, encourage members to carefully weigh the cost-benefit of proposed regulatory processes. It is critical that any solution address real regulatory gaps, without implementing duplicative and ineffective new regulations where none are needed. National Association of Mutual Insurance Companies

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For Banks, Help Isn't On The Way

By INVESTOR'S BUSINESS DAILY | Posted Wednesday, March 04, 2009 4:20 PM PT

Financial System: Banks, it seems, are everyone's favorite villains these days. Blamed for much of the financial crisis by everyone from the president to the media, they are routinely vilified. But do they deserve it?

For banks, news in recent days hasn't been very favorable. One in five mortgages reportedly is now underwater. And the Federal Deposit Insurance Corp., founded during the Depression, announced Wednesday it will go bust by the end of 2009.

As banks and other financial services companies report ever-widening losses, their stocks have plunged to record lows. Things are so bad the S&P 500 may soon remove a number of financial stocks.

Meanwhile, meeting at a luxury hotel in Florida, leaders of the AFL-CIO say they'd prefer the banks to be nationalized, pronto. As they do, Treasury Secretary Tim Geithner has returned to "reintroduce" his failed plan to infuse capital into the banking system and, in essence, take control of the industry.

Amid all this, both politicians and media pundits have seized on the financial chaos to blame "deregulation" and "greed" by bank CEOs for the problems.

Yes, banks have made lots of mistakes. But the current financial crisis didn't simply erupt out of nowhere. Nor are today's bankers any greedier or more self-interested than previous generations.

No, the real reason for our financial meltdown is pretty clear. We've written about it literally dozens of times, but in these times of bank hardship it bears repeating: Our government is largely to blame for our current problems.

That's bad enough. But many of the same people who caused these problems — Rep. Barney Frank and Sens. Chris Dodd and Chuck Schumer stand way out — are now making new laws to "fix" them.

Also as noted many times, Fannie Mae and Freddie Mac, the two companies created by the government to help fund mortgages for unqualified borrowers, are behind our current problems.

Though nominally private, Fannie and Freddie had major financial backing by the U.S. government. This let them borrow at below-market rates. They used this leverage to buy literally trillions in mortgages, packaged them and resold them on the market.

It seemed to work until a series of regulatory changes in the 1990s pushed by President Clinton and Democrats in Congress. In 1995, the Community Reinvestment Act was

changed to permit the securitization of subprime loans — which, as bank industry critics rightfully note, the financial industry embraced with wild abandon.

Over the next five years, the banks that today are being targeted with nearly $1 trillion in TARP and other aid were pushed hard by Washington to boost their lending to low-income households.

Subprime loans let them do so. In 2001, subprime and other high-risk loans totaled $330 billion, or about 15% of all loans. By 2006, they had reached $1.4 trillion, or 48%. And Fannie and Freddie owned or guaranteed more than half of the nation's $12 trillion in home mortgages. They were near-monopolies.

To be sure, more people did get into homes. For 35 years, the homeownership rate had hovered around 64%, which is about where it stood in 1995. By 2005, it reached nearly 70% — a record.

But it came at a price. When the Fed raised rates from 2004 to 2006, the housing market fell apart, and many banks were left holding billions in underwater mortgages. Home prices fell, and homeowners suddenly found themselves with no equity to borrow on.

That's a big reason for our current nasty recession.

Now, Geithner is back with another plan costing hundreds of billions to force banks to lend more money. And President Obama's Housing Relief Program would force those who pay their mortgages to subsidize as many as 9 million people who have defaulted.

This is moral hazard at its worst. Is it any wonder banks are in such bad shape? Or that 64% of Americans in a poll this week call Obama's $75 billion plan "unfair"? Sure, bank CEOs went along with this for a long time, and even profited from it.

But they didn't cause the problem — Congress and the White House did, by imposing market-distorting regulations on our banking system. And they're about to do it again.

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STEVE BARTLETT
PRESIDENT AND
CHIEF EXECUTIVE OFFICER

April 8, 2009

The Honorable Ruben Hinojosa
Member, Subcommittee on Capital Markets,
Insurance, and Government-Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Hinojosa:

On behalf of the Financial Services Roundtable, I would like to thank you for your leadership on regulatory restructuring issues, specifically systemic risk. Per your request, I am responding in writing to your list of questions from the March 5 Subcommittee on Capital Markets' hearing on "Perspectives On Systemic Risk" (see attached).

The Roundtable continues to engage on a range of regulatory restructuring issues and would like to work with you and other policymakers on these regulatory restructuring issues through the legislative process. I would also like to offer as a resource the expertise of our member companies as the Committee grapples with these issues. I have also attached the current version of the Roundtable's regulatory restructuring proposal for your review.

Again, I appreciate your commitment to addressing theses important regulatory restructuring issues important to all Americans. For any additional information, please feel free to contact me directly at 202- 589-2410 or Irving Daniels at 202-589-2417.

Sincerely,

Steve Bartlett

Steve Bartlett

Attachments

cc: Chairman Paul Kanjorski
Ranking Member Scott Garrett
Ms. Terrie Allison

QUESTIONS OF THE HONORABLE RUBEN HINOJOSA
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
"PERSPECTIVES ON SYSTEMIC RISK"
MARCH 5, 2009

FOR CONGRESSMAN BARTLETT: FINANCIAL SERVICES ROUNDTABLE

Q.1. Congressman Bartlett, several reports have called for a market stability or systemic risk regulator, such as Secretary Paulson's Blueprint, the G-30, and the Congressional Oversight Panel. How urgent is it for Congress to act? Do we need to start the process before President Obama goes to London for the G20 Summit April 2, 2009?

Answer

We have been in a financial crisis since at least the fall of 2007, and it would have been helpful if we had moved sooner on the crisis resolution and acted on the regulatory gaps and failures that the Roundtable and others identified as early as 2007. Having said that, the worst of the financial crisis hit just before last year's elections, and we now have gone through a successful change in Administrations.

Treasury Secretary Geithner is expected to outline the Administration's plan for regulatory restructuring in advance of President Obama's first trip to the G20 Summit April 2, 2009, in London, so it is helpful to see the broad outline sooner rather than later. Congress has now started hearings on the topic, for which Chairman Frank is to be commended. The Roundtable and others have testified in favor of sweeping new reforms, and we expect to be invited back to testify once legislation is introduced. At this point we believe that the Congress and the Administration have set the necessary wheels in motion, but we need to ensure that we act on comprehensive reform as I outlined in my testimony no later than this year.

Q.2. If we move a market stability regulator on a fast track as Chairman Frank has proposed, how do we ensure that we will return to tackle the broader regulatory reform proposals and a new regulatory architecture that some contend are needed to ensure a modern financial system able to lend to consumers and companies and create jobs in the future? What would you recommend as a deliberative process going forward?

Answer

The Roundtable clearly supports comprehensive regulatory reform as I outlined in my recent testimony. We expect Congress to enact legislation this year. While we would like to see a comprehensive package move at once, we understand the need for urgent action potentially on some critical items, such as an orderly resolution regime to resolve nonbank financial institutions and the need for a single, accountable market stability regulator, both of which the Roundtable supports.

An analogy would be a car used to drive to work or school that needs a complete overhaul. You may have to overhaul the engine first, then the electrical system, then the

transmission, and finally the brakes, but you need to do everything – sequentially perhaps, but completely – to ensure you have a car that ultimately is safe and runs efficiently, and you need it done in a timely manner for your daily needs of working and driving your children to and from school. The same thing applies in financial services reform. We need to start somewhere, but act comprehensively and consistently, with a clear vision of the future we want for our financial system and some basic principles to guide how we get there. It needs to be comprehensive and complete. Now that Chairman Frank and the Administration have set the wheels in motion, we will defer to their judgment on the best way to proceed, but we support comprehensive action and sweeping reform of our regulatory architecture this year to correct the past regulatory failings and clear regulatory gaps that I and others identified in our recent Congressional testimony.

Q.3. Some have pointed out the need for better and more formal regulatory coordination among all our financial regulators. I've been informed that the Financial Services Roundtable submitted draft legislative language last year in an attempt it deems necessary to ensure that we take not only a more principles-based approach to regulation, but also an enhanced and expanded President's Working Group to ensure that all regulators have a seat at the table. Should we include both these provisions – a few guiding principles and better regulatory coordination – in any legislation that moves forward quickly on this issue? If so, why? Does the Financial Services Roundtable, Congressman Bartlett, intend to revise the draft submitted last year and, if so, how do you plan to proceed from there?

Answer

As I indicated in my testimony, we need comprehensive regulatory reform. That means we need a new regulatory architecture as I described, and we also need some other critical elements, starting with some guiding principles to help inform regulators and regulated financial services firms about desired regulatory outcomes. Principles aren't a substitute for rules and regulations, but they are a starting point for subsequent rules and regulations, especially in the area of retail consumer finance. We need a few basic principles up front in any Congressional debate to guide subsequent actions to ensure consistency in our approach and our resulting architecture.

Because of the past and potential regulatory gaps during any kind of transition period, we also need better regulatory cooperation and coordination through an enhanced President's Working Group on Financial Markets, especially in times of financial stress and crisis but also in more normal times. Working from the Roundtable's 2008 legislative draft proposal – the Systemic Risk Reduction Act of 2008 – we would call this new group the Financial Markets Coordinating Council, require it to be enacted by the Congress to ensure Congressional approval and buy-in, retain the Secretary of the Treasury as the Chairman, include all national and representative state supervisors, and finally give it a more forward looking and enhanced mandate with regular reporting to Congress and the public. This would be an appropriate forum to raise any issues of regulatory or supervisory concern and serve as a means to identify future issues for the Congress to consider.

We would be pleased to re-submit our proposal, and would look forward to working with Chairman Frank and the Committee as your deliberations proceed this year.

Q.4. Congressman Bartlett, what do you think, if anything, needs to be done to protect our domestic economy from further systemic risk in the future? If you believe we need to act, how soon and what entity do you think could temporarily serve as the systemic risk regulator?

Answer

In general, the Roundtable has been supportive of most of the efforts of the Treasury Department, the Federal Reserve, the FDIC, and the other regulators to intervene in markets to stop last year's financial panic and collectively stabilize the financial system. This has been an enormous endeavor, resulting in last year's Emergency Economic Stabilization Act by the Congress and the current consideration of further legislative and regulatory actions this year.

As I testified, the Roundtable supports designating the Federal Reserve as the nation's market stability regulator. While there are other potential options such as the creation of another new agency, the Federal Reserve is the agency with the most market experience and closest proximity to U.S. and international financial markets, at least in the near-term. It obviously would have to increase its resources and skills, think carefully about how it organizes and governs these new mandated functions, and would have to be transparent in how it proceeds and its decision-making. Given other alternatives, the choice of the Federal Reserve, despite some possible downsides, is a good outcome, especially in the short-term to see us through the successful resolution of the current crisis as soon as possible. Once the present crisis subsides, the Congress can reassess any decision it makes, if it decides on giving this task initially to the Federal Reserve. To ensure full accountability, we would not recommend sharing this responsibility among multiple regulators.

Q.5. According to various and sundry sources, part of a market stability regulator's responsibility is to recognize and quickly address any and all systemic threats and new market vulnerabilities; to analyze that information; and then to take what that regulator would deem to be the appropriate action, such as alerting other regulatory agencies to a potential problem and providing the public with as much advance notice and information as feasible. Do you agree?

Answer

Yes. In my testimony, I distinguished between actions the Federal Reserve would take from a market stability regulator perspective in both non-emergency and emergency situations. In a non-emergency situation, for example, the identification of a suspicious activity or practice by a class or significant number of financial institutions would warrant a "time out," while the prudential regulator(s) is informed and consulted and has time to take appropriate corrective action with the affected firms. Due process would prevail in

nonemergency situations. An emergency situation, however, could be a significant shock that would have a material and adverse impact on our financial markets or our economy, and one in which the Federal Reserve could act unilaterally but only after a super-majority vote of the Board, after consultation with the Secretary of the Treasury and the President, and with full disclosure of its actions to the public.

Q.6. Congressman Bartlett, you indicate in your testimony and comments outside the Committee room that a new market stability regulator should have broad oversight over all markets, including those currently unregulated at either the national or state levels, such as hedge funds, mortgage brokers, and investment advisers. If Congress were to create a financial markets stability and/or systemic risk regulator, what regulatory limits should we impose?

Answer

To gain the benefits of having a single, accountable market stability regulator, at a minimum we want to ensure that it has the broad ability to gather pertinent information to assess potential systemic risk, have the resources and skills to analyze that data, and conduct scenario planning as well as contingency planning for both previously regulated financial institutions as well as for those financial institutions, such as hedge funds and state-licensed mortgage brokers, that previously have been unregulated. We want to ensure that the market stability regulator works with and through the prudential regulator(s) on nonemergency issues that have potential systemic implications (e.g., capital and liquidity requirements, enterprise-wide risk management standards).

As I indicated above, in emergency situations that are immediate and potentially have a material and adverse impact on our financial markets or our economy, the market stability regulator would have to work through a series of steps (e.g., a super-majority vote, concurrence with the Secretary of the Treasury and the President, reports to Congress and the public) to make a decision and then act upon it. There may be other safeguards and conditions that could be applied, but we will reserve judgment until we begin to see legislative drafts.

Q.7. Congressman Bartlett, a market stability regulator, however finally crafted, could have an enormous impact, both positive and negative, on our domestic economy and the global economy. If such a regulator were created, would it be possible to authorize new "powers" without curtailing market innovation in the U.S. while ensuring that U.S. markets can compete on a global level. What actions do you recommend that Congress take and/or give to the systemic risk regulator?

Answer

The designation of a new market stability regulator will have to done in a balanced way, especially in the current economic climate. We need to stabilize and strengthen our financial system so it can resume its full intermediation and lending functions in the near term, and we also need to ensure that it has the capabilities and resilience to compete

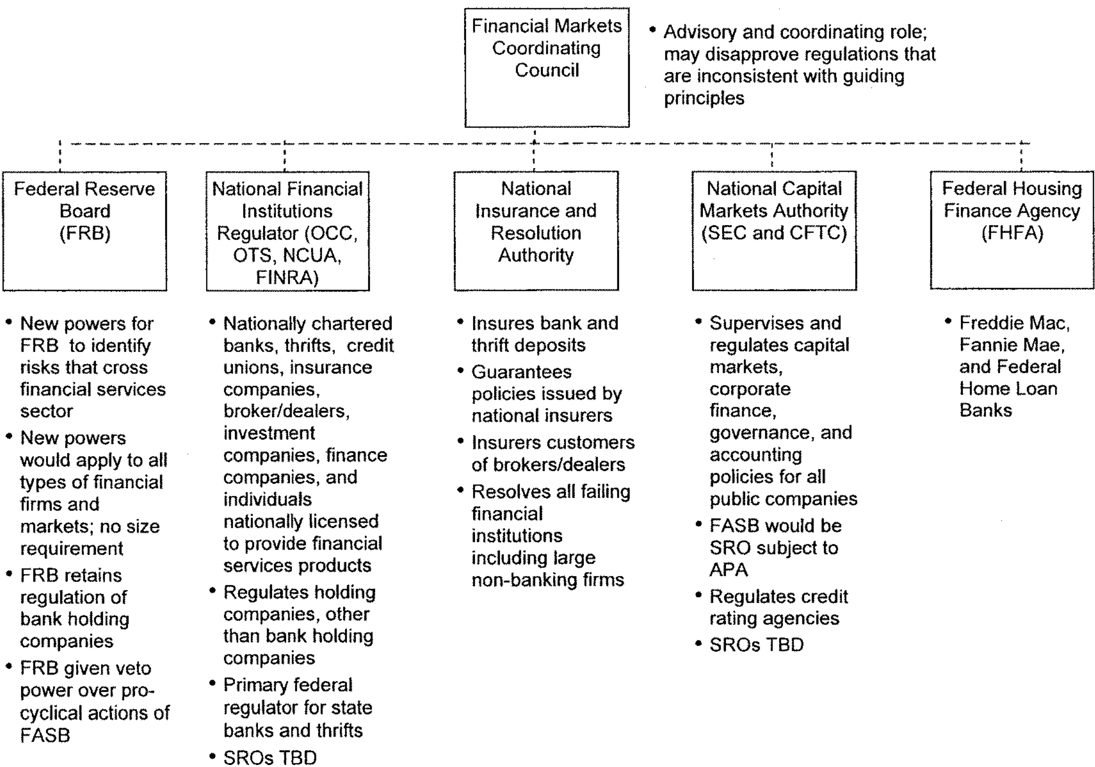
globally and innovate to serve all kinds of consumers in the longer-term, both of which are important to our economy. Congress will need to set clear objectives and monitor the actions of this new regulator carefully, especially in the early days to ensure that the right balance is being achieved. Ensuring that the market stability regulator is fully transparent in everything it does and is in constant touch with the prudential regulator(s) also will help to ensure the needed balance.

Q.8. Several people have approached me in the ante-room expressing concern that the Federal Reserve already has too much power and should be reigned in by Congress. They have expressed concern that if the Federal Reserve is selected as the financial markets stability regulator, it will have far too much power without Congressional oversight as well as creating even more conflicts of interest than exist today with our central bank. How could we minimize these potential conflicts of interest in what could be competing roles?

Answer

This is a serious issue and nontrivial issue. There are legitimate concerns that adding to the Federal Reserve's existing authority as a central bank, bank and holding company regulator, payments system overseer, and provider of services to banks may create added burdens and set up potential conflicts of interest with its other important roles. In this regard, another option could be to set up a new another new agency with the same basic powers outside, but outside of the Federal Reserve.

On balance, however, the Roundtable supports having the Federal Reserve assume the additional role as the market stability regulator, in large part because it is a natural extension of what is doing already to help stabilize the financial markets and the economy. To prevent potential conflicts, the best safeguards are to ensure that it works with and through the prudential regulator(s) on nonemergency issues and that it follows the broad procedures I reviewed above for truly exceptional emergency measures. Otherwise, its main mission it to observe and report back on potential systemic risks. In addition, we support full transparency and regular reports to Congress and the public to ensure that the Federal Reserve discloses its market stability concerns and actions fully and in a timely manner. If adopted by Congress, the Financial Markets Coordinating Committee we propose could be another check and balance on the new regulator, just as the Congressional authorizing committees would be.


FINANCIAL REGULATORY ARCHITECTURE PROPOSAL
Financial Markets Coordinating Council
• Advisory and coordinating role; may disapprove regulations that are inconsistent with guiding principles
Federal Reserve Board (FRB)
• New powers for FRB to identify risks that cross financial services sector
• New powers would apply to all types of financial firms and markets; no size requirement
• FRB retains regulation of bank holding companies
• FRB given veto power over pro-cyclical actions of FASB
National Financial Institutions Regulator (OCC, OTS, NCUA, FINRA)
• Nationally chartered banks, thrifts, credit unions, insurance companies, broker/dealers, investment companies, finance companies, and individuals nationally licensed to provide financial services products
• Regulates holding companies, other than bank holding companies
• Primary federal regulator for state banks and thrifts
• SROs TBD
National Insurance and Resolution Authority
• Insures bank and thrift deposits
• Guarantees policies issued by national insurers
• Insurers customers of brokers/dealers
• Resolves all failing financial institutions including large non-banking firms
National Capital Markets Authority (SEC and CFTC)
• Supervises and regulates capital markets, corporate finance, governance, and accounting policies for all public companies
• FASB would be SRO subject to APA
• Regulates credit rating agencies
• SROs TBD
Federal Housing Finance Agency (FHFA)
• Freddie Mac, Fannie Mae, and Federal Home Loan Banks

FINANCIAL SERVICES ROUNDTABLE
PROPOSAL FOR FINANCIAL REGULATORY REFORM

In anticipation of the most sweeping financial regulatory reforms since the Great Depression, the Financial Services Roundtable's Executive Advisory Council on Regulatory Restructuring has developed six proposals for financial regulatory reform. The first proposal addresses the need for a modern financial regulatory architecture, and the remaining proposals address new regulatory standards to guide the behavior of all financial services firms and regulators.

Six Proposals for Financial Regulatory Reform

1. New Architecture. *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*

2. Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide.*

3. Balanced and Effective Regulation. *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*

4. International Cooperation and National Treatment. *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.*

5. Failure Resolution. *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*

6. Accounting Standards. *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510–6602

BY ELECTRONIC MAIL AND MAIL DELIVERY

March 4, 2009

Hon. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve

Dear Chairman Bernanke:

As you may recall, late last year, when you were testifying before the House Financial Services Committee, you agreed, in response to my request, to provide me and the Committee with information about the counterparty transactions in which the Federal Reserve (or entities set up and funded by the Federal Reserve) purchased from certain counterparties multi-sector collateralized debt obligations (CDOs) on which AIG had written credit default swap (CDS) contracts. In connection with the purchase of these CDOs, counterparties unwound related CDS transactions. Also, the Federal Reserve funded the purchase of residential mortgage backed securities (RMBS) from AIG. I requested information on the identities of the counterparties from whom the CDOs and CDS were purchased, the price paid by the Fed for the CDOs, CDS and RMBS, and a description of how the prices were determined.

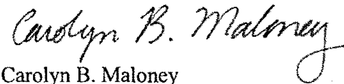
However, to date, your office has not provided that information to me nor, as far as I am aware, to the Financial Services Committee. This letter is to reiterate that request and to ask that the information be provided to me at the Joint Economic Committee and to the Financial Services Committee as soon as possible. As the New York Times editorial said on March 3, 2009 about these very transactions: "The AIG bailouts fail the basic test of transparency: Who ends up with the money?" I agree with the Times that "not knowing is not acceptable."

In further support of my request, I attach a letter from a fellow New Yorker, the noted economist and Nobel laureate Joseph Stiglitz, separately requesting release of this information on his own behalf and explaining how the Fed's providing this information is essential to informed debate over, and efficient development of solutions to, our current economic crisis, as well as to Congress' ability to oversee the use of taxpayers' money with respect to the AIG

bailout or similar efforts. This is the letter I put into the record at the Financial Services hearing at which you testified on February 25, 2009.

Thank you very much for your prompt response to this request.

Sincerely,



Carolyn B. Maloney
Chair, Joint Economic Committee

Enclosure

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Joseph E. Stiglitz
University Professor

February 24, 2008

Dear Representative Maloney,

I have been trying to study the impact on the American economy of the bail-outs to AIG and to banks. One of the critical questions is where did the money that we gave them go? It is important to know this for several reasons. First, the claim was made that it was necessary to bail-out AIG in order to prevent systemic risk to the American economy. In order to evaluate this claim, we must know who the ultimate beneficiaries were of the money provided to AIG. If, for instance, the money went abroad, then it was unlikely that AIG's failure would have represented systemic risk to the US. If the money went to a large investment bank, then we can assess the impact on that bank. Perhaps without the bail-out the bank would have survived, though admittedly its shareholders would have been worse off.

Secondly, going forward, we have to devise clear rules about when we will bail-out institutions and when we will not. With our growing national debt, it is imperative that we spend taxpayer dollars wisely. If only a small percentage of the AIG money went to banks which were systemically important, it would have been far more efficient to assist directly those firms. The AIG bail-out provides a good case study within which to frame this important policy debate.

Unfortunately, the public does not seem to have access to this information. I realize that some claims may be made that releasing such information at the time of the bail-out might have exacerbated market turmoil. I am, however, a strong believer in market transparency. Many of our current problems can be traced to inadequate transparency. Whatever one's views on this, sufficient time has elapsed that these concerns are no longer relevant. American taxpayers have a right to know where their money is going, and it is imperative that Congress has this information in order to frame appropriate legislative responses.

Firms should play by the rules. The basic rule of capitalism is that firms should bear the consequences of their mistakes. If there are exceptions, they should be narrow and well defined. I am requesting that you make publicly available information about who received the money given by the Fed and the U.S. Government to AIG and about the derivative contracts under which this money was delivered. The information I am requesting should be of immense help in assisting Congress to undertake the essential analyses I have described.

It would also be useful to know the analyses that the Federal Reserve and Treasury undertook prior to the bail-out, which led them to the conclusion that the failure of AIG would lead to systemic risk, as well as the analyses that they undertook prior to the decision not to bail-out Lehman Brothers which led them to the conclusion that the failure of Lehman Brothers would not lead to systemic consequences. It is important that the government have appropriate analytic frameworks for addressing these questions, and it is apparent that, at least in the case of Lehman Brothers, the existing frameworks are deficient.

As the current crisis continues to grow, it is important to have this information as quickly as possible.

I look forward to your response.

Sincerely,

Joseph E. Stiglitz
University Professor
Columbia University

AIG Increases Borrowings While Racing to Sell Assets
By Liam Pleven, Carrick Mollenkamp and Craig Karmin
10 October 2008
The Wall Street Journal
C1
American International Group Inc. drew down another $9 billion in loans from the government to meet massive demands for cash from its trading partners as the company scrambles to sell off its assets.

The insurer has now borrowed $70.3 billion from the government in three weeks and is in a race against time to sell assets to pay off the loan as the financial markets tumble, making it harder for the company to find buyers for its units. The government originally said it would loan the company $85 billion but raised the amount to $122.8 billion on Wednesday.

Thursday, AIG shares closed down 25% to $2.39 in 4 p.m. composite trading on the New York Stock Exchange.
"The Fed had no idea the capital markets would seize up and the stock markets would keep falling; both put AIG in a severe cash bind," said a person involved in the rescue talks.

The lion's share of the Fed's original loan has gone for two things: providing collateral to AIG's trading partners on complex derivatives known as credit default swaps, and covering losses in AIG's securities-lending program. When the threat of losses from the lending program mounted, the Fed had to step in again this week.

Market prices of many corporate bonds and other debt securities have fallen sharply since the Sept. 16 rescue. For example, average prices of corporate bonds with high credit ratings have dropped 6% since then, an unusually large decline for such securities over a relatively short period. As many of AIG's swap agreements required it to post collateral to the owners of the swaps whenever prices of insured investments fell, the amounts it owed grew substantially over the past few weeks. In addition, some assets that AIG provided as collateral likely also fell in value amid the credit-market turmoil, triggering additional margin calls from its counterparties.

Securities lending involves both lending securities and investing collateral for a return. If the value of the collateral declines, as it has for AIG and other securities lenders, the investor needs to make up the difference when the borrower returns the securities. AIG's program had faced problems for months, but they intensified after AIG was downgraded by credit-rating agencies in September, just before the government rescue.

AIG's securities-lender clients flooded the program for their collateral, creating a "mini-run" on the bank, says Doug Slape, chief financial analyst of the Texas Department of Insurance. The company began drawing down on the Fed loan commitment to cover the collateral requests, it told Mr. Slape in recent conversations, he said. By Oct. 3, Moody's

Investors Service said AIG's default-insurance and securities-lending program had experienced "substantial losses and write-downs" due to mortgage securities.

The Texas regulator grew concerned about the exposure in 2007. At the time, AIG told Texas it recognized that it needed to retain more cash, Mr. Slape said.

Securities lending has long been a reliable side business for life insurers, approved by state regulators. But Moody's warned in April about the risks that insurers were taking related to these programs.

Hampton Finer, a deputy to New York State Insurance Superintendent Eric Dinallo, said policyholders in AIG's life-insurance subsidiaries weren't at risk due to the securities-lending programs. But, he said, New York will review what types of assets insurers are allowed to invest securities-lending collateral in.

Mr. Slape said his team is keeping a close watch on three AIG insurance units because of the securities-lending exposure. Ohio's Department of Insurance said it is investigating the securities-lending activities of at least one life insurer. Darrel Ng, a spokesman for the California Department of Insurance, said the state is "looking at the securities-lending practices of those insurers domiciled in California," along with AIG's.

According to AIG's quarterly report for the period ending June 30, the collateral for the securities-lending program shows investments totaling $36.2 billion in mortgage securities and other bundled securities, $12.9 billion in corporate debt, and $10.5 billion in cash or short-term investments, for a portfolio totaling nearly $60 billion.

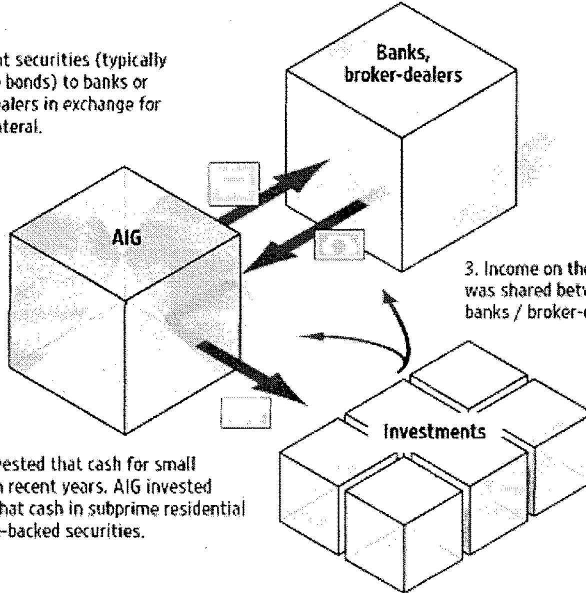
While insurance subsidiaries are regulated by the states, the federal government is now actively involved in AIG. Since the rescue, a large team from the Federal Reserve Bank of New York has been monitoring the company, with a dedicated office at AIG's headquarters in Lower Manhattan, on a different floor from the office of the company's new chief executive, Edward Liddy.

Staffers from the New York Fed, along with outside experts the Fed hired, are trying to assess how money is flowing within and from the company. The Fed also has been sending personnel to AIG divisions, such as the aircraft-leasing company, AIG Financial Products unit, American General Finance, and AIG offices around the world to assess the company's risks and its risk-management procedures.

Mr. Liddy and a top bank-supervision executive from the New York Fed communicate many times a day.
Market conditions aren't helping prospects for assets sales. In the current environment, with investors and credit-rating agencies voicing deep concern over the industry's capital reserves, potential suitors are holding back. AIG is also reluctant to part with businesses, many of which it built up over decades, at fire sale prices.

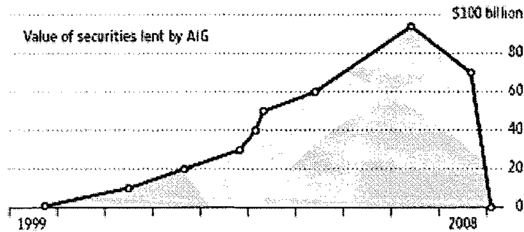
Insurance stocks were pummeled again Thursday, with Hartford Financial Services Group Inc. dropping 19% and Lincoln National Corp. losing 35%.

How AIG's Securities Lending Worked ...



... And Its Rise and Fall

AIG's securities-lending program grew to $94 billion in mid-2007 from $1 billion in 1999, then was essentially ended after last year's federal bailout of AIG.



Sources: AIG documents; Moody's

Initiative on
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FIXING FINANCE SERIES 2009-02

Regulating Insurance After The Crisis

Robert E. Litan

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

Initiative on
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Regulating Insurance After The Crisis

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March 4, 2009

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EXECUTIVE SUMMARY

Despite a long-standing policy debate, insurance remains the only major financial industry not to be regulated at the federal level, a tradition dating from the 19th century. However, recent financial turmoil has fundamentally changed the terms of this important discussion.

Many contend that as opposed to as many 51 separate regulators, a single federal insurance regulator would: allow insurers to pass substantial savings on to their consumers; preempt market distorting state regulation of rates; attract the expert talent needed to supervise the increasingly complex industry products; improve competition between insurers and non-insurance financial institutions for insurance-like products; better position insurers to compete globally and; make national policy with respect to insurer solvency

However, state insurance regulators and some smaller insurers and insurance agents favor the current system, arguing that: they alone have the interest, expertise, and accessibility to consumers to handle best consumer complaints; insurance rates must be subject to oversight if not outright control to protect consumers; and state regulators have moved aggressively in recent years to improve their solvency regulation.

After weighing these arguments, I conclude in this essay that insurers and agents operating in multiple states should have the option to operate under a more streamlined regulatory system, and in particular to choose between being chartered and thus regulated by individual state regulators, or by a new federal insurance regulator. Congress has considered but not yet enacted legislation establishing this "optional federal charter" system, analogous (although not identical) to the regulatory system that has long governed the U.S. banking industry.

Further, the recent financial crisis and associated bail-out of AIG make it is clear that, in addition to the optional federal charter, the government should *require* federal solvency and consumer protection regulation of the largest insurers that are deemed to be "systemically important financial institutions." Clearly, if the federal government is potentially needed as a source of debt or equity funds for certain insurers, there is a strong case for having the federal authorities actively oversee the financial safety and soundness of at least those firms that may benefit from federal, and thus national taxpayer, assistance.

Introduction

As policymakers vigorously attempt to breathe life back into the nation's financial system, attention has also turned to reforming financial regulation so that something like the current crisis never happens again. Given the failure and ongoing record-setting rescue of the holding company of the nation's largest insurance company, AIG, any final reform package that is enacted should also update the nation's antiquated system of state insurance regulation. Insurance is the only major financial industry not to be regulated at the federal level, notwithstanding the fact that competition in many lines of insurance is not only national, but global in nature.

This regulatory anomaly has been increasingly subject to question. In recent years, predating the current crisis, Congress has been considering legislation that would authorize an "optional" federal charter (OFC) for insurers, just as commercial banks have had since national banks were authorized in 1863. The arguments on both sides of the so-called "OFC debate" – which has concentrated on the life and property-casualty insurance industries – are well known. I summarize them briefly below.[1]

But the main point of this essay is that the recent financial turmoil has fundamentally changed the terms of this debate. At this writing, a number of life insurers are under significant financial stress due to heavy losses in their asset portfolios. Although the property-casualty insurance industry is in better financial shape, there is a crisis in coastal America that is most acute in the homeowners' insurance market in the State of Florida. In Florida, a long standing absence of available capital has been exacerbated by local political pressures to suppress insurance rates below market, threatening the bankruptcy of that state's backup homeowner insurance plan. Should that occur, yet another federal bailout could well be in the cards.

Given the clear federal taxpayer exposure to the potential failure of large insurers – or those deemed to be "systemically important financial institutions (SIFIs)" – it is time that a federal regulator oversees all aspects of their operations to assure their continued solvency. Other insurers that choose federal solvency regulation, as under the OFC model, also should be allowed to do so.

In both cases, to provide effective oversight of insurer solvency, federal regulators must also be able to preempt state regulations inconsistent with that objective. In particular, allowing individual states to regulate the rates of insurers whose solvency is regulated by the federal government would create highly perverse incentives: in the name of "helping consumers," states could keep rates below actuarially appropriate levels, knowing that solvency is not their problem, but the federal government's. This outcome not only would tie the hands of federal regulators, but also expose the insurers they regulate as well as their customers to greater risks of insurer insolvency. It would also give insurers put in this position incentives to limit or abandon insurance underwriting in states that choose not to permit market forces to set insurance rates (as they do for virtually all other goods and services sold in our economy). Such an outcome clearly would not be in consumers' interest. For all these reasons, federal solvency oversight of any insurer should preempt state rate regulation.

At the same time, there must be a federal system of consumer protection – one for accepting and quickly resolving complaints – for policy holders of federally regulated insurers. The federal system can easily be funded by assessments on federally chartered insurers. Dividing consumer protection oversight authority between the states and federal government would create more bureaucracy, add additional costs, and reinforce regulatory gaps and inconsistencies.

1. Similar issues exist with respect to the health insurance industry, but I do not consider them here, as they are part of a larger debate over health insurance reform.

The Pros and Cons of a Federal Charter for Insurance

There are many anomalies in America's system of financial regulation, but surely one of the more notable ones is the longstanding regulation of insurers (life, property/casualty, and health) by state governments. The tradition dates from the 19th century and was backed by an 1868 Supreme Court ruling holding that insurance was not commerce and therefore not subject to federal regulation of "interstate commerce."[2] In 1944, the Supreme Court overruled its earlier position on insurance and attempted to end this fiction by declaring insurance to be interstate commerce and, therefore, subject to federal regulation.[3] Congress, however, quickly stepped in to perpetuate the fiction and protect the state regulation of insurance by enacting the McCarran-Ferguson Act of 1945.

State insurance regulation covers the waterfront. State insurance commissioners (some of them elected and others appointed) oversee the solvency of insurers, approve insurance forms, supervise insurers' conduct to protect consumers from unscrupulous practices, oversee the activities of insurance agents, and depending on the state and type of insurance, approve the rates that insurers charge. Each state insurance commissioner in which an insurer does business engages in all of these activities, except for solvency regulation, which is typically delegated to the insurer's state of domicile.

The state system of insurance regulation contrasts with that of banks, which can choose their primary regulator (state or federal), mutual funds (federal), and securities and commodities brokers (primarily federal). Furthermore, whereas the prices charged by these other financial institutions and virtually all other producers of goods and services in the U.S. economy are set by market forces, some states still continue to regulate insurers' premiums, notably for automobiles and residential properties, even though the markets for such insurance are unconcentrated and therefore fundamentally competitive. Indeed, heavy-handed imposition of state price controls can drive insurers out of such markets, as has occurred recently in the Florida homeowners' insurance market.[4]

State regulation of insurance is especially anomalous in light of the national, and for some products global, character of the industry. In each of the major segments of the industry, many providers are active in every state, alongside many other regional and state-specific insurers. Nonetheless, under the state regulatory system, insurers must obtain approvals *from each state* every time they offer a new product, change a form, or change their prices. Agents who sell insurance also must be licensed to do business in each of the states in which they do business.

Some insurers and agents operating in multiple states, understandably, would like at least to have the option to operate under a more streamlined regulatory system. One way this could be accomplished would be to permit insurers to choose between being chartered and thus regulated by individual state regulators, or a new federal insurance regulator. Congress has considered but not yet enacted legislation establishing this OFC system, analogous (although not identical) to the regulatory system that has long governed the U.S. banking industry.[5] (All banks, whether chartered by the states or the federal government, are also supervised for safety and soundness by one of four federal regulators. It is possible, in the wake of the current crisis, that

2. Paul v. Virginia, 75 U.S. 7 Wall. 168 168 (1869).
3. United States v. South-Eastern Underwriters, 322 U.S. 533 (1944).
4. See for example, Liam Pleven, "State Farm Won't Cover Properties in Florida," The Wall Street Journal, January 28, 2009, C1.
5. During the 110th Congress, for example, Senators Sununu and Johnson and Representatives Bean and Royce introduced the "National Insurance Act of 2007," S. 40/H.R. 3200.

Congress will consolidate the number of federal bank regulators).

An alternative way to streamline the current state regulatory system would be to allow the state regulator of the insurer's choosing to act as a national regulator. Such a concept was proposed by former Congressman Richard Baker and Michael Oxley in 2004, in draft legislation called the State Modernization and Regulatory Transparency Act, better known by its acronym the "SMART Act."[6] In effect, this "single passport" system is in place, on a much larger scale, for all financial institutions doing business within the European Union. It is also the model under which corporations are governed. Many, but not all, of the advantages of having a single insurance regulator that I outline shortly would apply to either the federal charter or single passport system. However, for reasons discussed in the next section, I concentrate here on the federal charter model and on an even more far-reaching idea, mandatory federal insurer oversight of at least some large insurers, either of which, in light of recent events, are superior to the single passport approach.

Arguments Favoring a Federal Charter

Academic scholars and various interested parties have identified several advantages of moving to a single insurance regulator, and a federal one in particular:

- Insurers subject to a single regulator would be able to gain approvals for changes in policy language and new products more quickly and at lower cost than is the case under a system which requires regulatory approvals in up to 51 different jurisdictions. Speedier and less costly insurance approvals would permit insurers to respond to consumers needs more expeditiously. Such a system would enable insurers to deliver their products at lower costs, while strengthening competition among insurers, which is also in consumers best interest.

- A federal regulator (or a suitable state regulator under a single passport system) would be able to preempt state regulation of rates, which distorts markets. Contrary to a perception in some quarters that the regulation of insurance rates benefits consumers, the most recent academic research amply documents otherwise. For example, states that have tightly regulated auto insurance rates have not lowered average premiums below what they otherwise would be, while distorting insurance rates for individual classes of consumers, forcing safer drivers to subsidize higher risk drivers. Furthermore, by artificially restraining premiums, state premium controls have caused many more higher-risk drivers in states where these controls are present to obtain their insurance from so-called "residual risk" markets or plans because insurers cannot profitably sell insurance to these drivers at the controlled premiums.[7]

- A federal regulator would be able to realize economies of scale in supervision in a way that no single state regulator, even one as well recognized as the insurance department in the State of New York, can achieve. In particular, a federal regulator is better positioned to attract the kind of sophisticated expertise that is required to oversee the increasingly complex business of insurance. That regulator, in turn, can better spread the cost of its personnel across many insurers than can any single state authority.

6. For a more recent version of this idea, see Henry Butler and Larry Ribstein, "The Single License Solution," Regulation, Vol. 31, No. 4, Winter 2008.
7. David Cummins, editor, *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency* (Washington, D.C.: AEI-Brookings Joint Center on Regulatory Studies, 2002). See also Robert E. Litan and Philip O'Connor, "Consumer Benefits of an Optional Federal Charter: The Case of Auto Insurance", to be published in a forthcoming volume edited by Martin Grace and Robert Klein (Washington, D.C.: Brookings Institution Press and the American Enterprise Institute, 2009). This paper, along with others on the future of insurance regulation that were presented at a conference in July, 2008, is available at www.rmi.gsu.edu/insurance_regulation/rel_papers/conf_papers.html.

- A federal insurance regulator would put insurers on a more level playing field when competing with similar, or even close to identical products and services, which are offered by other financial services firms. Consider, for example, the annuity products offered by life insurers, which compete with bank savings accounts and certificates of deposits, and with mutual funds, or standby letters of credit that compete with surety bonds.[8] The fact that insurance companies must obtain approvals for their products in 51 different jurisdictions not only hampers them in competing with rival companies regulated only by a single authority, but deprives consumers of the benefits of more vigorous competition that greater regulatory parity would permit. Ideally, financial regulation should move in the direction of regulating like or similar products in a like or similar fashion, regardless of which type of entity offers them. The fragmentation of insurance regulation among the states makes this objective virtually impossible to achieve.

- As noted, insurance increasingly is a global business, with some U.S. companies (notably AIG) expanding abroad, and even more significant, many foreign insurers and reinsurers doing business or wanting to do business in the United States. Given the fact that other countries generally regulate insurance at the national level, U.S. insurers wanting to operate abroad therefore have the advantage of needing the approval of only a single foreign regulator. In contrast, foreign insurers doing business here, like their U.S.-based counterparts, must gain approvals from the regulators in each of the states in which they choose to operate. Because insurance regulation is fragmented at the state level with no federal regulatory authority in place, the United States has no federal agency with the interest and expertise to discuss and potentially negotiate insurance regulatory issues with foreign counterparts. A federal insurance regulator would rectify this problem (in a way that even a dominant state regulator, such as New York, under a single passport system would not).

- Finally, a federal regulator is best positioned to make national policy with respect to insurer solvency. In the wake of the financial crisis, the National Association of Insurance Commissioners (NAIC) in early December 2008 appeared receptive to proposals by the life insurance industry to relax state capital and reserve requirements. Whatever the merits of this particular policy idea – there are arguments on both sides – this is precisely the type of decision that should be taken by federal authorities. Although the NAIC's proposals influence state regulatory policy, they do not control it. On matters of such importance as the standards for insurer solvency, federal authorities stand in a better position than any individual state regulator to weigh the consequences of different regimes for the national economy. In particular, one expects federal authorities to take into account the impact of any set of standards on systemic risk. This is not the purview of any individual state regulatory authority, or even the NAIC, which represents the interests of all state insurance regulators, but not necessarily what is most appropriate to preserve the safety and soundness of the nation's overall financial system.

Arguments Against a Federal Charter

The foregoing arguments, up to now, have not been sufficiently persuasive to overcome the opposition to an OFC, which understandably comes from state regulators and, perhaps less obviously, from many smaller insurers and insurance agents. Several arguments have been advanced to support the state system:

8. This point has been frequently and well articulated by Peter Wallison. See his "Competitive Equity: An Optional Federal Charter for Insurance Companies," American Enterprise Institute, March 2006 (at www.aei.org).

- A federal regulator, or a single regulator from another state under a single passport system, might not have the same interest, expertise, and accessibility to consumers to handle consumer complaints as expeditiously and with as much interest and concern as is true under the current state system.

- A related concern, voiced by some consumer groups and a number of insurance commissioners, is that insurance rates must be subject to oversight if not outright control to protect consumers.

- State regulators, represented ably by the NAIC, have not been unmindful of the frictions that multiple state approvals cause for insurers and thus insurance markets more broadly. In particular, the NAIC announced an "action plan" in 2000 to bring greater uniformity to state regulation.[9]

- The NAIC has also taken steps since Congressional concerns were voiced in the 1980s and early 1990s about the adequacy of state regulation of insurer solvency to improve state solvency regulation. Thereafter the NAIC established an accreditation program to confirm that each of the states had the resources, legal authority, and appropriate standards (notably risk-based capital standards, modeled on similar standards that had been developed internationally for banks) to adequately regulate insurer solvency. Currently, all states and the District of Columbia, with the exception of New York (which has not passed one of the NAIC's model laws), have received this accreditation.[10]

Evaluation

I believe that the arguments opposing an OFC for insurers lack foundation, or collectively are outweighed by the benefits of a federal charter.

Perhaps the weakest argument is that state regulation of insurance rates remains necessary. There is no theoretical or empirical basis for this position. As already noted, insurance markets are structurally competitive and do not display the kind of concentration that would warrant price controls.

The most recent comprehensive study of insurance rate regulation to date dispels the notion that such regulation has benefited consumers.[11] I have confirmed this finding in a forthcoming paper that, among other things, finds that strict rate regulation tends to force higher risk auto insurance consumers to buy coverage from "residual" or "last resort" mechanisms typically at less-than-actuarially-appropriate rates that fail to discourage these higher-risk drives from driving more safely. This outcome leads to higher overall auto claims.[12]

Two states that have moved away from strict price controls over auto insurance premiums are New Jersey and South Carolina. Their experience demonstrates that consumers have not been harmed in the process, as perhaps some may have feared. To the contrary, consumers in both states generally have benefited.

The popular perception that tight regulation of auto insurance rates in California has benefited consumers in that state also is misplaced. On closer inspection, California rates stayed low initially for several years after rate regulation was tightened, largely because of safety improvements and changes in

9. National Association of Insurance Comissioners. "A Reinforced Commitment: Insurance Regulatory Modernization Action Plan." (Sept 2003). http://www.naic.org/documents/ topics_regulatory_modernization_plan.pdf
10. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (2008), p. 65.
11. Cummins (2002).
12. One recent study estimates that, as a result, auto insurance losses are 44 percent higher than what would be expected based on Massachusetts' demographic composition and its liability coverage. Richard Derrig and Sharon Tennyson, 2008, "The Impact of Rate Regulation on Claims: Evidence from Massachusetts Automobile Insurance," at http://ssrn.com/abstract=1115377.

the liability system, which meant rates should have declined in any event. Because any rates, whether higher or lower, required prior regulatory approval under Proposition 103, the California law actually had the effect of discouraging insurers from reducing rates to match declining claims costs. *If California instead had maintained its prior open, competitive market, auto insurance rates would have been even lower than they actually were.*[13]

Indeed, state insurance rate controls not only distort markets, but also can lead to financial peril. A classic, timely example is what has been happening to the Florida homeowners' insurance market, where record hurricane losses in 2004 and 2005 led insurers and leading catastrophe modelers to substantially increase their estimates for future losses and thus the need for premium increases. The state's regulators, however, have not allowed market forces to work, and have denied insurers' proposed rate increases. Many insurers have thus curtailed coverage and the state's largest homeowner carrier, State Farm, has announced that it will be halting all such coverage. As a result, the state-owned insurer, Citizens Property, has become the largest homeowner insurer (of last resort). But with subsidized rates at below market-clearing levels, Citizens is a financial disaster waiting to happen – when the next large hurricanes strike the state and exhaust Citizens' reserves and its reinsurance layer. Calls for a future federal rescue of Citizens will be inevitable.

Meanwhile, at a more mundane level, the work by the NAIC to harmonize different states' licensing rules and policy reforms remains very much a work in progress. The NAIC has been working toward uniformity since its creation in 1871. The NAIC's 2000 "action plan" was much too limited in scope (covering only the life insurance approval process), and even then it has not achieved uniformity. Moreover, the NAIC's efforts fundamentally do not change the fact that insurers operating in multiple states still must obtain approvals in each of the states any time they wish to offer a new product. Even with the best of intentions, the NAIC cannot realistically achieve uniformity because that would require uniform action by 50 state legislatures.

Finally, state regulators are not the only entities capable of addressing consumers' concerns. The Federal government has already risked $150 billion in taxpayers' money to address one insurer's threatened insolvency and could pledge additional tax dollars to prevent other insurers from failing. For a tiny fraction of this cost it could construct a gold plated insurance consumer assistance and complaint resolution operation, one that could easily be funded through fees paid by federally chartered companies and their sales forces, as outlined further below.

13. See both Cummins (2002) and Litan and O'Connor (2009).

The Financial Crisis and the Case for Federal Regulation of Some Insurers

Whatever one may think of the relative merits of an OFC for insurers, the subprime mortgage-generated financial crisis has and certainly should have fundamentally changed the nature of the debate, which so far has focused only on issues of efficiency in regulation and states' rights. For the reasons I now outline, I believe the weight of the argument has now shifted. In particular, whereas the focus of the debate up until now has been on whether insurers should have the *option* to be regulated at the federal level, the key challenge post-crisis is to implement a modernized, more effective system of insurance regulation. That system, in my view, should entail *compulsory* federal solvency and consumer protection regulation of the largest insurers that are deemed to be SIFIs, as discussed further below. Federal regulation should remain optional for other insurers. The current state system of insurance regulation should remain intact for insurers, agencies and producers that do not select the federal option.

Here are some other features of federal regulation that should apply:

Universality: Federal chartering and regulation should apply to all lines of insurance and reinsurance, other than health insurance, and should accommodate all corporate forms (i.e., stock, mutual, risk-exchange and fraternal companies).

Independence: The chartering, regulatory and supervisory authority for federal insurers, agencies and producers should be conducted by an office with sufficient independence, such as a bureau within the Treasury Department that operates independently like the Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS), or through a new financial solvency regulator.

Robust, Uniform and Exclusive Consumer Protection: Federally chartered insurers, agencies and producers should be subject to strong, uniform and exclusively federal consumer protection standards that ensure that consumers are treated fairly in all phases of an insurance transaction. The federal insurance chartering authority also should establish regional offices and comprehensive procedures for accepting and addressing consumer complaints.

Holding Company Regulation and Supervision: The federal chartering authority for federal insurers and federal agencies should have comprehensive power to supervise and regulate insurance holding companies and other affiliates of an insurer, brokerage or agency to ensure that holding companies and other affiliates do not jeopardize the solvency and integrity of federal insurers and brokers and agencies.

Rate and Form Regulation: Federally chartered insurers should be subject to a prior notice process for addressing policy forms, which does not delay the development and marketing of new products for consumers. Federal law should rely upon competitive market forces to establish premium rates for all forms of insurance.

BOX 1:

Implications of Bond Insurer Financial Difficulties for Federal Regulation

The recent financial troubles of the major previously "monoline" bond insurers reflects a failing of state regulation as well. For decades, there was little to question the financial soundness of the monolines, which concentrated primarily if not exclusively on insuring municipal bonds. In effect, the monolines were able to "rent" their AAA ratings and implicit endorsement of soundness by their state regulator to municipalities by charging them a premium for bearing the risk that their bonds might default. Currently, $2.3 trillion of municipal securities (about half of all "municipals" outstanding) are insured.

But in recent years, in their quest for larger profits from new markets, the monolines began insuring complex mortgage securities, including those backed at least in part by subprime mortgages. The insurers' near fatal mistake – as well as that of their state regulator – was to under-price the risk. In contrast to municipal bonds, as to which the insurers had decades of repayment experience in both good times and bad, the vast proportion of subprime-backed securities were issued, and insured, only during the past few years, a period of economic recovery. Thus, when subprime delinquencies began soaring in 2007, the monolines were surprised to find how heavily exposed they were to losses, and thus began facing a series of credit downgrades from the credit rating agencies (who had also badly miscalculated the risks of the securities).

If the monolines' ratings problems had been confined to their mortgage securities business, at least the damage to them and to the market would have been somewhat contained. But the financial danger faced by the monolines has spilled over into the municipal bond market, and thereby exposes state and local governments throughout the country to the risk of not being able to issue new bonds to finance their capital projects.

The one silver lining in all this is that the barriers to the formation of new municipal bond insurers are reasonably modest. Indeed, two new insurers have gone into the business in just the past year. Yet it still takes time for new entrants to attract the capital and thus the capacity to fill any void that might be left if one or more the exiting monolines were to fail. This is one of the reasons that Treasury at some point could be asked by various institutional investors and state and local governments to use some of the funds in the TARP to purchase municipal bonds, and why the Department could be asked to make equity investments in the bond insurers themselves.

Rationale For A New Regulatory Framework For The Insurance Industry

Clearly, the most important developments driving the recommendation to establish a system of mandatory federal regulation for systemically important insurers and optional federal regulation for other insurers are the recent bailouts undertaken or contemplated by the federal government of certain major insurers. In mid-September, the Federal Reserve felt it necessary to lend not once but twice to AIG to keep the world's largest property-casualty insurance conglomerate afloat. The Fed has recently also given AIG access to its new facility supporting the commercial paper market. In November, the Fed reworked its original rescue of AIG, pushing up the government's investment to a staggering $150 billion. At this writing, it is impossible for outsiders (maybe even insiders) to know how much more government assistance for AIG may be required.

In late October 2008, meanwhile, the Treasury Department took the surprising step of announcing that it was considering making equity injections from its Troubled Asset Repurchase Program (TARP) into a number of major life insurers, and that the insurers seemed amenable to partial government ownership. The Obama Administration's new Treasury Secretary, Timothy Geithner, has taken a different view, rejecting the idea of TARP capital infusions into life insurers at this point given the absence of a federal insurance regulator that could "stress test" such institutions. But Geithner also has indicated that the collapse of AIG, among other factors, has prompted the Administration to seriously consider federal charter proposals for the insurance industry.

Clearly, if the federal government is potentially needed as a source of debt or equity funds for certain insurers, there is a strong case for having the federal authorities actively oversee the financial safety and soundness of at least those firms that could benefit from federal, and thus national taxpayer, assistance. This transforms the debate over whether to allow insurers to *choose* their regulator (state or federal), and moves it to what criteria (discussed below) should be used to decide which insurance firms *must* be regulated by a federal supervisory authority.

Federal charter opponents have countered that the notion of federal regulation of insurers has been somehow discredited by the failures of bank regulators to have prevented so many banks from taking excessive risks, as well as by the apparent inability of the federal OTS, as the regulator of AIG's parent company, to have prevented the reckless sale of more than $400 billion in credit default swaps (CDS) which put the entire enterprise at risk.

These arguments are more than offset, in my view, by two other compelling considerations. One is that state regulators can act in ways that threaten the interests of federal taxpayers, as came close to happening in the AIG matter. Shortly before the Fed came to AIG's rescue, New York's Governor was putting pressure on the state's insurance department (which may have been equally willing to comply) to approve a $20 billion "bridge" loan from AIG's regulated insurers to the company's parent to help cover any liquidity shortfalls due to the parent's exposure to risk from writing an excessive amount of CDS contracts. Not only would such a loan have put the insurer and its customers at risk, but it was massively insufficient: the Fed not only had to come up with $87 billion in the initial rescue loan, but only several days later felt compelled to loan the company another $37.5 billion. This sequence of events underscores how federal intervention rescued not only AIG but also how the state regulator otherwise would have jeopardized the solvency of the insurers under its direct supervision.

Furthermore, recent disclosures about the risks of AIG's insurance operations – apart from its CDS activities – highlight critical failings in state insurance regulation. In particular, AIG ramped up over a nine year period a program of loaning securities in its insurance and retirement services subsidiaries to banks and broker-dealers, and invested the cash or collateral received for the loans increasingly in subprime securities. At its peak, the securities lending

program grew to $94 billion. When the subprime mortgage crisis hit, AIG began to suffer mounting losses on the subprime securities it had bought, losses which have contributed to the rising cost of the federal bailout.

In short, recent events have made it unnecessary to resolve the seemingly never-ending debate over which level of government (state or federal) does a "better" job of regulating. If the federal government is to have a financial stake in the performance of certain insurers or financial instruments they may insure – which is now clearly the case – then it is axiomatic that some federal authority must have a say in how the financial condition of those entities is monitored and protected.

Federal Regulation and the Way Forward

In a separate essay, "Fixing Finance: A Roadmap for Financial Reform," I have outlined with Martin Baily a comprehensive set of financial reform suggestions.[14] At the heart of those recommendations are the SIFIs: the notion that any large financial institution that poses significant "systemic risk" – and thus the likelihood that federal aid to some creditors will be required if the institution is threatened with failure – requires solvency regulation by the federal government. This idea is not ours alone. It has been endorsed in recent reports by the Group of Thirty and by the Congressional Oversight Panel created in October 2008 to oversee the Troubled Asset Repurchase Program.[15]

To be sure, a federal solvency regulator – perhaps a separate "systemic risk" regulator – must define which firms, including large insurers, qualify as SIFIs, using such criteria as size, leverage, and degree of interconnection with the rest of the financial institution. This job admittedly will be a difficult one, but recent events have given the government no other choice. Meanwhile, as noted earlier, other insurers not qualifying as SIFIs should have the option to be federally regulated.

Federally-regulated insurers must also be held to strong federal consumer protections, which should supplant or preempt existing state protections. Ideally, as argued in "Fixing Finance," a separate federal agency, charged with overseeing consumer protection for all financial institutions, would oversee consumer protection for insurance purchased from federally regulated insurers. Alternatively, if insurance is to be regulated by a separate federal insurance regulatory body, that agency would enforce consumer rules. In either case, the agency charged with consumer protection should have state and regional offices, and establish comprehensive procedures for accepting and addressing consumer complaints.

For reasons that already should be clear, federal regulation should preempt state regulation of prices and forms. It would hurt consumers, and indeed could be financially dangerous, to allow the federal regulatory authority only to oversee an insurer's financial soundness while permitting the states to regulate the fundamental ways insurers do business. This kind of arrangement literally could invite states to impose costs on insurers, either in the form of constraining their rates or the policies and services they offer, knowing that some other authority, namely the federal regulator, is responsible for ensuring that the insurers remain viable, or if they fail, that the federal government (and thus taxpayers) could bear the costs of picking up the pieces.

Furthermore, where states constrain rates to be less than anticipated losses and a reasonable allowance for profit, insurers will have strong incentives to limit or abandon their underwriting in those states, as has recently occurred in Florida. This would reduce competition in those insurance markets, to the detriment of consumers living in the affected states. As already noted, given the competitive structures of both the life and property-casualty insurance industries, states can avoid these undesirable outcomes by allowing markets and competition to set rates, as they do for prices in virtually all other spheres of our economy.

14. Robert E. Litan and Martin Neil Baily, "Fixing Finance: A Roadmap for Reform," The Initiative on Business and Public Policy at Brookings' *Fixing Finance Series*, 2009-01, February 17, 2009. Available at http://www.brookings.edu/papers/2009/0217_finance_baily_litan.aspx

15. See Group of Thirty. "Financial Reform: A Framework for Financial Stability" (Washington D.C., Jan 2009) and Congressional Oversight Panel, "Special Report on Regulatory Reform" (Washington, D.C., Jan 2009).

Finally, a remaining question is how best to protect policy holders from insurer insolvencies. There is a strong argument for retaining the individual state guaranty funds, which generally protect policy holders of failed insurers for claims up to $300,000, even for federally regulated insurers. The state guaranty system has proved effective so far. There is no reason why it couldn't continue to be effective.

Nonetheless, federal policymakers may want to establish for policyholders of federally regulated insurers only a separate federal insurance guaranty fund operated in much the same way in which the state funds now operate (by assessing healthy insurers the cost of making good on guarantees of failed insurers, after the fact). In considering that option, however, policy makers must weigh the possibility that without large, systemically important insurers in the state systems, the state funds and/or the federal fund (even with ex post assessment system) may be unable to honor their commitments under extreme circumstances. If this risk is deemed sufficiently great, then retaining the current state guaranty system may be the preferred option.

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MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

April 3, 2009

The Honorable David Scott
United States House of Representatives
225 Cannon House Office Building
Washington, DC 20515

Re: Responses to Questions at a Hearing Regarding "Perspectives on Systemic Risk", Held Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities, of the Committee on Financial Services, U.S. House of Representatives, on March 5, 2009.

Dear Representative Scott:

Managed Funds Association ("MFA")[1] is pleased to submit this letter in response to the questions that you asked me at the hearing on March 5, 2009, "Perspectives on Systemic Risk" (the "Hearing"). During the Hearing, you asked that MFA provide answers to two questions regarding the tax treatment for U.S. hedge fund managers and the creation of offshore funds by U.S. hedge fund managers. For your convenience, we have stated your requests below followed by MFA's response.

I. *Please explain why U.S. hedge fund managers are taxed at capital gains rates on certain of their income.*

A. U.S.-based hedge funds are organized and taxed as partnerships; hedge fund managers are taxed as partners in those funds.

U.S.-based hedge funds are commonly structured as partnerships. The Internal Revenue Code of 1986, as amended (the "Code") does not treat a partnership as a taxable entity, but instead provides that partnership income "flows through" to the partners in the partnership. This means that the partnership itself is not directly taxed; partnership income is passed on to the partners of the partnership. Thus, partnership income is taxed directly to the partners, and each partner pays taxes on its individual share of that income.

As with most partnerships, some partners invest money and other partners contribute their intellectual capital and "sweat equity." In the context of investment partnerships, partners who invest their expertise, time and effort to the business venture may receive an equity interest in the partnership in return for their investment, commonly

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York, NY.

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referred to as "carried interest." Because that carried interest represents equity in a partnership, it is treated in a similar manner to other equity partnership interests under the Code. Thus, if a partnership earns a profit, the Code provides that such profit will be taxed to each partner in the partnership in a similar manner, regardless of the nature of their investment.

The Code imposes taxation on partnership income depending on (1) the character of the asset held by the partnership; and (2) the period of time in which such asset is held. For example, if a partnership invests in a start-up company or buys real estate (both of which are treated as capital assets), and several years later sells its share in that company or the real estate, the Code taxes the income from that transaction as long-term (*i.e.*, over one year) capital gain to the partners, eligible for the preferential capital gains rate (currently, 15 percent). On the other hand, if the partnership holds the investment for a short term (*i.e.*, less than one year), the Code taxes any gain as short-term capital gain and the partners are taxed at ordinary income rates (currently, a maximum of 35 percent).

U.S. hedge fund managers invest their intellectual capital, whereas hedge fund investors invest their money in these partnerships. U.S. partnership tax law has historically treated their partnership interests in a similar fashion because hedge fund managers and hedge fund investors both share risks in connection with their respective investments in the business enterprise.

It is noteworthy that hedge fund managers not only receive a carried interest in a U.S.-based hedge fund; they also charge asset-based management fees based on the amount of assets in the hedge fund. The Code requires that U.S. hedge fund managers pay federal income tax at ordinary income tax rates on this fee.

B. MFA Opposes Proposals to Re-characterize Carried Interest.

MFA opposes proposals that seek to re-characterize carried interest as compensation for personal services for two reasons. First, the fundamental point behind a carried interest is that it represents the contributions of intellectual and sweat equity of a partner to a business enterprise. For more than fifty years, the Code has permitted partners in investment partnerships to pool the capital of investors with the skills of entrepreneurs in joint profit-making enterprises. To align interests and contributions to the partnership, the Code treats a partner's "carried" interest in the profits on the same terms as to the other partners. Partners in a partnership should be treated similarly regardless of the form of their investment. Any legislative proposals that seek to change the fundamental tax treatment of partnerships under the Code should consider the damaging effect those proposals would have on business and capital formation in United States and their potential, unintended impact on competitiveness of U.S. businesses.

In addition, MFA opposes re-characterization of income attributable to a carried interest because such a change in law would create collateral tax issues that will be very punitive to investment partnerships. While hedge funds and other investment partnerships do invest in capital assets (such as stocks and securities), they frequently hold them for less

than one year. Thus, much hedge fund income is now taxed as short-term capital gains (*i.e.*, at ordinary income rates).

For the reasons noted above, MFA opposes any legislative proposals that seek to change the tax treatment of carried interest. Re-characterizing carried interest would disrupt longstanding business practices in U.S. capital markets and would inappropriately punish a business model that encourages shared risk and return.

II. Why do U.S. fund managers establish offshore funds?

A. Current Tax Law Discourages U.S. Hedge Fund Managers from Receiving Investments from U.S. Tax-Exempt and Non-U.S. Investors through the Managers' Domestic Funds.

Separate and apart from the issue of how U.S. hedge fund managers are taxed as partners in domestic hedge funds, current U.S. tax law also discourages certain hedge fund investors from investing in domestic hedge funds managed by U.S. hedge fund managers. Specifically, the Code makes it very difficult for U.S. tax-exempt entities (such as pensions, retirement funds and endowments) and non-U.S. persons to invest in domestic hedge funds.[2] This tax result deters these investors from investing in domestic hedge funds.

Because of this adverse tax consequence, U.S. tax-exempt and non-U.S. investors currently invest in non-U.S. based hedge funds. To meet the demands of their investors and compete with non-U.S. hedge fund managers, many U.S. hedge fund managers have established offshore investment funds. Without such funds, U.S. tax-exempt and non-U.S. investors would likely direct their investments to hedge funds managed by non-U.S. based managers.

To accommodate the classes of investors, U.S. hedge fund managers generally form offshore funds as entities that are treated as corporations for U.S. tax purposes. Non-U.S. and tax-exempt investors can invest with U.S. hedge fund managers through these offshore corporations and avoid the adverse tax consequences that the Code would impose if they invested in domestic funds. Because these investors own shares of a corporation (the offshore hedge fund) rather than partnership interests in a domestic hedge fund, the Code

[2] As you are likely aware, the Code provides that U.S. tax-exempt entities generally are not subject to U.S. income tax. Nonetheless, the Code requires that these entities declare and pay taxes on "Unrelated Business Taxable Income" or "UBTI". The Code defines UBTI as any money earned from conduct unrelated to the entity's tax-exempt purpose. The Code, however, excludes from the definition of UBTI investment income (*i.e.*, dividends, royalties, rents, capital gains and interest income) unless such income is derived from debt-financed property. Many hedge funds use the same amount of debt (leverage) in connection with their trading strategies. As a result, a U.S. tax-exempt investor that invests in a domestic hedge fund would be required to treat the debt-financed income flowing through the hedge fund partnership as UBTI.

The Code does not subject non-U.S. investors to U.S. income tax unless such investor conducts a trade or business within the United States. In that case, the Code requires that non-U.S. investors file a U.S. tax return and pay taxes on the same terms as a U.S. individual or corporation. If a foreign investor invests in a domestic hedge fund, they are treated as engaged in a U.S. trade or business to the extent that the partnership is so engaged.

treats their share of the offshore feeder corporation as dividend income, and thus the Code excludes this income from the definition of UBTI. Similarly, the Code does not treat non-U.S. investors as engaging in a U.S. trade or business and therefore subject them to U.S. income tax because they are investors in an offshore corporation. These non-U.S. investors are, however, subject to tax in their home country on any dividends received.

B. *MFA Opposes Proposals that Create Limitations on Legitimate Business Activities That Occur Offshore.*

MFA supports any legislative and regulatory measures that seek to prevent, detect and punish any illegitimate investment activities and tax evasion, regardless of whether they occur onshore or offshore. We also support the government's need to monitor and prevent money laundering, terrorist and other criminal enterprises. MFA believes, however, that proposals that create indiscriminately burdensome limitations on all offshore investment activities managed by U.S.-based financial institutions, including hedge fund managers, put them at a significant disadvantage in relation to their non-U.S. competitors.

As discussed above, U.S. hedge funds engage in legitimate offshore investment activities for a number of reasons, including to broaden their investor base internationally and to take advantage of opportunities to raise capital from this broader category of investors. These transactions are quite legitimately conducted offshore and generally are not motivated by a desire to avoid disclosure or evade U.S. federal income tax. While action by policy makers and regulators to prohibit offshore abuses is appropriate, it should be more carefully tailored to prevent those abuses without unnecessarily hindering legitimate offshore investment activities.

III. Conclusion

As stated in my testimony at the Hearing, hedge funds have several important market functions. Hedge funds provide liquidity and price discovery to capital markets, capital to companies to allow them to grow or turn around their businesses, and sophisticated risk management to investors such as pension funds, to allow those pensions to meet their future obligations to plan beneficiaries..

Legislation or regulation that creates a punitive tax regime or that unnecessarily hinders legitimate investment activities would affect not only U.S. hedge fund managers, but also the proper functioning and orderly operation of our capital markets and financial system as a whole. We believe that informed and smart tax and offshore legislative or regulatory measures will likely address identified tax-related concerns. To that end, MFA and its members are committed to being constructive participants in the regulatory reform discussions and working with policy makers to reestablish a sound financial system and restore stable and orderly markets.

MFA would welcome the opportunity to meet with you or members of your staff to respond to any further questions you may have. Feel free to contact Carl Kennedy or me at (202) 367-1140 with any questions or if you would like to arrange such a meeting.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
C.E.O. & President

cc: The Honorable Chairman Paul E. Kanjorski, Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives

The Honorable Ranking Member Scott Garrett, Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, U.S. House of Representatives