DEVELOPMENTS IN STATE INSURANCE REGULATION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION, AND COMPETITIVENESS

OF THE

COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

JULY 1, 1987—GENERAL OVERVIEW
JULY 29, 1987—LIFE INSURANCE COMPANY SOLVENCY
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GENERAL OVERVIEW

WEDNESDAY, JULY 1, 1987

House of Representatives, Committee on Energy and Commerce, Subcommittee on Commerce, Consumer Protection and Competitiveness,

Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2322, Rayburn House Office Building, Hon. James J. Florio (chairman) presiding.

Mr. Florio. The subcommittee will kindly come to order. We have been informed that Mr. Lent and a few other members are on their way. They ask out of respect to our witnesses we start the hearing.

I would like to welcome all in attendance to what I regard as an extremely important hearing of this subcommittee. The subcommittee, of course, has jurisdiction over a whole host of areas involving product safety, product quality and the committee has jurisdiction over consumer protection, product liability, insurance, Consumer Product Safety Commission, and this cluster of issues I think is extremely important to the major area of committee concern about competitiveness of our economy.

We have had, as I think most know, a series of hearings stretching back some period of time involving insurance. Today we hope to get an update on the progress of the States in dealing with the liability insurance crisis and other matters and in preventing a recurrence of recent problems.

The insurance crisis dealt a blow to our economy that we could ill afford at a time of mounting debts and deficits and slipping productivity. Some assure us that the crisis is over. Others are less optimistic. We are hopeful that officials at the State level who are most qualified to evaluate the situation will advise us today on the current situation.

During the last 1 or 2 years, some States have responded to the insurance crisis with a number of initiatives, such as tightened rate regulation, increased data collection, and restrictions on midterm cancellations. An important question for us today is whether these measures are adequate and sufficient.

Some believe that the steps being taken are sufficient. Others argue that not enough States have acted and that lack of uniformity and lack of authority at the State level make these steps inherently inadequate. Even more troubling, many observers say that because of the cyclical nature of the insurance industry, a return of the insurance crisis is inevitable. I am hopeful that today's wit-

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Forty years ago Congress made clear the primary responsibility of the States for regulation of insurance. While Congress also said it would periodically review this mandate, history dictates that we look to the States first in this subject matter area.

It should not be assumed that because a congressional committee is investigating this issue that Federal action is the solution. Simply substituting Federal regulation for State regulation will not necessarily improve the situation, particularly when we reflect on the rather sad performance in recent years of many Federal agencies in enforcing the laws for which they have responsibility.

On the other hand, just because we have always done something in a particular way does not mean it must be conducted that way for all time. Reassessment is called for, especially when we are facing very different economic circumstances. The one thing we cannot do is ignore the situation and allow a policy of drift until we are decimated again by the increasingly devastating swings in the insurance cycle. Too much is at stake for business, professionals, municipalities, nonprofit corporations and others who depend on liability insurance.

The views of our State officials are greatly valued by this subcommittee. We have had a good working relationship over the last number of years, and we look forward to their views today.

I would like to yield to my colleague from New Jersey, Mr. Rinaldo.

Mr. RINALDO. Thank you very much.

I am pleased to join you this morning as we continue our examination of insurance issues, particularly as they have an impact in the product liability area. I want to welcome the Commissioner from my own State of New Jersey, Mr. Kenneth Merin, and extend my appreciation to all of the witnesses here this morning for the testimony they will present. The State regulatory system, as you know, is the primary means of regulating the insurance industry across the country. Under McCarran-Ferguson the regulation of insurance is reserved to the States and to a large degree we must rely upon you and your colleagues to assure that consumers are protected.

I am sure all of you are aware of the pressure that began in Congress over 1 year ago for Federal reforms in the insurance field. We have been inundated with requests to address liability concerns, and they range from reform of the torts system, repeal of McCarran-Ferguson, regulation of insurance at the Federal level, or a variety of other means of addressing liability issues.

The chairman of the subcommittee has held an extensive schedule of hearings to give this matter the thorough review that it deserves. I support that approach. Because I believe if we are to legislate in this area, we can only do so after a full hearing record is established, the problems specifically identified, and the appropriate responses drafted. I don't think we have arrived at that stage yet.

I am sympathetic with the concerns of businessmen and women in my district and the State of New Jersey, that the current system penalizes them and does not truly reflect their costs. But I think it is equally true that the insurance industry bears some responsibility for the current climate. All too often insurance companies are ready to settle out of court. They are ready to settle quickly. They want to expedite the settlement because they don't want to have a costly legal battle.

I think if there were greater resistance on the part of the industry to fight nuisance claims we might see fewer cases being brought.

Mr. Chairman, I join you this morning in hoping that the testimony we receive can help us in our deliberations, and I look forward to the testimony of our witnesses.

Mr. FLORIO. I would like to recognize the ranking member of the full committee who has always had a deep interest in the insurance issues this committee deals with. We are pleased to have him here this morning. Mr. Lent.

Mr. LENT. Thank you, Mr. Chairman.

I am really here because I didn't want it to become entirely a New Jersey show.

It is my pleasure to attend this hearing this morning. Even though my current responsibilities require I focus on the activities of the full committee, issues like insurance remain a priority. I commend you for holding this hearing.

Today's testimony will add to what we learned from the many hearings in the last Congress. Those focused mostly on liability insurance, and I understand your first insurance hearing this year also focused on liability insurance. We will be hard pressed to forget problems all of our constituents face regarding liability insurance, but let us keep this in perspective.

Liability insurance, according to the GAO testimony before this subcommittee, accounts for only 8 percent of the property casualty insurance business. When you look at the total insurance business in the United States, liability insurance accounts for only 2 percent. Yet it is liability insurance that has gotten 100 percent of the attention of Congress and seems to provide the fuel for Federal consideration of the regulation of insurance. I, for one, am a supporter of the States' role in regulation of insurance, but I am mindful of the fact that insurance is interstate commerce, and we in Congress have a duty to oversee and facilitate that commerce.

Hence, our adoption of the Risk Retention Amendments of 1986, and, incidentally, I would like to single out Commissioner Levinson of Delaware for the fine work that he has done in his State in implementing the risk retention law of 1986. I do believe that Congressional review of State regulation is appropriate, but I firmly believe this review must be narrow and deliberate. Any changes to the existing regulatory scheme must be carefully considered. We must first identify what problem we are attempting to correct and then examine any proposed solution to see if it will actually correct the problem.

Finally, even if the proposed solution will correct the problem, we must be certain it will not create new problems. Mr. Chairman, I commend you for calling this hearing and for providing witnesses that will give us a diverse range of views.

Thank you.

Mr. FLORIO. Thank you very much. We are now pleased to hear from our witnesses. We have the Honorable John Washburn, who is Commissioner in Illinois, but today is here in his capacity as Vice President for the National Association of Insurance Commissioners; my Commissioner, the Honorable Ken Merin, Commissioner of Insurance of the State of New Jersey. We are pleased to have him here. The Honorable James Corcoran, Superintendent of Insurance of the State of New York. I am sure Mr. Lent is pleased to welcome him here as a representative from that State. The Honorable Michael Hatch, Commissioner of Commerce of the State of Minnesota; and the Honorable David Levinson, Insurance Commissioner of the State of Delaware. Wilmington is closer to my district than Trenton is, I guess I can count him almost as a Commissioner from New Jersey as well. As a result of a mutual understanding between the witnesses, Mr. Levinson, who apparently was up until 4 a.m. this morning in a legislative session in Wilmington—he is going to tell us about his success in getting some legislation through—Mr. Levinson, it has been agreed to by everyone, will be the first witness, and he will be excused, as his physical resources give out, to leave whenever he feels appropriate. We would be pleased to hear from you.

STATEMENTS OF DAVID N. LEVINSON, INSURANCE COMMISSIONER, STATE OF DELAWARE; JOHN WASHBURN, VICE PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS; KENNETH D. MERIN, COMMISSIONER, NEW JERSEY DEPARTMENT OF INSURANCE; JAMES P. CORCORAN, SUPERINTENDENT OF INSURANCE, STATE OF NEW YORK; AND MICHAEL A. HATCH, COMMISSIONER OF COMMERCE, STATE OF MINNESOTA

Mr. LEVINSON. Representative Florio, members of the committee, thank you for receiving testimony today from various insurance commissioners and from officers of the National Association of Insurance Commissioners concerning the problems faced by the insurance industry. State regulators are serious in their attempts to deal with these problems. However, there are serious disagreements among us regarding the best solution. That, in my opinion, is how it should be. For every complex problem there is always a simple solution. And it is always wrong. If all regulators agreed upon a single simple solution, that solution would be suspect. I do believe, however, that there is an approach to a solution that has a high probability of success.

The insurance industry does face serious problems today, many of which have little to do with the proper regulation of the insurance industry. The uninsurability of certain risks, which in fact are societal problems; uncertainties, real or perceived, within the civil justice system; rapidly and widely fluctuating interest rates leading to the cyclical nature of insurance underwriting—none of these can be significantly affected by insurance regulators although some of us have made an effort.

The major insurance issue we must confront is how we are going to spread risks throughout our society and which risks we are going to spread. This problem is probably most clearly illustrated in the area of health insurance. We, as a society, are substituting health insurance premiums for taxes. The cost of the medically indigent is often picked up by medical providers who, in turn, pass the cost along to premium paying policyholders. This "hidden tax" is regressive. The financial ability of the policyholder to pay the "hidden tax" is never considered. Indeed the "healthy wealthy", who are often self-insured, pay nothing at all. This "hidden tax" is paid for by health insurance policyholders, collected by insurance companies and never approved, assessed, debated or monitored by any elected official or legislative group. And there is little, if anything, that an insurance regulator can do about that.

The recent crisis in availability and affordability of liability insurance has been the result of complex economic forces, with little immediate regulatory correction possible. But while understandable Congressional frustration has led to proposed actions entirely unrelated to the crisis, various State proposals have, in an experimental way, begun to fashion specialized solutions, by line in some instances and geographically in others. Liability lakes (pooling of pools), and, which in our State we got passed at 2:56 a.m. yesterday, joint underwriting associations, specialized mutuals, market assistance programs, emergency powers legislation, flex rating in New York—all involve creative proposals at the State level to attack the problem.

One question, inevitably raised, has been the overall adequacy of State regulation in those areas where society's intent is clear and whether the Federal Government could do the job better. Let me make clear at the outset my own bias. I have no ideological preference for either State or Federal regulation. I am an orthodox pragmatist. Arguments made regarding State regulation versus Federal control which relate to other sectors of our economy apply to insurance as well. I am certain that others who testify today will make the standard arguments for each position. I would like to say that there have been substantial improvements in recent years in many States' regulatory apparatus and that most regulatory functions are performed efficiently most of the time at a State level. Licensing of agents, consumer and unfair claims investigations, and various educational functions are visible examples. These functions are clearly more appropriately managed at a State level because of the local nature of the activity involved. Moreover, any failure to perform these functions effectively at a State level penalizes only the residents of the individual State; and they possess the political power to replace those who manage their affairs.

There are, however, three problems to which I believe a national solution, although not necessarily a Federal solution, is appropriate. First there is the problem of dealing with interstate fraud. Let me give you an example. Recently Delaware's Insurance Department received calls regarding the operation of a company which called itself North American Insurance Company, or NAIC, a name which my colleagues in the National Association of Insurance Commissioners did not particularly appreciate. This company alleged inaccurately that it was a Delaware domestic insurer. Delaware issued a cease and desist order prohibiting the company from alleging that it was authorized by the State of Delaware to sell insurance, an order which the company ignored. The principals of the company were located in Texas. Texas moved through the Texas courts to stop the company from selling insurance in Texas. The principals of the company simply moved to Atlanta, GA, changed the name of the sham insurer, and they continue to do business today. When the heat gets too hot in Georgia, no doubt the individuals will simply move to another jurisdiction. And this is only one of a number of such examples. We have fully informed the Federal Bureau of Investigation which, although it has jurisdiction, has indicated no particular interest in pursuing the matter.

Anti-competitive behavior by insurers, particularly in small States, is a second problem which some States cannot solve without assistance. When availability of liability insurance rose to the level of a national crisis during the past 2 years, insurers moved in concert to radically raise rates. While regulators of large States have the market ability to provide a countervailing force through the threat of expulsion when such rate increases are not justified, regulators of small States are virtually helpless in the face of concerted action by the industry. The threat of a small State like Delaware to expel a multinational giant has all of the effect of a B–B gun on an elephant.

An even more substantial long-term problem lies in the area of surety. Some State regulators are frustrated by their own inability to act in this area, where collusion and coercion is so effective that a large body of actionable evidence is difficult, if not impossible, to assemble. For several years, the Federal Government has been investigating anticompetitive practices in the surety business. Since, under McCarran-Ferguson, actions are protected from antitrust attack only if the activity constitutes the "business of insurance" and only to the extent that it is "regulated by State Law" (15 USC Section 1012(b)) and since the Sherman Antitrust Act is explicitly applicable to any "agreement with respect to or action of boycott, coercion, or intimidation", the Federal Government is not preempted from acting.

However, the Federal Government has not acted, despite its clear interest in doing so and remarkable concentration and persistence in this single area. This leads me to conclude that the Federal Government cannot act effectively in the area of insurance regulation even when it has the power to do so. And I do not say this critically. The business of regulating insurance is extremely complex. And the Federal Government simply does not have the experience or expertise to act effectively.

I think it is important to note that both the control of interstate fraud and anticompetitive behavior are systemic problems. If all State regulators did their jobs perfectly, these problems would continue to exist. Only by creating an entity with the power to act in all States can these problems be solved. And yet the Federal Government has neither the experience nor the expertise to be that entity.

The third problem for which a solution is required is of even greater significance and of still greater complexity—that is the problem of guaranteeing policyholders that the companies which insure them are and remain solvent, able to pay claims when those claims come due. The organization of the insurance industry includes licensed insurers, unlicensed but admitted excess and surplus lines insurers, nonadmitted insurers, domestic, foreign and alien insurers and reinsurers and the potential proliferation of risk retention groups. No individual State regulator of the insurance industry can possibly have full knowledge of the financial stability of every company which insures or reinsures the citizens of his State. Instead the State regulator must rely on other States' and other countries' regulation of their domestic companies.

If each State had guaranty associations covering all lines, and if each State regulator and every alien regulator did his job perfectly, the current system of solvency regulation would work perfectly. However, 13 States have no Life & Health Guaranty Associations. And if an insurance company can find a weak link in the State chain of insurance regulation, the system begins to break down. And those weak links arise from time to time for the same reasons that any system can fail—incompetence, indifference, lack of resources or downright corruption. Moreover, alien regulators vary from good to poor to nonexistent. And no one knows how much alien reinsurance will never be collected or how many domestic companies will fail because of the failure of alien reinsurers to pay.

I suggested at the outset of my remarks that these three problems, interstate fraud, anticompetitive behavior in small States and solvency regulation, require a national solution. But a national solution is not necessarily a Federal solution. As I have mentioned earlier, the Federal Government does not have the experience or expertise to regulate the insurance industry and it would take many years to develop that experience and expertise, years during which insurance regulation would founder and fail. Fortunately, a national organization already exists that has a virtual monopoly of regulatory expertise of the insurance industry and decades of institutional experience. It understands the problems of interstate insurance fraud, some of its members understand the problem of anticompetitive behavior in small States, and it has a rapidly growing data base relating to financial solvency of insurers. That organization is the National Association of Insurance Commissioners. As an organization, the national Association of Insurance Commissioners has the ability to solve each of the problems that I have raised today. What it lacks is the statutory authority, the resources, and perhaps the political will. My recommendation today is that this committee consider legislation giving to the NAIC the necessary authority and resources to solve the problems of interstate insurance fraud, anticompetitive behavior and solvency oversight. There is precedent for such congressional delegation of power and I believe that it would have a very good chance of success.

Such legislation would require that all insurers and reinsurers, both domestic and alien, insuring or reinsuring U.S. citizens, file reports with the NAIC, which reports would include both financial and market data; pay an appropriate fee to the NAIC to cover all costs and thus insure the complete financial independence of the NAIC; and empower the NAIC to examine any company that fails to comply, at the company's expense, and if necessary, to suspend or revoke the license of any company to insure or reinsure U.S. citizens.

The National Association of Insurance Commissioners is controlled by 54 Insurance Commissioners, 11 of whom are elected and the balance of whom are appointed by their State's Governor. They are by and large responsible, dedicated, and capable individuals. And they are supported by thousands of staff members with tens of thousands of years of experience in insurance regulation.

The current leadership of the National Association of Insurance Commissioners, President Ed Muhl of Maryland and Vice President John Washburn of Illinois, are each strong, knowledgeable, independent regulators in whom I, for one, have complete confidence. And I believe that the entire membership and staff of the NAIC would rise to the challenge of enhanced authority and responsibility.

I would like to again thank Representative Florio and the members of the committee for giving me the opportunity to present my views today on these important issues affecting all of our citizens.

Mr. FLORIO. Thank you very much.

STATEMENT OF JOHN WASHBURN

Mr. FLORIO. Commissioner Washburn.

Mr. WASHBURN. Thank you very much for the opportunity to come before you today and talk about the insurance regulation. I come before you wearing two hats, that of the Director of the Department of Insurance of the State of Illinois and that of Vice President of the National Association of Insurance Commissioners, the NAIC.

I will try to confine my prepared remarks to those as the Vice President of NAIC because I think you have got some other commissioners who can talk about their State experience. I have given a formal paper to the committee, so I will just summarize my remarks.

Mr. FLORIO. Without objection, the formal statements of all the witnesses will be put into the record in their entirety, and all the witnesses may feel free to proceed as they see fit.

Mr. WASHBURN. Insurance is a dynamic problem quickly responding to the changes as it sees the need. Regulation of this business must also be able to change and expand as it sees its function change. To understand how this takes place, both at the State and national level, let me take a couple minutes to explain how it works today in insurance regulation.

States have regulated insurance for 120 years. For such a system to survive this length of time, it has got to gain some independence from relying on any one State or insurance commissioner. The regulatory structure today expands as the operations of the insurance entity expand. So an insurer operating in only one State may only have one insurance commissioner looking at it. As it expands its operations into three States, it has three States looking at it.

An insurance entity operating in all 50 States has 50 different looks at that insurance operation. So the expansion goes along with the expansion of the insurance operation. Collectively we have about 6,500 people involved in insurance regulation with a budget of close to $300 million.

The NAIC assists States in really three different ways. Insolvency regulation: the NAIC has just completed its financial analysis of 4,910 insurers licensed to do business in the United States. This analysis uses sophisticated screens to identify potential problems in the United States, on companies. There is then a team of senior examiners from the different States who come in and analyze these results. This information is then communicated to the domestic State, to the domiciliary State of the company that is identified as a problem.

In this way, each and every State, no matter how large or small, benefits from the combined resources of NAIC both from its EDP capability and from the combined experiences of senior examiners from all over the country.

The information is also sent to every State in which that insurer operates, so every State is from, through this system, the collective judgment of senior people throughout the country with this capability. And this does not depend on how active the State is with the NAIC or anything else, it just automatically happens.

There is then a task force, examination oversight, that monitors State actions in light of the problems that have been revealed. This committee also insures there are adequate resources and coordination to attack these problems, so insolvency regulation—we have a system that looks at the problem, identifies them, notices them to the States, and then checks on the State's progress and makes sure that adequate things are happening at the different State levels.

Second, the States could come together to solve problems and exchange ideas. In marketplace regulation especially, the States come together often to work on national problems. A good example of this was 2 years ago when the Insurance Services Office came out with a new claims made form for all commercial liability. We found some real problems with that. The States cooperatively got together and we made the Insurance Services Office come up with some major revisions to that policy. We can attack these problems on a group basis where we really see the need.

The third is that we develop model legislation for dealing with marketplace solvency questions where we come to an agreement on a particular way of going.

The question the chairman had asked is: What have we done through the crisis, what are we doing about making sure the crisis doesn't happen again?

In the midst of the problem, when the crisis was happening, the NAIC set up a market assistance program for States whose insurance markets or staff were not sufficient to set up one on their own. It also provided a clearing house on how to set up a program if a State wanted to do so on its own.

We set up a clearing house on just who exactly was writing a particular line of business and we put together some problems for some particular groups who were having trouble getting coverage. One was nurse-midwives where we were asked to solve that problem.

The NAIC also developed two model laws to deal with two of the obvious symptoms of the problem—mid-term cancellations, and nonrenewals.

We share some of the frustrations that we have heard from others on data, and are in the process of updating a computer capability and requesting new information that will focus more on marketplace activities.

We also intend to have the capability to assist States in analyzing their own marketplace through help from the NAIC. We are constantly developing new regulatory laws and tools, some looking towards potential problems that we see ahead and some dealing with some problems where they have come up; we have tried to analyze what caused those problems and how we can attack them better.

An example of the former might be our model legislation on financial guarantee insurance, where we see there may be some problems ahead in that area, and we want to get ahead, we want to get a regulation out there, we want to get a law out there that will help us deal with these problems before they hit the policyholders.

A couple of examples of the latter would be a new reporting on loss reserves to distinguish reserves on a primary business from reinsurance businesses. This is an answer to one of the major insolvencies that has happened. We think that may be one of the causes for us not spotting it early enough.

Also, we have made changes in the recent annual statement to require insurers to disclose more information on the collectability of reinsurance balances. These changes occur in our methods constantly, in how we look at it, and the reporting mechanisms constantly.

We are trying to get better at looking at reserves and coming up with a better system of annualizing reserves. We are trying to look back over the early eighties to see if we had a different way of evaluating the securities insurance industry, whether that would have changed what was happening in the marketplace, to see if that would have had an impact.

While the NAIC is doing this, the States are not restricted from following someone else's leads. As you are going to hear, the States have adapted many different programs, captive insurance company bills, many innovative programs. We may not agree on each and every approach, but that doesn't mean we don't agree on the end product, protection of the policyholders.

Indeed, reasonable people can believe in different methods to achieve the same end. I think that that happens a lot. The beauty of the regulatory process today is that where we agree, we can attack the problem nationally. Where we disagree, we can innovate at the State level and thus allowing the States to be laboratories of regulation, and all of us can benefit from the innovation that takes place in each of our States.

Thank you very much.

[Testimony resumes on p. 28.]

[The prepared statement of Mr. Washburn follows:]

STATEMENT OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. Chairman and Members of the Subcommittee:

I am John Washburn, Director of Insurance for the State of Illinois and Vice President of the National Association of Insurance Commissioners. As you know, the NAIC is the association of the chief insurance regulatory officials of the fifty states, the District of Columbia and the four United States territories and provides a forum for the exchange of ideas and formulation of uniform policy, where appropriate.

Thank you for the opportunity to appear and address the performance of the state insurance commissioners in serving the needs of insurance consumers, the industry and the general public. Today I would like to update the material the NAIC submitted to this Subcommittee in January 1987 concerning state activity in several areas in which the Subcommittee had expressed interest. The statement contained detailed information concerning rate regulation, availability, tort reform, claims-made policies, solvency regulation and guaranty funds, and the qualifications of state insurance department employees. In addition, I will discuss the purpose of the regulation of insurance and how the states are implementing that purpose.

Insurance is a vital aspect of American society, both in the private lives of the country's citizens and in the business community. The objective of insurance regulation is to provide protection for the policyholders. In today's environment, however, such an objective may too narrowly define the goals of insurance regulation. Insurance has become more than a private contract for service. It fulfills a public function.

The role of insurance in today's modern and complex society must be examined to determine the goals of insurance regulation today. A prime function of insurance is to provide security to the policyholder. Insurance provides a definite and known cost for indefinite and unknown events, and thus provides security for the insurance consumer. To provide this security to the policyholder, the product and entity offering the product must be reliable and solvent. Also, through marketplace regulation, regulators assure that consumers are treated equitably and fairly by insurers and agents. Insurance regulation strives to address these needs. To meet these goals, an extensive and complex state regulatory system is in place in this country.

This system of insurance regulation has existed for over 120 years and does not rely on any one state or insurance commissioner. As an insurance company's operation expands, regulatory review and scrutiny also expands through the involvement and oversight of the state insurance departments. The state regulatory structure on a national basis consists of approximately 6,500 individuals possessing a variety of professional skills including legal, actuarial, underwriting, claim adjudication, financial, and many others. The total budgets of the state insurance departments for 1986 exceed $267,000,000.

Although I will not dwell on the regulatory systems that function daily, it should be remembered that those services and responsibilities are an important aspect of the state regulatory scheme. On a daily basis, state insurance department personnel handle complaints from consumers regarding marketing or claims problems, oversee the conduct of insurers and agents in the marketplace, review products and rates and monitor the financial solvency of the industry. While state insurance regulators face common problems and concerns, the state system allows for a variety of initial approaches to solve these problems. An obvious advantage of state regulation is that the best solution or solutions then can be adopted on a national basis. Today, I will focus on the NAIC and the state insurance departments as an environment for experimentation and innovation.

State Response to the Insurance Crisis

The NAIC's statement to this Subcommittee in January of 1987 described the states' response to the availability of liability coverage including creation of a market assistance programs (MAPs), joint underwriting associations (JUAs) and enactment of laws prohibiting or restricting midterm cancellations and nonrenewals. In the legislative sessions just completed, the state legislators have considered additional alternatives.

Some states have re-evaluated their rating laws to determine what adjustments are appropriate according to the marketplace in that state. State rating laws are categorized as: (1) state-made rates; (2) mandatory bureau membership; (3) prior-approval; (4) flex rating; (5) file-and-use; (6) use-and-file; and (7) no-file laws. All states have some type of rating law except Illinois, which allowed its law to expire in 1971.

In the last session a number of states modified their rating laws in response to the insurance crisis in pricing of the product. Four state legislatures have implemented a more restrictive approach to rating. In addition to legislative action, some states in which the insurance commissioner has discretion to evaluate the competitiveness of the insurance environment have temporarily implemented more strict filing rules. Vermont, Wyoming, Nevada and Washington are examples. These actions demonstrate the close regulatory oversight that exists concerning rating.

Flex rating is a recent innovation which requires prior approval by the insurance commissioners of annual rate increases or decreases if the proposed changes exceed a specific predetermined range. New York was the first state to adopt such a law, but Missouri, Oregon, Minnesota, Virginia, Washington, and Maine also have some type of flex rating. At least 11 states considered flex-rating provisions in 1987.

California has developed a plan they hope will soften the pricing cycle of insurance products in that state. The plan includes: holding a public hearing on whether the Insurance Services Office (ISO) should publish gross advisory rates, which would include investment income; working with ISO to determine the accuracy of its 1986 rates; supporting the strengthening of penalties imposed for violations of the state rating law and unfair practices act; and establishing a commercial lines rate monitoring system to help the department track insurance company practices.

One final example of how the state legislatures act independently in dealing with insurance issues is the action taken recently in New Mexico prohibiting rating organizations from filing a single set of uniform rates applicable to all member companies if there are substantial variations among the members regarding loss ratios, loss experience and other factors relating to rate levels.

<u>Solvency Surveillance</u>

An insurance policy is a promise for future payment. In order to fulfill this promise the insurance companies must be solvent. The state regulators are constantly striving to improve their oversight of the financial condition of the insurance industry. An important aspect of such regulation is to obtain the most recent information possible and analyze that data as efficiently and timely as possible. To that end, the NAIC has been improving its analysis of the financial information of the insurance companies. Recent activity in this area includes requiring additional disclosure on reinsurance transactions, asset liquidity and reinsurance collectibility.

In the NAIC's January 1987 response to this Subcommittee, the NAIC outlined its role in the solvency oversight regulatory scheme. The NAIC has just completed this year's processing of the annual statements of 4,910 insurers doing business in this country.

Phase I of the NAIC's plan to have submission of annual statement data in machine readable form was conducted this spring. All insurers doing business in New York, New Jersey and Texas were required to submit 1986 annual statement data on diskettes. Although adjustments are occurring in the initial pilot program, the project has demonstrated that the diskette filings will be a significant enhancement of the financial analysis process in the near future. It is anticipated that the pilot program will continue next year with additional states participating. All insurers are expected to be required to submit their annual statements on diskettes in 1989.

The NAIC Examiner Team has completed its first two rounds of examinations. The examiner team consists of senior financial examiners from various states who convene at the NAIC in Kansas City to review the annual statements of insurers. The examiner team analyzes the financial condition of insurers with four or more ratios outside the acceptable range established by the NAIC Insurance Regulatory Information System (IRIS). The team also examines companies that were designated as needing immediate or targeted regulatory attention last year and those whose financial reports reflect other potential problems.

The examiner team prepares synopses or summaries of the financial condition of most of the companies reviewed, which are then sent to all states. A state is immediately informed if its domestic insurer is designated as needing immediate attention. The domiciliary state is required to notify the examiner team of regulatory action initiated as a result of such designation. This exchange of information among the states assures that all states share the expertise of the experienced examiner team. The following table illustrates the results of the 1986 project.

Preliminary Results: 1986 Examiner Team Project

	P & L		LIFE		FRATERNAL	
	#	%	#	%	#	%
Immediate Regulatory Attention	200	9.4	187	11.3	4	2.9
Targeted Regulatory Attention	313	14.7	154	9.3	2	1.5
Total Regulatory Attention	513	24.1	341	20.6	6	4.4
No Regulatory Attention	102	4.8	180	10.9	16	11.8
Reviewed But No Synopsis Written	218	10.3	110	6.7	4	2.9
Total No Regulatory Attention	320	15.1	290	17.6	20	14.7
Total Companies Reviewed	833	39.2	631	38.2	26	19.1
Companies Scanned But No Review	1294	60.8	1023	61.8	110	80.9
Total Companies Processed	2127	100.0	1654	100.0	136	100.0

Companies that have been determined to be "immediate attention" insurers must submit quarterly filings to the NAIC. The examiner team continues to monitor these companies throughout the year to measure changes in financial condition. Based upon the selection criteria determined by the IRIS project, 1,490 companies were reviewed by the end of the first seven-week part of the project in 1987, compared to 1,311 for the same seven week period in 1986. Additional criteria were utilized to select companies for review by the examiner team this year. Added to the list were annuity writers, companies listed in the NAIC report of multi-state delinquency proceedings, and companies reporting negative surplus.

This year, in answer to identified problems, the examiner team analyzed in greater detail the insurer investments in affiliate companies, reinsurance ceded to affiliates, and company liquidity. In addition, the NAIC is exploring the development of procedures and standards for improving the adequacy of loss reserves for property and casualty companies.

Data Collection/Data Processing Capabilities

A concern voiced by members of the Congress that is shared by the insurance commissioners is the adequacy of data collection by the states and the NAIC.

A working group of commissioners recently completed a review of the data collected by the states, including the need for additional detail in existing data collection, the need for new data elements, and the need for change in the way the data is reported. The working group considered the collection of financial data, market demographic data, and tort system demographic data.

The Commissioners concluded that financial data is readily available in the form of the annual statement prepared by each insurance company and submitted to the regulators in the various states in which each company operates. The annual statement is a voluminous document with over 40,000 individual entries designed to reflect a company's assets, business written, reserves maintained, and overall operating experience. Because of the extensive information already available through the annual statement format, the NAIC is spending its efforts in making better use of this data. Of course, the NAIC will continue its refinement of the annual statement to make it a more useful dynamic regulatory tool.

With regard to market data it is generally recognized that enhancements are needed. This is especially true for specific sub-lines of insurance and classes of risks which have or will have availability or affordability problems or both. The NAIC will be revising its Statistical Handbook, the blueprint for industry data collection, to obtain more current and specific information so that emerging problems can be identified.

An obvious corollary of data collection is the necessary data processing capability. A study was conducted of the NAIC's present capabilities and future needs to improve the NAIC's ability to process the annual statement data. The study included input from state regulators, NAIC personnel, and data processing professionals. An operational plan was developed as a result of the study.

The plan calls for enhancement of the NAIC's ability to capture data, to improve accessibility and flexibility of data, and to improve the communications link among the states and the NAIC. As a result, the NAIC data base would be expanded to include more information on the transactions involving reinsurance and alien insurers. The plan would also improve the states' abilities to track fraudulent activity of individuals or companies across state lines as well as improve the speed and efficiency of analyzing insurers' financial statements.

Field examinations of insurance companies continue to be an important tool in determining the financial health of an insurer. To assist the states in performing these examinations more efficiently and effectively, the NAIC has developed a program to provide the states with access to electronic data processing (EDP) auditing software and related products. This allows insurance department financial examiners to use EDP auditing techniques when examining insurance companies making the examination more efficient and effective. Examiners from twenty-two states have been trained to date and additional training sessions are scheduled. The NAIC Examination Oversight Task Force has established an audit software user group to provide further support to the state examiners and to explore additional examination applications of the audit software.

State Data Reporting Requirements

Since the beginning of 1986, at least 24 states have expanded the data reporting requirements for companies writing liability insurance and have prescribed forms for this reporting. The purpose has been to enable the regulatory authorities to better understand the factors used to justify rate increases by insurers. In this way the regulator will be able to determine more quickly the appropriateness of the rates and investigate significant affordability and/or availability problems. After compiling the information, the commissioner in many cases is required to prepare a report for the legislature or governor. In some states, the information will be used to measure the effects of tort reform.

The requirements for data reported vary from state to state, but generally include data on premium exposures, losses and loss adjustments. The data is reported for all lines of commercial liability insurance in some states; or in some cases, problem lines designated by the commissioner.

Financial Guaranty/Investments

Innovations in financial services and insurance products require the regulators to develop new methods of regulation. One such area is financial guaranty insurance. Recently the NAIC adopted a Financial Guaranty Model Act. The insurance commissioners developing the model act concluded that effective regulation and protection of the financial guaranty business can only be accomplished by limiting the writing of financial guarantees to monoline companies. The large amount of capital leveraged for relatively low premiums caused concerns among the regulators on the effect of problems spreading to the other lines written by an insurer.

Another area of concern relating to solvency is investments by insurers. Recently, some states have expressed concern over investment by life insurance companies in high yield/high risk obligations, referred to as "junk bonds." New York recently enacted a regulation limiting a domestic life insurer's aggregate investment in junk bonds to 20 percent of the insurer's admitted assets and to 10 percent for all publicly traded junk bonds. Arizona has a similar regulation. The concern is that there is not an adequate historical record with which to project the investment's behavior through various economic cycles. A study group of the NAIC has reviewed a proposal for changes in the NAIC/Securities Valuation Office (SVO) Bond Rating Criteria as well as an overall review of the SVO procedures. Along with that review, the Bond Criteria Study Group is examining the rating of so-called junk bonds.

Another NAIC committee is examining the issues raised when banks act as agents and brokers and when banks participate in the reinsurance business. This committee is also studying the regulatory mechanisms used for other financial service industries to determine what methods could be utilized in insurance regulation. Additionally, the committee has under consideration a model law which would prohibit insurance brokerage firms from owning a controlling interest in insurance companies.

Another NAIC task force is monitoring the implementation of the book entry system for securities and the use of national securities depositories by insurance companies. The NAIC is vitally interested in encouraging the four states with depository trust companies to afford reciprocal treatment of securities in the case of insurer insolvency. The NAIC is, therefore, developing a bulletin that may be issued by these states indicating that the states have adopted the Uniform Insurers Liquidation Act and will afford reciprocal treatment of insurer assets in the event of insolvency.

<u>Insurance Guaranty Mechanisms</u>

In its January 1987 response to this Subcommittee, the NAIC outlined the nature and underlying rationale for the establishment of insurance guaranty associations, or funds, for both property/casualty and life/health insurers. As you recall, these associations do not directly guarantee the solvency of insurance companies, but they reimburse policyholders and third party claimants who demonstrate a justifiable loss against the insolvent company. The NAIC Guaranty Fund Task Force is constantly monitoring the effectiveness of the NAIC model laws for both the property and liability sector and the life and health area.

Regulators considered funding alternatives for the Life and Health Insurance Guaranty Fund Model Act because of potential capacity problems in the annuity business. A survey of all insurers writing annuity business was initiated and the results indicated that the method for assessing companies which was adopted by the NAIC may cause capacity problems in certain states. The task force, at the NAIC's recent meeting in Chicago, discussed how annuities and guaranteed investment contracts (GICs) should be treated under the NAIC model act and whether any changes in the assessment method are appropriate in light of the survey results.

In addition, the NAIC has recently appointed a group to evaluate the appropriateness of a model guaranty fund law for health maintenance organizations (HMOS). Over the last several years HMOS have become a significant factor in the health care insurance market. Competition in this market has been fierce. Also, many of these entities are under-capitalized due to the past attitude of encouraging formation of these alternative mechanisms to control health care costs. These factors have led certain states to take a variety of actions including increased financial and capital requirements, hold harmless arrangements with health care providers, insolvency reinsurance, and insolvency funds.

<u>**Reinsurance**</u>

The NAIC is currently developing criteria for rating the credit standing of banks that issue letters of credit. These letters of credit are issued to secure reinsurance recoveries. Insurers are allowed a credit on their financial statements for reinsurance ceded. These credit rating standards will be used by SVO to compile a list of domestic and foreign banks that meet the standards. The list will include tha banks whose letters of credit are used by insurers for reinsurance credit on their annual statement. The implementation of these credit rating standards would permit foreign banks to write letters of credit for reinsurance. Currently, foreign banks cannot issue such letters directly. Instead, they use intermediaries which significantly adds to the cost to the credit facility.

The NAIC has also considered adoption of a restriction on reinsurance treaties. Under this restriction, a bank could issue letters of credit equal to no more than 5 percent of its capital and surplus to cover any one reinsurance treaty or agreement.

Additionally, several states are currently using different methods for evaluating insurer solvency, taking into account the amount and quality of reinsurance. Illinois is one state experimenting in this regard, and if we find our method to be of assistance in solvency surveillance, we will then present the alternative to the NAIC for use by all states.

<u>Market Conduct and Other State Regulatory Mechanisms</u>

Market conduct surveillance is another state regulatory mechanism used to evaluate insurers' compliance with statutes and regulations relating to the insurers' market practices and their dealings with policyholders and claimants. Various groups of the NAIC are considering model legislation or regulations which may have a direct impact on the insurance consuming public. The Medicare Supplement, Long-Term and Other Limited Benefit Plans Task Force has recommended specific guidelines for insurance sold to consumers over 65 years of age. The task force is also in the process of drafting a consumer guide for insurance for senior citizens.

There has been concern lately over advertising on television and by so-called "lead cards" that have been directed to senior citizens. Several states have required filing of all health advertising utilized in the senior citizen insurance market.

The NAIC recently enacted a Long-Term Care Insurance Model Act which has served as a prototype for those considering the health care needs of senior citizens including the Federal Long-Term Care Task Force created by the last Congress.

Additionally, the NAIC is considering amendments to the NAIC Model Rules Governing the Advertising of Life Insurance which will impose new restrictions and disclosure requirements on universal life products and establish standards for marketing and advertising of life and annuity products. There are also new restrictions in the amendments regarding the marketing of life insurance and annuity products to students.

Concern over the use of "after market auto body parts" in repair of an insured's car by insurers has also been addressed by model legislation. The working group that proposed the model legislation had several meetings with interested parties, including an open hearing in Chicago this spring. The model requires that: (1) all after market parts are physically identified; (2) their use is disclosed; and (3) the insurer guarantees that after market parts are of like kind and quality to the originally manufactured part.

Another working group of the NAIC is studying the issue of collision damage waivers in rental car agreements. The issue is being reexamined due to recent changes in rental car insurance contracts which have resulted in the perception that these coverages no longer be merely incidental to the rental car company's primary business. Additionally, commissioners are concerned that when a consumer rents a vehicle there is a structure or other method of buying insurance which enables the consumer to realize benefits from competition in price and coverages.

State regulation of the insurance industry also includes oversight of the conduct of insurers in the marketplace, and this involves market conduct examinations of an insurer. To enhance the education and training of the state department personnel who perform these examinations, a new professional society was founded during the NAIC national meeting in June. The state market conduct examiners have formed the society and plan to develop a certification program for state examiners.

Summary

This has been an overview of the insurance regulatory system in the United States. The rapidly changing environment of insurance calls for a system of regulation which is flexible and can readily adapt to new conditions in the market and rapidly developing new and innovative products. The state system of regulation is ideally suited to meet these challenges. The NAIC exists to supply the uniformity which would not otherwise be possible or feasible by the efforts of the states individually.

The NAIC has strived to enhance the capabilities of the state departments in a number of instances. The establishment of a state computing network, which allows an exchange of information between the states and the NAIC, is one example. In addition, the educational efforts by the NAIC through its commissioners training program and special workshops for department personnel strengthen the quality of state regulation.

We noted at the outset that the primary objectives of insurance regulation in the United States are to protect the interests of policyholders, insure insurance company solvency and assure that rates are not inadequate, excessive or unfairly discriminatory. While these goals are the same throughout the United States and its territories, they may only be achieved by a system which is adaptive to the various economic, social and political realities that are encountered on a daily basis. Each state insurance commissioner operates separately and exercises individual judgment and authority whether it is in rate regulation, market practice surveillance or solvency management. At the same time, each commissioner is privileged to share in the collective work efforts of his fellow commissioners. It is the unique blend of uniformity and flexibility which is the hallmark of insurance regulation in the United States.

Mr. FLORIO. Commissioner Merin.

STATEMENT OF KENNETH D. MERIN

Mr. MERIN. Thank you, Mr. Chairman, members of the committee.

I have submitted my testimony, and I will just try to highlight it very briefly in the interest of time.

I speak best about the New Jersey Department of Insurance. The New Jersey Department of Insurance, in my opinion, is not one of the best insurance departments in the country. It is far from being the worst, but it is certainly not one of the best. The Insurance Department of New Jersey is kind of rooted in a time warp that goes back many, many decades. There have been very few improvements in the Department of Insurance, in my opinion, since World War II—that is based on conversations with people who have been working at the Department of Insurance for 30, 40, and in some cases, 50 years, who are witness to that lack of progress.

The facilities, the equipment, were virtually nonexistent when I first got to the Department of Insurance in 1984. I took a look at the U.S. flag that was sitting behind the Commissioner's desk and I unfurled the flag because I didn't believe how old it was. I unfurled it and saw there were only 48 stars on it. Alaska and Hawaii came in in 1958 and this was 1984, and we had still not made that minor adjustment.

We were using manual typewriters, all sorts of equipment that there is no way in the world we could regulate effectively with the type of resources that we had. The size of the department had not increased significantly. The manual equipment was outdated even for manual equipment.

So we tried to make some progress, some strides in the infrastructure of the department. We tried to attract better people, we tried to improve on the equipment. We are moving in that area. We have practically doubled the budget of the department in the last couple of years and we intend to continue the progress in that area.

In my opinion, one of the reasons for the crisis of the last couple of years, and perhaps one of the reasons for this cyclical nature of the industry, to the extent that it does exist, is because of lack of effective regulation. I believe that what a couple of my colleagues have said is correct, the NAIC is moving ahead rapidly and aggressively, we are seeing improvement in State regulation, but in the past, I think there has been a lot left undone that should have been done.

Another problem is with the industry itself. We all realize that it is a cyclical business. We also are familiar with, as I am sure you are, the cash flow underwriting of the last couple of years.

I think there are several questions that can be legitimately asked of the insurance industry. We are attempting to ask those specific ones that we have the ability to ask, but there are a lot of other areas that the New Jersey Department of Insurance just does not have the capability of getting into.

We are very interested in knowing what impact the tendency toward conglomerate ownership has had on that industry. The extent to which the various financial services have gotten mixed up in one corporate entity led the industry into some of the pitfalls they have found themselves in.

I have listed in my statement some of those areas. We're concerned about that. I think there are some concerns, particularly about reinsurance, particularly what goes on overseas. We are well aware of the problems that Lloyds had in the late 1970's and early 1980's. Those problems led to Parliament intervening in the Lloyds entity.

I think that a lot of the problems we had were due to reinsurance problems, surplus lines problems, to capacity that is not regulated as tightly as perhaps it should be.

Again, I think most of my remarks are self-explanatory, and I just indicate that I am happy to answer any questions that you have.

[Mr. Merin's prepared statement follows:]

STATEMENT OF KENNETH D. MERIN

Before I begin my remarks, I would like to thank Chairman Florio and the other members of the Subcommittee on Commerce, Consumer Protection and Competitiveness, for inviting me to speak here today.

It appears that the longest, most severe insurance affordability and availability crisis in recent history has abated. The insurance industry is in the midst of a recovery, and it seems to be going back to business as usual. In light of the devastating effect the crisis had on commercial insurance buyers, I do not think we want to go back to business as usual.

My remarks will focus on issues concerning State regulation of insurance. It is important to dwell on problems in the State regulatory system because, in my opinion, one of the reasons the insurance crisis occurred was due to the lack of a strong regulatory system.

Many of our concerns were outlined 4 years ago in a report issued by the Conference of Insurance Legislators. The report, "Risk . . . Reality . . . Reason . . . in Financial Services Deregulation," argued that regulators were not able to do their jobs because they lacked the necessary computer capability, as well as administrative support.

In essence, the report said that with proper technological tools, regulators could monitor insurer and industry activities with greater reliability, and predict problems that lead to market disruptions and economic dislocation before they become severe. For example, computerized systems would enable regulators to closely scrutinize an insurer's reserve adequacy and predict problems before the company is impaired beyond rehabilitation.

The report also underscored the fact that whatever limited modern tools regulators did possess, those tools were not, for the most part, being used to their best advantage. For instance, the report noted that computerized systems used by regulators earlier in this decade were, for the most part, limited to licensing procedures and "not to the substantive work of monitoring for solvency."

On the issue of State regulation, the report concluded that: "Without the right people, power and tools, State regulation of financial services could prove to be an embarrassment to regulators, themselves, and to the legislators who set regulatory goals but neglected to provide the wherewithal to achieve them." I find the last comment to be particularly prescient.

When I began my first term as commissioner in 1984, I found a State agency stuck in a 40-year time warp, attempting to regulate an industry that had evolved into one of the most complex segments of the financial services sector. All of the concerns noted in the COIL report were apparent in the New Jersey Department of Insurance.

We have been working to improve our regulatory system. Our budget has grown significantly in recent years. In fiscal year 1984 the Department's budget was $7 million. The anticipated budget for fiscal year 1988 is $13.5 million.

We are also significantly increasing our staffing level. In fiscal year 1984 the Department had 263 employees, of which 227 were involved in insurance; for fiscal year 1988 there will be an anticipated 360 positions, with 307 earmarked for insurance, (The Department of Insurance also regulates the real estate industry.)

The department also has revised job title requirements and upgraded salary levels for many positions. There has been an all-out effort to advertise in the local, national, and trade press for qualified applicants, especially examiners and actuaries. However, it still is difficult to compete with the salaries offered by insurance companies. We also are relying, with greater frequency, on the expertise of outside consultants in special cases. In addition, the department is promoting extensive educational programs for the staff (such as junior college-level courses for administrative personnel and CPCU classes for professionals).

As the department continues to automate, we can better utilize our budget to hire professional personnel, rather than paper processors.

The COIL report indicated that state-of-the-art technology is most needed in the area of financial monitoring. Our financial examination division has the massive task of monitoring the solvency of the 1,000 insurers that do business in the State.

The division also is responsible for conducting, on either a triennial (for property/casualty companies) or 5-year (for life insurers) basis, in-depth field examinations of the financial practices of the 98 insurers domiciled in the State. (There are 64 property/casualty companies, 15 life/health companies, 6 fraternal organizations, 3 reciprocals, and 10 "miscellaneous" types of small insurance concerns domiciled in New Jersey.) In addition, the division regularly participates with other State insurance departments in NAIC zone examinations of foreign and alien insurance companies. The examination process to date has been handled manually.

New Jersey is in the process of developing a new Financial Examination Monitoring System (FEMS), which will allow examiners to streamline financial review procedures, automate report preparation, improve the timeliness of information gathering, automate calculations and permit more frequent financial analysis. The FEMS program should alleviate much of the tedious busywork that keeps examiners from their primary goal: the timely review of insurers' financial conditions. Automating the examination process should alleviate the backlog we now have with our triennial and 5-year reviews.

FEMS also will permit the department to tie in with insurance company computer systems, allowing more timely access to data. That tie-in will allow our examiners to closely track areas of special concern, permit interim analyses, and enable the department to pinpoint both company and industrywide problems in a timely manner.

To use just one example of how FEMS will eliminate cumbersome manual procedures: examiners currently must verify companies' investment data, contained in schedule D of their annual reports, to ascertain that investments are valued in accordance with NAIC standards.

To get the job done, an examiner now must compare the schedule D section of the annual statement to a listing issued by the NAIC's Securities Valuation Office. Once that takes place the examiner recalculates certain securities based on whether or not amortization is allowed. Under the present manual system, repetitive calculations must be done, and the process can take up to 2 months.

Using FEMS, an examiner will be able to get the information from the company on computer tape and match it against an SVO computer tape. Exceptions then can be reviewed manually. When totally automated, the procedure is expected to take just days to complete.

In addition to our computerization project we have worked closely with the NAIC, which, with the help of several key States, including New Jersey, is proposing to replace its current computer system with new state-of-the-art technology. In addition to its efforts to improve its national monitoring responsibility with up-to-the-minute automation, the NAIC over the past 3 years has upgraded its staff and organization significantly.

Efforts to automate are in no way limited to just the financial examinations division. In 1986 the department continued installation of a word processing/personal computer network which is improving office automation. The system, which includes electronic mail, electronic scheduling and intensive word processing for each of the Department's divisions, will enhance our communications ability.

We also plan to move ahead with automation/computerization in the rate analysis area. The department reviews more than 2,500 rate filings annually; the review process presently can take from 3 months to more than 1 year to complete. Automation will greatly enhance the department's ability to store, analyze and evaluate data. We anticipate that once automated, the rate filing review process will take less than 3 months to finish.

In addition to addressing the items noted in the COIL report, our department also has submitted to the legislature a package of bills which propose a number of reforms in the area of commercial liability insurance regulation. While many of our proposals are primarily relevant to New Jersey, some may have broader applicability.

The proposed legislative package is too comprehensive to detail here. I will say that it touches on a wide variety of issues, including solvency, capacity, competition, rate and price monitoring and control, and alternatives to the traditional insurance mechanism (such as captives, risk retention groups, et cetera).

We think these bills, if approved, will help us avoid or at least better handle future insurance market contractions, should they arise, while maintaining an attractive business climate.

The feature of the package that I consider to be the most innovative is a proposal giving the insurance commissioner the authority to require an insurer to include safety standards as part of its underwriting procedure for hazardous, unusual, exotic or special risks. If the legislation is approved, those risks will be determined through a joint department and industry consensus. Let me dwell on this proposal for a moment.

Historically, safety and risk management were vital parts of the underwriting process. Insurers were instrumental in setting safety and inspection standards for industry as preconditions for insurance coverage, particularly in such areas as boilers and machinery and elevators. Perhaps the best example of the influence of the insurance industry on safety is Underwriters Laboratories, which was established by fire insurers in the Midwest to test materials, devices and processes against fire hazards. Underwriters Laboratories today is an independent organization that still issues safety ratings for a variety of products.

That commitment to safety, risk management and loss control until recently was a basic tenet of insurance, and when pursued made uninsurable risks insurable. I believe it has not been vigorously pursued in recent years.

We envision that the insurance regulator and the insurance industry would work together to minimize risks. One example of the way in which this partnership could work involves the problems of Leaking Underground Storage Tanks.

We are familiar with the sight of a gas station temporarily closed down while its storage tanks are being replaced. The industry knows that those tanks begin to leak after a certain number of years. The effective life span of those tanks varies, depending upon the materials utilized in the composition of the tank.

We also are able to determine what the "most effective container" is, and what its life span is.

Under our proposal, the department would issue a regulation either preventing an insurer from providing insurance to a service station, or requiring mandatory insurance surcharges, unless that service station used appropriate technology. Since tanks are always being replaced, innovations in technology can be picked up when replacement of the tank is due. The insurer would not be liable for the worthiness of the product, but the effect of this program would guarantee that the best available technology would be used.

Obviously there are a multitude of situations in which this type of joint effort could be utilized. The best way to keep insurance rates down is to avoid the possibility of having to pay claims.

Another key area of concern addressed in our legislative package is reinsurance. The liability crisis brought home, in no uncertain terms, the ultimate impact of the reinsurance market on primary insurers. The collapse of Integrity Insurance Company, of New Jersey, was due primarily to the company's inability to collect some $25 million in reinsurance owed to it by Mission Reinsurance Co., leaving Integrity hopelessly insolvent.

Mission Reinsurance Co., in turn, is a member of Mission Insurance Group, which is estimated to be insolvent by $448 million and now is in liquidation in California. Ironically, Mission Group's insolvency, estimated to be the largest of a property/casualty insurer, was blamed in part, on Mission's inability to collect on its reinsurance.

This scenario illustrates the need to exercise a higher degree of control over reinsurance agreements. It may not be feasible for State regulators to monitor the international reinsurance industry, but in New Jersey we are proposing to more closely regulate the reinsurance practices of companies doing business in the State.

One of the activities we propose to regulate in our legislation is the amount of credit a primary insurer would receive for specified reinsurance transactions. In addition, there will be regulations as to when insurance companies can count reinsurance as a State-recognized asset.

To prevent reinsurers from avoiding their share of claims payments, the new regulations would also limit the credit for any reinsurance contract which has different conditions from the insurance policy it reinsures. Finally, any primary insurer that has a substantial amount of its book of business reinsured would be subject to closer monitoring by the department.

Because we recognize that no State can immunize itself from the effect of poor regulation in another State, and because we recognize the limited constitutional and practical powers of a State regulatory agency, we also are asking the New Jersey Legislature to pass a resolution urging the Federal Government to take a more active role in the regulation of insurance. Some areas in which the Federal Government might take a more active role would include:

- A Federal study to determine the extent stock ownership aggravates industry cycles by forcing insurance company management to take the short-term versus long-term view (i.e., the need for impressive shareholder dividends each quarter might cause a stock company to engage in the potentially dangerous practice of cash-flow underwriting more readily than a mutual insurer).
- An investigation into the ramifications of barring corporate conglomerates from owning property/casualty insurers. A number of recent insurance company problems may have been exacerbated due to the purchase of insurance companies by large noninsurance conglomerates. The conglomerates are reputed to have replaced senior insurance company management with managers who had little or no insurance experience or expertise. This may have contributed to the relaxation of underwriting standards and an emphasis on quick profits through cash-flow underwriting.
- In light of the significant amount of U.S. capital that is paid out to alien reinsurers, a Federal study is suggested to determine the effect on the "balance of payment deficit" of the alien reinsurance market.

In addition to the effect on the current balance of payment deficit, the study might also address the question of encouraging a stronger national reinsurance market. Another topic for possible inclusion is whether the new tax law is acting as a disincentive to placing long-tail reinsurance business with U.S. companies.

- Implementing a Federal system of licensing and monitoring alien reinsurers.
- Establishing national standards, similar to those being proposed in New Jersey, for the transaction of reinsurance business.
- Studying the feasibility of creating a Federal reinsurance program for high-risk pollution and toxic substance risks, with risk management and safety engineering principles clearly spelled out.

Although there are serious, ongoing insurance problems in New Jersey, I do not think that they are insurmountable. We will continue to grapple with controversial issues until solutions are reached.

I will conclude by restating my belief that in New Jersey, at least, we are on the brink of a new era of insurance regulation. The old image of dusty, antiquated offices and listless paper shufflers is fading; it is being replaced by state-of-the-art technology and well-trained personnel, committed to protecting New Jersey's insurance consumers.

Thank you.

Mr. FLORIO. Thank you very much.

STATEMENT OF JAMES P. CORCORAN

Mr. CORCORAN. Thank you. If Ken will give us back the Giants, we will give him a flag, typewriters, whatever you want. Thank you, Mr. Chairman, Congressman Lent, Congressman Rinaldo.

I will try to paraphrase my 23-page statement, which basically is a history of what the New York State Insurance Department did in response to the insurance crisis.

It is very important that we limit our discussion here to that today because we will be building in the future on that, and I think NAIC has demonstrated it has been a learning and building experience with tremendous acceleration. I would note the New York State Insurance Department now has staffed up to 750 employees with a budget of nearly $15 million and with an authorized strength of 900 employees. Many of these things have been accelerated within the last 4 years of my tenure in office, and the legislature and the Governor are very supportive of that activity.

We, too, are going through an evolution of high tech enhancement. I think we are pretty much on our way to do that. Each State must review its own marketing conditions and choose its own solution to this problem. I would add, I support strongly Commissioner Washburn's statement the National Association of Insurance Commissioners is an increasingly effective agency for this kind of interstate cooperation, innovative methods of one State can be evaluated by other States with the NAIC serving as a valuable forum for the exchange and communication of ideas and information critical to sound regulation.

Now, the cause of the crisis. It is key we talk about that before we go forward. We all have our own beliefs. The Commissioners are not in agreement, but I think we all agree the phenomenon called cash flow underwriting was the key to many of the crises we faced, the phenomena of high interest rates and not properly underwriting or evaluating risks and hoping the investment income would make up the difference. We are all agreeable the irresponsible behavior of the industry was no doubt the major cause. As far as the extent of the civil justice system, we can differ how much it exacerbated it, but there is no doubt there is a need for enhanced regulation, and we have all gone that route in various directions.

A question has been asked, what can be done by government to stop the crisis before it began, during a period when insurers first began charging inadequate rates, engaging in cash flow underwriting? In hindsight, it appears to me a number of forces and conditions prevented regulators from taking an anticipatory approach. The downward slide in prices coincided with the dominant theme or philosophy of government called deregulation.

Let me point out it is my strong view that some activity in Washington exacerbated the situation considerably: its inadequate budget, the ICC's philosophy of deregulation. When the SEC could not properly regulate the mergers going on in the marketplace, D&O coverage became a serious problem. So applying a philosophy to regulation in my view was an exacerbating factor.

There was continued little public understanding that inadequate rates can prove just as harmful. I would point out to you at the time, prior to the crisis, no legislation would seriously consider a regulator's request for expanded authority to order insurer rate increases which would in some instances have doubled rates. So, perhaps we needed a crisis to show that we need to face long-term solutions to stabilize the marketplace.

The only alternative available to regulators was a case-by-case review of filed rates. We formed a cash flow underwriting task force within the Insurance Department to investigate some of the more egregious examples of under-pricing. During 1982–86, the New York Department fined 31 commercial liability insurers over $85,000 for under-charging their insurers. However, with some 30,000 individual risk filings made annually, and to have stopped the downward slide rates with that mechanism was a Herculean feat.

Among the theories that have circulated to explain the crisis is the alleged conspiracy among insurers to defraud the American people by banding together to increase rates to unsupportable levels. Conspiracy theories are fun, they gain a lot of public attention, they tend to capture the public eye, but however for explaining the liability crisis to rest upon a conspiracy would involve the following scheme—ingenuous or purely insane. Property casualty insurers, beginning in the late 1970's, conspired to lower their rates so as to enable them to steal each other's business and go on to lose so much money when they were ready to vote to raise their rates to outrageous levels, no one could afford it and withdrew from the insurance market, so they would not get the money at all.

As reported to my department when the crisis first hit regarding unaffordability, we responded by forming maps, market assistance programs, hot lines, and some 17 months since its inception we had about 5,000 hot line calls. The amazing part of the entire thing was when we sat down with the industry getting these hot line calls and in forming our market assistance programs for public entities, local police, child care centers and small businesses, when the industry attention was directed to individual cases, all of a sudden many of these things were under-writable. That was, of course, a stop-loss approach and totally inadequate for long-term solutions.

Governor Cuomo established the Jones Commission, chaired by a distinguished former Associate Judge of New York's highest court and whose members included myself and the full spectrum of civic, legislative, consumer, business and insurance leaders. The Commission issued two scholarly, yet real-world, reports that analyzed the causes of the crisis and made extensive long-term recommendations for overcoming existing problems and preventing their recurrence. Many of these recommendations formed the basis for the omnibus program enacted by the New York State Legislature within 3 months of the issuance of the first report.

Governor Cuomo was particularly concerned about allegations of an insurer conspiracy to withhold essential insurance coverages until major "tort reforms" desired by insurers were enacted. As a result of the Governor's concern, I conducted a thorough investigation, including in-depth interrogations under oath of top officers, including CEO's, from the largest commercial liability insurance carriers, the principal rate advisory organization (Insurance Services Office), leading insurance brokers and major reinsurers. The investigation, as did the Jones Commission, produced no evidence of any conspiracy to lower prices, to raise prices, to close markets or to otherwise violate New York's insurance antitrust statute. The investigation also produced no evidence that the crisis was precipitated in an attempt to force "tort reform" on the public.

To the contrary, several witnesses admitted that their action was guilt by gross stupidity by insisting on retaining market share while facing more inadequate rate levels. A number of witnesses testified when they did attempt to restore rates to adequate levels, their market share fell precipitously. I am still trying to explain to myself and the world in general why people who are CEO's continue to lose money, except saying "But we have to continue to have a large share of the losses to maintain market share."

Now, all this precipitated our response in New York to the crisis. We evaluated documentation and recommended a broad scope of long-term positions, not short-term responses. The philosophy of consistent regulation, coupled with the will to regulate and the tools to do the job, rather than allowing market forces to prevail, long-term approach of problems resolved, resolution that would encourage the insurance market to react responsibly under clearly defined rules, under a long-term strategy that would temper the disruptive gyrations of the socalled insurance cycle.

I strongly believe we have to take a position, no matter what the industry says and others too—the public will no longer tolerate these cycles. That is why we enacted legislation in every form to mitigate extreme swings up and down. To make insurance available, the Legislature of New York allowed municipalities to form state-wide reciprocal insurers which hold the promise of providing necessary coverage at the lowest possible cost by eliminating the profit factor. These would be treated just like insurance companies and licensed by the Department to make sure of their solvency requirements; two, permits public entities and not-for-profit organizations to purchase insurance on a true-group basis; three, gives the Insurance Department authority to expand New York's Fair Plan, a joint underwriting association, to write additional essential property/casualty coverages if we determine meaningful coverage is unavailable—a new tool the superintendent has now to compel the industry after determination by the Department that certain lines are not available to compel them to write those lines in the future, and to protect insurance parties against arbitrary cancellation.

Now, to contain insurance prices, the legislature did some modest tort reform, changing our standard of review, reversal in lower court decisions from "shocks the conscience of the court" to "deviates materially from what would be reasonable compensation"; provides penalties for frivolous lawsuits, and after looking at these modest tort reforms, the industry was required to file with the Department a rate reduction properly reflecting the cost reduction.

Now all of these activities are the keystone to all of our action in the future, which is to strengthen Insurance Department resources, to address affordability concerns basically on the flex-rating system. Flex-rating establishes an innovative flexible rating system ("flex-rating") for commercial insurance rates. Flex-rating is a novel blending of prior approval and open competitive rating under which the Department establishes limitations on annual insurer rate level increases or decreases beyond which prior approval is required. Flex-rating is intended to minimize wide pricing swings in problem markets without sacrificing the insurance industry's ability to respond to market forces and conditions. The Department was also directed to review base rates implemented during the year prior to enactment of the legislation and to establish statistically-based rates wherever possible.

That basically means prior to establishing the flex-rating system, we make sure the base rate from which this system is keyed off of is not excessive and not inadequate.

And the legislature appropriated an additional $3 million for the Insurance Department to provide for enhanced human and computer resources needed to implement the new legislation, all costs to recover from the insurance industry assessment, no cost to taxpayers or policyholders, bringing our total budget to, as I said previously, nearly $50 million.

Now, it is my belief regarding the tort reform issue that the industry destroyed its credibility with its obsessive discussion about tort reform. I was amazed, no matter what hearings we had and what discussion, the industry could not come forward and say we were part of the problem. For that reason, it was very difficult to deal with them especially. They seemed to only be able to calculate hysteria and couldn't seem to give us good commitments on calculations on suggested tort reform.

To date, the Department has issued approximately 16 new major regulations based on the new tort, the new flex-rating system, and we are presently reviewing those submissions.

With respect to rate reductions mandated on the New York legislation to reflect anticipated savings, I believe they have ranged from about 3 percent to 20 percent reduction in commercial rates, a typical reduction being about 7 percent.

Right now we are viewing approximately 1,800 filings on that. We believe we have the resources to do so. That was part of the overall upgrading of the Department's data collection. We have in the testimony some extensive statements about what we are doing in data collection, and I agree with Ken, that that is key. I think we are meeting that challenge right now.

All indications to date are the crisis and availability of essential insurance coverage in New York has eased considerably, although there continues to be a few pockets of availability, problems which we now have the power to address through JUA as we see fit. This year there were many difficult risks, such as the Coney Island Cyclone, which is an interesting story because when that entity couldn't get insurance, and we found out the potential insurance was bogus, they were more annoyed at the Department finding that out. They simply wanted the insurance, couldn't care less whether there was adequate coverage.

We are making sure now the types of insurance people get are real insurance so the third-party victims don't become wards of the State. That we will be discussing with the Commerce Department in the future. We have serious concerns about risk retention.

Right now we see there has been stabilizing in the market, there are right now new mechanisms to which we can respond and we look forward to working with Congress, and I think these oversight hearings are very constructive for all of us. I think in total we are very proud of what we have done in New York and with the NAIC, and we can look forward to a new evolving issue.

Now, on evolving issues, there are new and more dynamic accelerations going on all over in insurance. I am very concerned with the investment junk bonds, life insurance portfolios, the NAIC model bill on financial guaranty insurance. The same fine group of people who really got us into the insurance crisis are going down the road to credit-worthiness of corporate America. NAIC has already anticipated and responded to that and is suggesting legislation nationally.

We are also responding to the question about and the concerns on junk bonds. I think the NAIC is an organization that is anticipating problems, responding beforehand, and there has been a tremendous acceleration in growth, and we look forward to working with Congress. I think the dialogue we will have will be very constructive.

[Testimony resumes on p. 59.]

[The statement of Mr. Corcoran follows:]

REMARKS OF SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK

JAMES P. CORCORAN

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON ENERGY AND COMMERCE

SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION AND COMPETITIVENESS

INTRODUCTION

GOOD MORNING. MY NAME IS JAMES P. CORCORAN. I AM SUPERINTENDENT OF INSURANCE FOR THE STATE OF NEW YORK. I APPRECIATE YOUR INVITATION TO APPEAR TODAY AND WISH TO THANK CHAIRMAN FLORIO AND THE MEMBERS OF THE SUBCOMMITTEE FOR THIS OPPORTUNITY.

MY REMARKS TODAY ARE MADE PRIMARILY ABOUT, AND ON BEHALF OF, NEW YORK. YOU HAVE ASKED FOR MY VIEWS ON THE CURRENT STATUS OF THE INSURANCE BUSINESS AND THE REGULATION OF THAT BUSINESS IN MY STATE.

ON BALANCE THE INSURANCE BUSINESS IN NEW YORK, WITH OVER 1100 LICENSED INSURERS OR ACCREDITED INSURANCE ORGANIZATIONS, INCLUDING OVER 600 PROPERTY/CASUALTY INSURERS, IS HEALTHY, WELL-REGULATED (BY A STAFF OF 750 EMPLOYEES), AND PROVIDES ESSENTIAL INSURANCE COVERAGES TO THE PEOPLE AND BUSINESSES OF MY STATE. RATHER THAN CONCENTRATE ON THE NUMEROUS REGULATORY ACTIVITIES THE NEW YORK INSURANCE DEPARTMENT IS ENGAGED IN, I BELIEVE IT WILL BE MORE USEFUL TO THE SUBCOMMITTEE IF I LIMIT MY REMARKS TODAY TO THE RECENT LIABILITY INSURANCE CRISIS, WHICH THREATENED BUSINESS AND GOVERNMENT IN OUR STATE AND TAXED THE RESOURCES OF MY DEPARTMENT. THE NEW YORK EXPERIENCE MAY BE USEFUL IN ILLUSTRATING HOW A STATE CAN RESPOND, RESPONSIBLY, TO ITS PROBLEMS.

EACH STATE MUST REVIEW ITS OWN MARKET CONDITIONS, CHOOSE ITS OWN SOLUTIONS AND CAREFULLY MONITOR THE PROGRESS OF THE INSURANCE BUSINESS, MAKING APPROPRIATE REGULATORY CORRECTIONS AS SOON AS THEIR NEED BECOMES EVIDENT. THAT DOES NOT MEAN THAT STATES CANNOT LEARN FROM EACH OTHER. I SHOULD ADD THAT THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC) IS AN INCREASINGLY EFFECTIVE AGENT FOR THIS KIND OF INTERSTATE COOPERATION. INNOVATIVE METHODS OF ONE STATE CAN BE EVALUATED BY OTHER STATES, WITH THE NAIC SERVING AS AN INVALUABLE FORUM FOR THE EXCHANGE AND COMMUNICATION OF IDEAS AND INFORMATION CRITICAL TO SOUND REGULATION.

HOW THE CRISIS AROSE

WHILE ALMOST EVERYONE AGREES THAT THERE HAS BEEN A LIABILITY INSURANCE CRISIS, THERE IS NO CONSENSUS ON ITS PRECISE CAUSES. MY PERSONAL BELIEF CONTINUES TO BE THAT A PRINCIPAL CAUSE OF THE CRISIS WAS THE UNDERPRICING OF LIABILITY COVERAGES WRITTEN IN THE LATE 1970'S AND EARLY 1980'S WHEN SHORT-SIGHTED INSURERS SOUGHT TO OBTAIN THE MAXIMUM AMOUNT OF CASH. THIS MONEY WAS THEN INVESTED AT HISTORICALLY HIGH INTEREST RATES IN THE HOPE AND BELIEF THAT THE ADDITIONAL INVESTMENT INCOME WOULD MORE THAN OFFSET LOSSES FROM UNDERWRITING. WHEN INTEREST RATES PLUMMETED, WHILE INSURANCE LOSS COSTS SURGED, INSURERS SUFFERED LOSSES IN CAPACITY AND RESPONDED BY RAISING PRICES DRAMATICALLY AND BY RESTRICTING AVAILABILITY. DURING THIS PERIOD TOO MANY INSURERS WERE IRRESPONSIBLE AND TOO OFTEN BEHAVED IN IRRATIONAL WAYS. UNDER A PURELY COMPETITIVE SYSTEM GONE AMOK, EVEN THE LARGEST AND MOST RESPONSIBLE INSURANCE COMPANIES PROVED POWERLESS TO ACT PRUDENTLY OR PROFITABLY. RATHER THAN TOO LITTLE COMPETITION AS THE CAUSE OF THE CRISIS, ANALYSIS REVEALS THERE WAS INTENSE COMPETITION.

ANOTHER CAUSE OF THE CRISIS WAS SUGGESTED IN THE REPORT OF THE TORY POLICY WORKING GROUP OF THE U.S. ATTORNEY GENERAL'S OFFICE, WHICH CONCLUDED THAT "... OVER THE PAST DECADE THERE HAS BEEN A VERITABLE EXPLOSION OF TORY LIABILITY IN THE UNITED STATES." SUPPORTERS OF THIS VIEW CITE THE SHIFT IN SOME AREAS TOWARD VIRTUAL NO-FAULT LIABILITY, A DRAMATIC GROWTH OF DAMAGE AWARDS IN TORT LAWSUITS AND AN INCREASE IN RECOVERIES THROUGH EXPANSION OF THE DOCTRINE OF JOINT AND SEVERAL LIABILITY.

ALL OF THESE CONCLUSIONS ABOUT THE ONIGINS OF THE PROBLEM ARE CONSISTENT WITH THOSE REACHED BY NEW YORK'S JONES COMMISSION, APPOINTED BY GOVERNOR MARIO M. CUOMO IN JANUARY 1986 TO STUDY THE LIABILITY INSURANCE CRISIS.

THE QUESTION HAS BEEN ASKED WHETHER ANYTHING COULD HAVE BEEN DONE BY GOVERNMENT TO RAVE STOPPED THE CRISIS BEFORE IT BEGAN, DURING THE PERIOO WHEN INSURERS FIRST BEGAN CHARGING INADEQUATE RATES. IN HINDSIGHT, IT APPEARS TO ME THAT A NUMBER OF FORCES AND CONDITIONS PREVENTED REGULATONS FROM TAKING AN ANTICIPATORY APPROACH -

1. THE DOWNWARD SLIDE IN PRICES OOINCIDED WITH THE DOMINATING NATIONAL PHILOSOPHY OF DEREGULATION - POPULARLY SOLD AS GETTING GOVERNMENT OFF BUSINESS'S BACK.

2. THERE WAS AND CONTINUES TO BE LITTLE PUBLIC OR LEGISLATIVE UNDERSTANDING THAT INADEQUATE RATES CAN ULTIMATELY PROVE TO BE JUST AS HARMFUL AS EXCESSIVE RATES.

3. NO LEGISLATURE WOULD SERIOUSLY CONSIDER A REGULATOR'S REQUEST FOR EXPANDED AUTHORITY TO ORDER INSURER RATE INCREASES WHICH WOULD, IN SOME INSTANCES, HAVE DOUBLED RATES.

4. THE PROBLEM OF HATE INADEQUACY AROSE IN COMMERCIAL LINES COVERAGES WHERE BOTH PARTIES TO THE INSURANCE TRANSACTIOR WERE BELIEVED TO BE SOPHISTICATED PARTIES WHO DESIRED NO GOVERNMENTAL INTERVENTION.

5. THE ONLY ALTERNATIVE LEFT TO THE REGULATOR WAS A CASE-BY-CASE REVIEW OF FILED RATES ARD THEIR SUPPORTING INFORMATION. IN NEW YORK, AS FAR BACK AS 1981, WE ESTABLISHED A "CASH FLOW UNDERWRITING" TASK FORCE WITHIN THE INSURANCE DEPARTMENT TO INVESTIGATE SOME OF THE MORE EGREGIOUS EXAMPLES OF UNDERPRICING. AS A RESULT, DURING THE PERIOD 1982-1986 WE FINED 31 COMMERCIAL LIABILITY INSURERS OVER $850,000 FOR UNDERCHARGING THEIR INSUREDS. HOWEVER, WITH SOME 30,000 INDIVIDUAL RISK FILINGS MADE ANNUALLY, TO HAVE STOPPED THE DOWNSLIDE IN RATES THROUGH THE USE OF SUCH ADMINISTRATIVE PROCEEDINGS WOULD HAVE REQUIRED GREATER RESOURCES THAN ARE AVAILABLE TO GOVERNMENT AGENCIES ARD WOULD HAVE BEEN THE MOST UNPOPULAR SERIES OF ACTS EVER COMMITTED BY AN INSURANCE REGULATOR.

AS I READ THE CURRENT CONGRESSIONAL MOOD, IT IS ONE THAT FAVORS INCREASING COMPETITION AMONG INSURERS. WHAT BROUGHT ABOUT THE INADEQUATE RATES WHICH IN TURN LED TO THE CRISIS WAS THE HIGH LEVEL OF CUT-THROAT, UNFAIR AND DESTRUCTIVE INSURER COMPETITION, BASED UPON A COMPULSIVE URGE TO INCREASE MARKET SHARE.

AMONG THE THEORIES WHICH NAVE CIRCULATED TO EXPLAIN THE CRISIS IS ONE THAT ALLEGES A CONSPIRACY AMONG INSURERS TO DEFRAUD THE AMERICAN PEOPLE BY BANDING TOGETHER TO INCREASE RATES TO UNSUPPORTABLE AND UNCONSCIONABLE LEVELS. NOW I

KNOW THAT CONSPIRACY THEORIES TEND TO CAPTURE THE PUBLIC'S ATTENTION. HOWEVER, FOR THE EXPLANATION OF THE LIABILITY CRISIS TO REST UPON A CONSPIRACY WOULD INVOLVE THE FOLLOWING INGENIOUS SCHEME:

> PROPERTY/CASUALTY INSURERS, BEGINNING IN THE LATE 1970'S, CONSPIRED TO LOWER THEIR RATES TO SUCH INADEQUATE LEVELS AS TO ENABLE THEM TO STEAL EACH OTHER'S BUSINESS AND THUS GO ON TO LOSE SO MUCH MONEY THAT THEY WOULD THEN BE ABLE BOTH TO RAISE THEIR RATES TO OUTRAGEOUS LEVELS NO ONE COULD AFFORD AND AT THE SAME TIME TO WITHDRAW FROM THE INSURANCE MARKET SO THEY WOULD MAKE NO MONEY AT ALL.

A MORE LOGICAL EXPLANATION OF INSURERS' BEHAVIOR IS THAT THEY ARE NO WISER THAN OTHER BUSINESS PEOPLE IN THIS COUNTRY WHO FIND IT HARD TO SEE BEYOND THE NEXT QUARTER'S EARNINGS AND WHO FAIL TO APPRECIATE THAT INTEREST RATES THAT RISE TO HISTORIC LEVELS WILL SOMEDAY DROP.

NEW YORK'S FIRST RESPONSES TO THE CRISIS

AS REPORTS CAME TO MY DEPARTMENT OF THE INCREASING UNAVAILABILITY AND UNAFFORDABILITY OF MANY LIABILITY COVERAGES, OUR FIRST RESPONSE WAS TO USE THE INFLUENCE OF THE DEPARTMENT TO ASSIST PERSONS AND BUSINESSES IN NEED OF INSURANCE. WE FORMALIZED THIS PROCESS BY ESTABLISHING A TELEPHONE HOTLINE FOR COMMERCIAL LIABILITY COVERAGES IN JANUARY 1986. THE HOTLINE WAS STAFFED BY KNOWLEDGEABLE DEPARTMENT EXAMINERS WHO HAD COMPILED A LISTING OF INSURERS (BASED UPON AVAILABILITY SURVEYS OF THE VARIOUS PROBLEM MARKETS) THAT EXPRESSED A WILLINGNESS TO ACCEPT INSUREDS MEETING THEIR UNDERWRITING STANDARDS. IN THE 17 MONTHS SINCE ITS INCEPTION, THE DEPARTMENT HAS RESPONDED TO SOME 5,000 HOTLINE CALLS.

FOR MARKETS WHERE FEW CARRIERS EXPRESSED A WILLINGNESS TO WRITE BUSINESS, THE DEPARTMENT ESTABLISHED MARKET ASSISTANCE PROGRAMS (MAPS). FOR EACH MAP, THE DEPARTMENT CALLED TOGETHER RESPONSIBLE INSURANCE CARRIERS AND PRODUCERS WHO, IN VOLUNTARY COOPERATION UNDER DEPARTMENT AUSPICES, AGREED TO ACCEPT THESE HARD-TO-PLACE RISKS. FOUR SUCH CUSTOMIZED MAPS HAVE BEEN ESTABLISHED:

— A MUNICIPAL MAP FOR PUBLIC ENTITIES;

— A POLICE PROFESSIONAL MAP FOR LOCAL POLICE FORCES;

— A COMMUNITY SERVICES MAP FOR CHILD-CARE AND NON-PROFIT ACTIVITIES; AND

— A MISCELLANEOUS GENERAL LIABILITY MAP FOR SMALL BUSINESSES, RECREATIONAL ACTIVITIES AND START-UP ENTERPRISES.

AS AN EXAMPLE OF THE SUCCESS OF THIS INITIATIVE, SINCE THE MUNICIPAL MAP WAS ESTABLISHED OVER 300 NEW YORK PUBLIC ENTITIES HAVE OBTAINED INSURANCE THROUGH ITS AUSPICES.

CONCURRENT WITH THESE EFFORTS, GOVERNOR CUOMO ESTABLISHED THE JONES COMMISSION, CHAIRED BY A DISTINGUISHED FORMER ASSOCIATE JUDGE OF NEW YORK'S HIGHEST COURT AND WHOSE MEMBERS INCLUDED MYSELF AND THE FULL SPECTRUM OF CIVIC, LEGISLATIVE, CONSUMER, BUSINESS AND INSURANCE LEADERS. THE COMMISSION ISSUED TWO SCHOLARLY YET REAL WORLD REPORTS THAT ANALYZED THE CAUSES OF THE CRISIS AND MADE EXTENSIVE LONG TERM RECOMMENDATIONS FOR OVERCOMING EXISTING PROBLEMS AND PREVENTING THEIR RECURRENCE. MANY OF THESE RECOMMENDATIONS FORMED THE BASIS FOR THE OMNIBUS PROGRAM (DISCUSSED BELOW) ENACTED BY THE NEW YORK STATE LEGISLATURE WITHIN 3 MONTHS OF THE ISSUANCE OF THE FIRST REPORT.

GOVERNOR CUOMO WAS PARTICULARLY CONCERNED ABOUT ALLEGATIONS OF AN INSURER CONSPIRACY TO WITHHOLD ESSENTIAL INSURANCE COVERAGES UNTIL MAJOR "TORT REFORMS" DESIRED BY INSURERS WERE ENACTED. AS A RESULT OF THE GOVERNOR'S CONCERN, I CONDUCTED A THOROUGH INVESTIGATION, INCLUDING IN-DEPTH

INTERROGATIONS UNDER OATH OF THE TOP OFFICERS (INCLUDING CEO'S) FROM THE LARGEST COMMERCIAL LIABILITY INSURANCE CARRIERS, THE PRINCIPAL RATE ADVISORY ORGANIZATION (INSURANCE SERVICES OFFICE), LEADING INSURANCE BROKERS AND MAJOR REINSURERS. THE INVESTIGATIOR, AS DID THE JONES COMMISSION, PRODUCED NO EVIDENCE OF ARY CONSPIRACY TO LOWER PRICES, TO RAISE PRICES, TO CLOSE MARKETS OR TO OTHERWISE VIOLATE NEW YORK'S INSURANCE ARTI-TRUST STATUTE. THE INVESTIGATION ALSO PRODUCED NO EVIDENCE THAT THE CRISIS WAS PRECIPITATED IN AN ATTEMPT TO FORCE "TORT REFORM" ON THE PUBLIC.

TO THE CONTRARY, SEVERAL WITNESSES RUEFULLY ADMITTED THAT THEY AND THEIR COMPANIES WERE GUILTY OF GROSS STUPIDITY BY INSISTING ON MAINTAINING THEIR MARKET SHARE WHILE FACING EVER MORE INADEQUATE RATE LEVELS. A NUMBER OF WITNESSES TESTIFIED THAT, WHEN THEY DID ATTEMPT (IN THE EARLY 1980'S) TO RESTORE RATES TO ADEQUATE LEVELS, THEIR MARKET SHARE FELL PRECIPITOUSLY. THEY COULD NOT MAINTAIN THEIR COMPETITIVE POSITION UNTIL THEY ROLLED BACK THEIR RATE INCREASES. IT WAS ONLY IN 1986, WHEN THE FULL IMPLICATIONS OF WHAT THE INDUSTRY WAS DOING TO ITSELF BECAME CLEAR, AND DIRECT INSURANCE AND REINSURANCE CAPACITY WAS DECIMATED DUE TO PRICE EROSION AND ADVERSE EXPERIENCE, THAT PRICE INCREASES WERE SUSTAINABLE, ESPECIALLY WHEN INSURERS SAW THEIR INVESTMENT INCOME DROP WITH THE THEN RAPIDLY FALLING INTEREST RATES.

NEW YORK'S LEGISLATIVE RESPONSE

WE REVIEWED ARD EVALUATED THE REPORT OF THE JONES COMMISSION, THE DEPARTMENT'S INVESTIGATION OF INSURER BEHAVIOR, THE INFORMATION FLOWING IN FROM OUR HOTLINE AND MAPS, AND OTHER STAFF ANALYSES OF THE ACTIVITIES OF PROPERTY/CASUALTY INSURERS, INCLUDING OUR CONTINUOUSLY UPDATED MARKET AVAILABILITY SURVEYS. AFTER CONSIDERING THE INFORMATION FROM ALL OF THESE

SOURCES, WE DEVELOPED A PROPOSAL FOR A PROMPT LEGISLATIVE RESPONSE TO THE AVAILABILITY AND AFFORDABILITY CRISIS.

OUR BROAD OBJECTIVES WERE TO DESIGN:

1. A BALANCED, RESPONSIBLE AND COMPREHENSIVE LEGISLATIVE PROGRAM THAT WOULD ADDRESS AND OVERCOME THE LIABILITY INSURANCE CRISIS;

2. A PHILOSOPHY OF POSITIVE AND CONSISTENT REGULATION, COUPLED WITH THE WILL TO REGULATE AND THE TOOLS TO DO THE JOB, RATHER THAN ALLOWING UNTRAMMELED MARKET FORCES TO PREVAIL;

3. A LONG-TERM APPROACH TO PROBLEM RESOLUTION THAT WOULD ENCOURAGE THE INSURANCE MARKET TO ACT RESPONSIBLY UNDER STABLE AND CLEARLY DEFINED RULES;

4. A SOLUTION WHOSE GOAL WAS, NOT TO PUNISH INSURERS FOR THEIR ANTI-SOCIAL BEHAVIOR, BUT RATHER TO CREATE A COMPETITIVE ENVIRONMENT IN WHICH THEY COULD EARN REASONABLE PROFITS AND THUS BE ENCOURAGED TO COMMIT THEIR CAPITAL TO NEW YORK'S INSURANCE NEEDS; AND

5. A NEW LONG-TERM STRATEGY TO REGULATE INSURER RATE SETTING THAT WOULD TEMPER THE HISTORICALLY WIDE, DANGEROUS AND DISRUPTIVE GYRATIONS OF THE SO-CALLED INSURANCE CYCLES.

INTERROGATIONS UNDER OATH OF THE TOP OFFICERS (INCLUDING CEO'S) FROM THE LARGEST COMMERCIAL LIABILITY INSURANCE CARRIERS, THE PRINCIPAL RATE ADVISORY ORGANIZATION (INSURANCE SERVICES OFFICE), LEADING INSURANCE BROKERS AND MAJOR REINSURERS. THE INVESTIGATION, AS DID THE JONES COMMISSION, PRODUCED NO EVIDENCE OF ANY CONSPIRACY TO LOWER PRICES, TO RAISE PRICES, TO CLOSE MARKETS OR TO OTHERWISE VIOLATE NEW YORK'S INSURANCE ANTI-TRUST STATUTE. THE INVESTIGATION ALSO PRODUCED NO EVIDENCE THAT THE CRISIS WAS PRECIPITATED IN AN ATTEMPT TO FORCE "TORT REFORM" ON THE PUBLIC.

TO THE CONTRARY, SEVERAL WITNESSES RUEFULLY ADMITTED THAT THEY AND THEIR COMPANIES WERE GUILTY OF GROSS STUPIDITY BY INSISTING ON MAINTAINING THEIR MARKET SHARE WHILE FACING EVER MORE INADEQUATE RATE LEVELS. A NUMBER OF WITNESSES TESTIFIED THAT, WHEN THEY DID ATTEMPT (IN THE EARLY 1980'S) TO RESTORE RATES TO ADEQUATE LEVELS, THEIR MARKET SHARE FELL PRECIPITOUSLY. THEY COULD NOT MAINTAIN THEIR COMPETITIVE POSITION UNTIL THEY ROLLED BACK THEIR RATE INCREASES. IT WAS ONLY IN 1985, WHEN THE FULL IMPLICATIONS OF WHAT THE INDUSTRY WAS DOING TO ITSELF BECAME CLEAR, AND DIRECT INSURANCE AND REINSURANCE CAPACITY WAS DECIMATED DUE TO PRICE EROSION AND ADVERSE EXPERIENCE, THAT PRICE INCREASES WERE SUSTAINABLE, ESPECIALLY WHEN INSURERS SAW THEIR INVESTMENT INCOME DROP WITH THE THEN RAPIDLY FALLING INTEREST RATES.

NEW YORK'S LEGISLATIVE RESPONSE

WE REVIEWED AND EVALUATED THE REPORT OF THE JONES COMMISSION, THE DEPARTMENT'S INVESTIGATION OF INSURER BEHAVIOR, THE INFORMATION FLOWING IN FROM OUR HOTLINE AND MAPS, AND OTHER STAFF ANALYSES OF THE ACTIVITIES OF PROPERTY/CASUALTY INSURERS, INCLUDING OUR CONTINUOUSLY UPDATED MARKET AVAILABILITY SURVEYS. AFTER CONSIDERING THE INFORMATION FROM ALL OF THESE

SOURCES, WE DEVELOPED A PROPOSAL FOR A PROMPT LEGISLATIVE RESPONSE TO THE AVAILABILITY AND AFFORDABILITY CRISIS.

OUR BROAD OBJECTIVES WERE TO DESIGN:

1. A BALANCED, RESPONSIBLE AND COMPREHENSIVE LEGISLATIVE PROGRAM THAT WOULD ADDRESS AND OVERCOME THE LIABILITY INSURANCE CRISIS;

2. A PHILOSOPHY OF POSITIVE AND CONSISTENT REGULATION, COUPLED WITH THE WILL TO REGULATE AND THE TOOLS TO DO THE JOB, RATHER THAN ALLOWING UNTRAMMELED MARKET FORCES TO PREVAIL;

3. A LONG-TERM APPROACH TO PROBLEM RESOLUTION THAT WOULD ENCOURAGE THE INSURANCE MARKET TO ACT RESPONSIBLY UNDER STABLE AND CLEARLY DEFINED RULES;

4. A SOLUTION WHOSE GOAL WAS, NOT TO PUNISH INSURERS FOR THEIR ANTI-SOCIAL BEHAVIOR, BUT RATHER TO CREATE A COMPETITIVE ENVIRONMENT IN WHICH THEY COULD EARN REASONABLE PROFITS AND THUS BE ENCOURAGED TO COMMIT THEIR CAPITAL TO NEW YORK'S INSURANCE NEEDS; AND

5. A NEW LONG-TERM STRATEGY TO REGULATE INSURER RATE SETTING THAT WOULD TEMPER THE HISTORICALLY WIDE, DANGEROUS AND DISRUPTIVE GYRATIONS OF THE SO-CALLED INSURANCE CYCLES.

THE OMNIBUS BILL WHICH WE FASHIONED AFTER EXTENSIVE DISCUSSIONS WITH LEGISLATIVE LEADERS AND THE GOVERNOR'S OFFICE TRANSLATES THESE OBJECTIVES INTO THE SPECIFIC GOALS OF ENHANCING AVAILABILITY, OF CONTAINING INSURANCE PRICES, AND OF STRENGTHENING THE INSURANCE DEPARTMENT BY GIVING US THE ADDITIONAL RESOURCES NECESSARY TO MONITOR AND CONTROL THE INSURANCE BUSINESS MORE EFFECTIVELY.

TO MAKE INSURANCE MORE AVAILABLE, OUR LEGISLATION:

1. ALLOWS MUNICIPALITIES, SCHOOL DISTRICTS ARD OTHER PUBLIC ENTITIES TO ORGANIZE ARD SUBSCRIBE TO THEIR OWN STATE-WIDE RECIPROCAL INSURERS, WHICH HOLDS THE PROMISE OF PROVIDING NECESSARY COVERAGES AT THE LOWEST POSSIBLE COST BY ELIMINATING THE PROFIT FACTOR ARD BY REDUCING LOSSES THROUGH REGUIRED RISK MANAGEMENT PROGRAMS;

2. PERMITS PUBLIC ENTITIES AND NOT-FOR-PROFIT ORGANIZATIONS TO PURCHASE INSURANCE ON A TRUE-GROUP BASIS;

3. GIVES THE INSURANCE DEPARTMENT AUTHORITY TO EXPAND NEW YORK'S FAIR PLAN, A JOINT UNDERWRITING ASSOCIATION, TO WRITE ADDITIONAL ESSENTIAL PROPERTY/CASUALTY COVERAGES IF WE DETERMINE MEANINGFUL COVERAGE IS UNAVAILABLE IN THE VOLUNTARY INSURANCE MARKET; AND

4. PROTECTS COMMERCIAL INSURANCE BUYERS AGAINST ARBITRARY CANCELLATION AND NON-RENEWAL OF THEIR COVERAGES.

TO CONTAIN INSURANCE PRICES, OUR LEGISLATION:

1. MODIFIES, UNDER CERTAIN CIRCUMSTANCES, THE DOCTRINE OF JOINT AND SEVERAL LIABILITY TO PROVIDE, WITH RESPECT TO NON-ECONOMIC DAMAGES SUCH AS PAIN AND SUFFERING, THAT A DEFENDANT FOUND TO BE NO MORE THAN 50% LIABLE IS GENERALLY RESPONSIBLE ONLY FOR A PROPORTIONATE, EQUITABLE SHARE OF THESE DAMAGES;

2. CHANGES OUR APPELLATE COURT STANDARD FOR REVERSAL OF A LOWER COURT DECISION FROM "SHOCK[S] THE CONSCIENCE OF THE COURT" TO "DEVIATES MATERIALLY FROM WHAT WOULD BE REASONABLE COMPENSATION", A CHANGE EXPECTED TO REDUCE THE NUMBER OF EXCESSIVE AWARDS;

3. REDUCES AWARDS IN TORT ACTIONS BY AMOUNTS RECOVERABLE FROM SPECIFIED COLLATERAL SOURCES, SUCH AS WORKERS' COMPENSATION AND HEALTH INSURANCE, TO PREVENT DUPLICATE RECOVERIES;

4. PROVIDES FOR PERIODIC PAYMENT OR STRUCTURED AWARDS OF DAMAGES WHERE FUTURE LOSSES EXCEED $250,000, RATHER THAN FOR LUMP-SUM PAYMENT;

5. PROVIDES FOR A PENALTY OF UP TO $10,000 IF A COURT DETERMINES THAT A TORT ACTION OR DEFENSE WAS BEGUN OR HAS BEEN CONTINUED FRIVOLOUSLY;

6. IMMUNIZES UNCOMPENSATED DIRECTORS AND OFFICERS OF NOT-FOR-PROFIT CORPORATIONS FROM LIABILITY, OTHER THAN FOR GROSS NEGLIGENCE OR INTENTIONAL HARM; AND

7. REQUIRES INSURERS TO FILE NEW RATES THAT PROPERLY REFLECT THE COST-REDUCTIVE EFFECTS ATTRIBUTABLE TO THESE VARIOUS TORT CHANGES.

TO STRENGTHEN THE INSURANCE DEPARTMENT'S RESOURCES TO ADDRESS AVAILABILITY AND AFFORDABILITY CONCERNS, OUR LEGISLATION:

1. ESTABLISHES AN INNOVATIVE FLEXIBLE RATING SYSTEM ("FLEX-RATING") FOR COMMERCIAL INSURANCE RATES. FLEX-RATING IS A NOVEL BLENDING OF PRIOR APPROVAL AND OPEN COMPETITIVE RATING, UNDER WHICH THE DEPARTMENT ESTABLISHES LIMITATIONS OR ANNUAL INSURER RATE LEVEL INCREASES OR DECREASES BEYOND WHICH PRIOR APPROVAL IS REQUIRED. FLEX-RATING IS INTENDED TO MINIMIZE WIDE PRICING SWINGS IN PROBLEM MARKETS, WITHOUT SACRIFICING THE INSURANCE INDUSTRY'S ABILITY TO RESPOND TO MARKET FORCES AND CONDITIONS. THE DEPARTMENT WAS ALSO DIRECTED TO REVIEW BASE RATES IMPLEMENTED DURING THE YEAR PRIOR TO ENACTMENT OF THE LEGISLATION AND TO ESTABLISH STATISTICALLY-BASED RATES WHEREVER POSSIBLE;

2. REQUIRES INSURERS TO FURNISH THE DEPARTMENT WITH DETAILED PREMIUM AND LOSS INFORMATION ON SPECIFIED LINES AND CLASSES OF LIABILITY INSURANCE. THE DEPARTMENT WILL

REPORT TO THE GOVERNOR AND THE LEGISLATURE ANNUALLY, COMMENCING IN 1988, WITH RECOMMENDATIONS FOR FURTHER STATUTORY AND ADMINISTRATIVE CHANGES DESIGNED TO REDUCE OR CONTAIN INSURANCE COSTS;

3. APPROPRIATES AN ADDITIONAL $3 MILLION FOR THE INSURANCE DEPARTMENT, TO PROVIDE FOR THE ENHANCED HUMAN AND COMPUTER RESOURCES NEEDED TO IMPLEMENT THE NEW LEGISLATION (WITH ALL COSTS TO BE RECOVERED FROM INSURANCE INDUSTRY ASSESSMENTS), BRINGING OUR TOTAL BUDGET FOR 1987/88 TO NEARLY $50 MILLION.

ALTHOUGH INSURERS AND REINSURERS CAMPAIGNED VIGOROUSLY THROUGHOUT THE COUNTRY FOR MUCH MORE DRASTIC "REFORMS" IN THE TORT LAWS, GOVERNOR CUOMO RESISTED EFFORTS TO ESTABLISH A DOLLAR CEILING OR "CAP" ON RECOVERIES FOR PAIN AND SUFFERING AND TO IMPOSE OTHER CUTBACKS ON VICTIMS' RIGHTS OF RECOVERY. NEW YORK'S POSITION IS BASED ON THE PHILOSOPHY THAT HISTORICAL, COMMON LAW TORT RIGHTS MAY BE ABROGATED ONLY WHERE:

-- PUBLIC POLICY CONSIDERATIONS AND BENEFITS ARE SO POWERFUL AS TO CLEARLY OUTWEIGN THE LOSS OF VICTIMS' RIGHTS;

-- THERE IS A DETERMINABLE RATE REDUCTION AND ASSURANCE OF FULL AVAILABILITY;

-- ALL MEASURES TO LOWER COSTS THROUGH ENHANCED RISK MANAGEMENT PROGRAMS HAVE FAILED; AND, FINALLY,

-- THERE IS NO OTHER VIABLE ALTERNATIVE.

IT IS MY BELIEF THAT THE INSURANCE INDUSTRY HAS BEEN DESTROYING ITS CREDIBILITY WITH ITS OBSESSIVE, CONTINUAL PUSH FOR "TORT REFORM" AS THE PANACEA TO ITS PROBLEMS. WHEN ASKED TO PUT A PRICE ON THE REDUCTIVE VALUE OF THESE "REFORMS", THE INDUSTRY HAS NO ANSWER. SOMEHOW, INSURERS CAN CALCULATE THE PRICE OF HYSTERIA BUT THEY CAN'T CALCULATE THE EFFECT OF TORT REFORM.

OUR EXPERIENCE WITH THE NEW LEGISLATION

AT THIS TIME, IT IS TOO EARLY TO DRAW FINAL CONCLUSIONS ABOUT THE DEGREE OF SUCCESS OF THE NEW YORK APPROACH IN MITIGATING THE EFFECTS OF THE LIABILITY CRISIS AND IN PREVENTING ITS RECURRENCE. IT WILL TAKE CONSIDERABLE TIME UNDER THE NEW LEGISLATION FOR CLAIMS TO OCCUR AND CASES TO BE BROUGHT, HEARD AND SETTLED. IT WILL ALSO TAKE TIME TO HIRE AND TRAIN NEW PERSONNEL, TO DEVELOP REFINED STATISTICAL PROGRAMS, TO AUTOMATE REPORTING AND TRACKING SYSTEMS, TO ESTABLISH AND IMPLEMENT REGULATIONS AND TO MONITOR INSURER ACTIVITIES THROUGH STEPPED UP MARKET CONDUCT INVESTIGATIONS.

LET ME, HOWEVER, REPORT ON WHAT WE HAVE DONE TO DATE. AS I INDICATED EARLIER, OUR BUDGET WAS INCREASED BY $3 MILLION TO SUPPLEMENT OUR EXAMINER STAFF AND IMPROVE OUR DATA PROCESSING CAPABILITIES. OUR PROPERTY AND CASUALTY BUREAU, WHICH IS PRIMARILY RESPONSIBLE FOR THE RATES, FORMS AND MARKET CONDUCT OF PROPERTY/CASUALTY INSURERS (THEIR SOLVENCY IS THE RESPONSIBILITY OF ANOTHER BUREAU), WAS AUTHORIZED TO HIRE 78 NEW PEOPLE, MOST OF THEM EXAMINERS AND OTHER PROFESSIONALS. SO FAR, IN ACCORDANCE WITH NEW YORK'S COMPETITIVE CIVIL SERVICE PROCEDURES, 50 PERSONS HAVE BEEN HIRED, 40 OF THEM EXAMINERS. ONE

REASON THE POSITIONS HAVE NOT ALL BEEN FILLED IS THAT, AS WITH EVERY BRANCH OF GOVERNMENT, IT IS DIFFICULT TO RECRUIT QUALIFIED PERSONS WITH AN ACCOUNTING OR ACTUARIAL BACKGROUND.

EVENTUALLY, OUR MARKET CONDUCT EXAMINATION STAFF WILL BE EXPANDED FROM 9 TO 40 EXAMINERS, WITH 11 OR 12 TEAMS OF 3 EXAMINERS EACH DOING FIELD INVESTIGATIONS TO TEST AND VERIFY COMPLIANCE. SUPERVISION OF THE FLEX-RATING SYSTEM WILL BE LARGELY HANDLED IN OUR OFFICE WITH A STAFF OF 40, INCLUDING 2 ACTUARIES. WE EXPECT THAT 4 PEOPLE WILL BE ASSIGNED ON A FULL-TIME BASIS TO REVIEW SO-CALLED "A-RATE" FILINGS, WHICH INVOLVE EVALUATION OF JUDGMENT RATES FOR INDIVIDUAL SPECIAL RISKS. AN ELABORATE IN-HOUSE TRAINING PROGRAM FOR OUR STAFF HAS BEGUN. ULTIMATELY, THE NUMBER OF PEOPLE IN THE BUREAU WILL REACH 125, ALMOST TRIPLE THE NUMBER BEFORE ENACTMENT OF THE OMNIBUS LEGISLATION.

THE DEPARTMENT HAS ISSUED, OR IS IN THE PROCESS OF PROMULGATING, SOME 16 MAJOR REGULATIONS OR AMENDMENTS OF EXISTING REGULATIONS, ALL DESIGNED TO IMPLEMENT OUR NEW SYSTEMS. THESE REGULATIONS TREAT SUCH MATTERS AS FLEX-RATING, INCREASED STATISTICAL REPORTING REQUIREMENTS, GROUP INSURANCE, LIMITATIONS ON CANCELLATION AND NON-RENEWAL, RULES FOR INDIVIDUAL RISK SUBMISSIONS ("A-RATES"), TREATMENT OF DEFENSE COSTS AND STANDARDS FOR CLAIMS-MADE COVERAGES.

WITH RESPECT TO RATE REDUCTIONS MANDATED UNDER THE NEW YORK LEGISLATION TO REFLECT ANTICIPATED SAVINGS DUE TO TORT MODIFICATIONS, THE DEPARTMENT NOTIFIED ALL PROPERTY/CASUALTY INSURERS OF ITS RECOMMENDATIONS FOR RATE REDUCTIONS IN THE VARIOUS LIABILITY INSURANCE SUBLINES. THESE RANGED FROM 3% TO 20%, WITH A TYPICAL REDUCTION OF 7%. WITH A FEW MINOR EXCEPTIONS, INSURERS HAVE ADOPTED

THE DEPARTMENT RECOMMENDATIONS IN THE MORE THAN 1800 FILINGS REQUIRED UNDER THE STATUTE.

UNDER FLEX-RATING, SINCE OCTOBER 1, 1988, THE DEPARTMENT HAS ALREADY RECEIVED OVER 400 COMMERCIAL FILINGS, INCLUDING COMMERCIAL AUTOMOBILE AND COMMERCIAL MULTIPLE PERIL FILINGS. FEWER THAN 5% OF THESE THUS FAR HAVE EXCEEDED OUR FLEX-BANDS, MOSTLY ON THE UPSIDE.

THE RULES FOR INDIVIDUAL RISK RATING PLANS UTILIZED BY INSURERS HAVE ALSO BEEN TIGHTENED CONSIDERABLY. AS A RESULT, THE NEW INSURER RATING PLANS MOST BE APPROVED BY THE DEPARTMENT AND RATING PLAN CRITERIA MUST BE OBJECTIVE AND APPLIED IN A NON-DISCRIMIHATORT MANNER. INSURER FILES MUST DOCUMENT CLEARLY THE COMPLETE BASIS AND OBJECTIVE EVIDENCE FOR A PREMIUM MODIFICATION, AND MAXIMUM DEBIT OR CREDIT SWINGS IN SCHEDULED RATING PLANS HAVE BEEN LIMITED TO 25% IN THE AGGREGATE. IN THE PAST, THESE SWINGS EXCEEDED 40% AND WERE OFTEN USED TO COMPETE UNFAIRLY. OUR EXPANDED MARKET CONDUCT EXAMINER FORCE WILL BE CONDUCTING INVESTIGATIONS TO ENFORCE COMPLIANCE WITH THE NEW RULES.

AS PART OF THE OVERALL UPGRADING OF THE DEPARTMENT'S DATA COLLECTION AND ANALYSIS CAPABILITIES, WE HAVE:

-- HIRED 15 ADDITIONAL PEOPLE TO STAFF THE INSURANCE REGULATORT SYSTEMS BUREAU (EDP);

-- CONDUCTED EXTENSISVE IN-HOUSE CONFERENCES TO DETERMINE DATA AND DATA REPORTING NEEDS FOR MONITORING RATES, FORMS, COVERAGES, SOLVENCY AND MARKET CONDUCT OF INSURERS, AND THE LICENSING OF BROKERS AND AGENTS;

-- ACQUIRED OUR OWN MAINFRAME COMPUTER TO INCREASE DATA PROCESSING CAPACITY BEYOND WHAT WAS AVAILABLE THROUGH SHARING TIME WITH OTHER USERS OF NEW YORK STATE'S CENTRALIZED COMPUTER FACILITY;

-- UPGRADED OUR PROPERTY AND CASUALTY INTERACTIVE FILINGS, INQUIRIES AND COMPLAINTS (PACIFIC) SYSTEM, WHICH, AMONG ITS SEVERAL FUNCTIONS, TRACKS VIA COMPUTER DETAILED INFORMATION ON RATE FILINGS MADE WITH OUR PROPERTY AND CASUALTY BUREAU;

-- BEGUN EXTENSIVE EFFORTS TO DEVELOP AN INTEGRATED DATA BASE, THROUGH THE NEWLY ACQUIRED MAINFRAME COMPUTER, THAT WILL ENABLE OUR EXAMINERS AND ACTUARIES TO HAVE, AT THEIR FINGERTIPS, THE KINDS OF DATA THEY NEED TO MAKE BETTER EVALUATIONS AND DECISIONS;

-- DESIGNED NEW REPORTING FORMS TO FACILITATE DATA CAPTURE OF REQUIRED INFORMATION;

-- IMPROVED OUR ABILITY TO ESTIMATE THE COST-REDUCTIVE EFFECT OF FURTHER PROPOSED MODIFICATIONS IN THE TORT LIABILITY SYSTEM;

-- PROVIDED FOR OBTAINING IMPORTANT NEW DETAILED INFORMATION ON EMERGING PROBLEM AREAS AND ON SUCH DIFFICULT MARKETS AS MUNICIPAL LIABILITY, PUBLIC SCHOOL LIABILITY AND CHILD CARE LIABILITY; AND

-- BECOME A MAIN FORCE BEHIND AN NAIC PROJECT AIMED AT SOLVING THE SEEMINGLY INSURMOUNTABLE PROBLEM OF CAPTURING, ON A TIMELY BASIS, THE MORE THAN 40,000 DATA ITEMS CONTAINED IN EACH INSURER'S ANNUAL STATEMENT.

ALL INDICATIONS TO DATE ARE THAT THE CRISIS IN AVAILABILITY OF ESSENTIAL INSURANCE COVERAGES IN NEW YORK HAS EASED CONSIDERABLY, ALTHOUGH THERE CONTINUE TO BE A FEW POCKETS OF CONTINUING UNAVAILABILITY. (COVERAGE FOR SOME SMALL, FAMILY DAY CARE PROVIDERS SEEMS TO BE A SPECIAL PROBLEM THAT WE ARE NOW ADDRESSING.) IN JULY 1986, THE DEPARTMENT RECEIVED A TOTAL OF 585 HOTLINE CALLS; THESE CALLS ARE NOW DOWN TO 125 PER MONTH. TELEPHONE REQUESTS FOR ASSISTANCE IN OBTAINING RECREATIONAL LIABILITY COVERAGE TOTALLED 83 IN MAY 1986 AND ONLY 12 IN MAY 1987. THIS YEAR, MANY DIFFICULT RISKS SUCH AS THE CONEY ISLAND "CYCLONE" WERE, UNLIKE LAST YEAR, ABLE TO PURCHASE INSURANCE IN THE VOLUNTARY MARKET. FOR SCHOOL DISTRICTS, WHERE THE MARKET HAD DRIED UP, COMPETITION AMONG INSURERS HAS BEEN RESTORED AND PRICES REDUCED.

AS NOTED EARLIER, THE NEW LEGISLATION GRANTS ME THE AUTHORITY TO ACTIVATE THE JOINT UNDERWRITING ASSOCIATION (JUA) TO WRITE PROBLEM COVERAGES FOR WHICH NO MEANINGFUL VOLUNTARY MARKET EXISTS. ON A NUMBER OF OCCASIONS, I PUBLICLY ADVISED THE INSURANCE INDUSTRY OF MY INTENTION TO ACTIVATE THE JUA FOR HARD-TO-PLACE COVERAGES. CONVINCED THAT I WAS SERIOUS (AND I MOST CERTAINLY WAS), THE INDUSTRY FOUND ENOUGH VOLUNTEERS TO CREATE A MARKET DIRECTLY OR THROUGH MAP PROGRAMS FOR THESE COVERAGES. AS A RESULT, THERE HAS BEEN NO NEED AS OF THIS DATE TO EXPAND THE JUA. THUS, THE MERE EXISTENCE OF THE AUTHORITY TO EXPAND THE JUA HAS SO FAR MADE INVOKING THAT AUTHORITY UNNECESSARY.

CONTEMPLATING THE LONG-TERM EFFECTS OF THE PROPERTY/CASUALTY CRISIS LEADS ME TO CONCLUDE THAT SOCIETY HAS NOT YET SEEN ALL OF ITS MANIFESTATIONS. NO

ONE HAS FULLY MEASURED THE AMOUNT OF INSURANCE BUSINESS THAT HAS BEEN, AT LEAST TEMPORARILY BUT POSSIBLY PERMANENTLY, LOST TO THE AMERICAN INSURANCE INDUSTRY. ANGRY AT AND FRUSTRATED BY THE IRRESPONSIBILITY OF INSURERS, AMERICAN BUSINESS NEVER AGAIN WANTS TO GO HAT-IN-HAND TO THE INSURANCE INDUSTRY ONLY TO BE SUMMARILY DENIED COVERAGES. THEREFORE, AMERICAN BUSINESS HAS LOOKED ELSEWHERE. WITH THE ASSISTANCE OF THE LARGEST BROKERS, WHO ALSO DO NOT EVER AGAIN WANT TO BE FACED WITH EVAPORATING MARKETS, BUSINESS HAS TURNED TO FOREIGN SOURCES, OR HAS ESTABLISHED ITS OWN OVERSEAS OR CAPTIVE INSURERS, OR HAS SELF-INSURED DIRECTLY. WHAT IS MOST TROUBLING, HOWEVER, IS THAT THE SOLVENCY OF THESE NEW MECHANISMS, WHICH GENERALLY LACK SECURITY FUND PROTECTIONS AND THE REGULATORY SCRUTINY OF THEIR FINANCIAL CONDITION THAT MY DEPARTMENT PROVIDES, MAY NOT WITHSTAND A SEVERE DOWNTURN IN THE ECONOMY OR ADVERSE LOSS EXPERIENCE. THIS IS ESPECIALLY SO IF INSUFFICIENT RESERVES HAVE BEEN ESTABLISHED BECAUSE OF LACK OF EXPERTISE OR UNWARRANTED OPTIMISM. LEFT TO FEND FOR THEMSELVES WILL BE COUNTLESS INNOCENT BUT UNCOMPENSATED VICTIMS WHOM THE REST OF US WILL BE OBLIGATED TO SUPPORT.

IS THERE A FEDERAL ROLE?

THERE ARE SEVERAL MAJOR AREAS IN WHICH INSURANCE HAS PLAYED AN IMPORTANT ROLE, BUT TODAY IS UNABLE TO PERFORM ITS TRADITIONAL FUNCTION. THIS RESULT IS NOT DUE TO INEFFICIENT STATE REGULATION. RATHER, IT IS ONE OF LACK OF INSURANCE CAPACITY TO PROVIDE FOR THE POTENTIALLY STAGGERING AND UNPREDICTABLE COSTS OF THE COVERAGES INVOLVED.

THE FIRST AND FOREMOST OF THESE DIFFICULT COVERAGES IS ENVIRONMENTAL LIABILITY. POLLUTION KNOWS NO STATE BOUNDARIES. WATERWAYS AND AIR CARRY OUR ENVIRONMENTAL PROBLEMS FROM ONE REGION TO ANOTHER AND EVEN FROM COUNTRY TO

COUNTRY. THE LIABILITY COSTS OF POLLUTION ITSELF AND OF ENSUING CLEAN-UP EFFORTS CAN BE SO ENORMOUS THAT ANY STATE WITH A MAJOR POLLUTION PROBLEM COULD HAVE ITS ECONOMY AS WELL AS ITS ECOLOGY SERIOUSLY DAMAGED. RESOLUTION OF THESE PROBLEMS AT THE STATE LEVEL IS BECOMING MORE AND MORE DIFFICULT. THE COURTS ARE DEVELOPING INCREASINGLY INNOVATIVE THEORIES THAT READ INSURANCE POLICY LANGUAGE WELL BEYOND THE SCOPE OF THE EXPOSURES CONTEMPLATED WHEN PREMIUMS WERE COLLECTED, AND AS A RESULT DUMP POLLUTION COSTS INTO THE PERCEIVED DEEP POCKETS OF INSURERS. IF A STATE, ITS BUSINESS COMMUNITY AND THE INSURANCE INDUSTRY CANNOT MEET THE COSTS OF THE CONTROL AND CLEAN-UP OF POLLUTION, THEIR INADEQUACIES WILL LITERALLY SPILL OVER TO OTHER REGIONS.

AS NEW YORK'S JONES COMMISSION OBSERVED, PRODUCTS LIABILITY ALSO CALLS FOR A NATIONAL, RATHER THAN A REGIONAL, SOLUTION. A PRODUCT MANUFACTURED IN ONE STATE MAY BE SOLD ANYWHERE. HERE, INABILITY TO PREDICT THE ULTIMATE COSTS OF THE LIABILITY WHICH MAY FLOW FROM THE MANUFACTURE OR DISTRIBUTION OF A PRODUCT MAKES THE PRICING OF INSURANCE COVERAGE EXCEEDINGLY DIFFICULT. AS A RESULT, MANUFACTURERS ARE UNABLE TO INTELLIGENTLY PRICE THEIR PRODUCTS, AND WHOLE INDUSTRIES - SUCH AS SPORTING GOODS - MOVE ABROAD.

THE NEED FOR A FEDERAL ROLE IS NOT CONFINED TO LIABILITY COVERAGE. THE INDIVIDUALLY CATASTROPHIC COSTS OF TREATING VICTIMS OF AIDS ARE ALREADY TAXING THE ABILITY OF STANDARD HEALTH INSURANCE MECHANISMS. ALL EVIDENCE NOW AVAILABLE POINTS TO AN EXPLOSIVE GROWTH IN THE NUMBER OF PATIENTS OVER THE NEXT DECADE. MANY PERSONS FEAR THAT THE DISEASE WILL SPREAD BEYOND THE HIGH-RISK COMMUNITIES CURRENTLY AFFECTED. IT IS THEREFORE ESSENTIAL TO PROVIDE NOW FOR A NATIONAL HEALTH COVERAGE MECHANISM TO PAY FOR THE CARE OF THESE PATIENTS AND AT THE SAME TIME TO PROMOTE INNOVATIVE TREATMENT FACILITIES TO CONTROL COSTS.

THERE IS A CLOUD ON THE HORIZON, CAUSED BY FEDERAL ACTION THAT WAS TAKEN TOO IMPETUOUSLY. THE LIABILITY RISK RETENTION ACT OF 1988 (LRRA) PERMITS RISK RETENTION GROUPS TO BE ESTABLISHED IN ANY ONE STATE AND THEN TO WRITE INSURANCE IN ALL OF THE OTHER STATES WITHOUT MEETING THOSE STATES' LICENSING REQUIREMENTS OR OTHERWISE COMPLYING WITH MOST OF THE LAWS AND REGULATIONS OF THOSE STATES. FEDERAL PURCHASING GROUPS HAVE ALSO BEEN UNLEASHED UNDER THIS ACT. LRRA WAS A WELL-INTENTIONED RESPONSE TO THE LIABILITY CRISIS AND PERMITS THE ESTABLISHMENT OF RISK RETENTION GROUPS AS ANOTHER WEAPON IN THE ASSAULT ON UNAVAILABILITY OF ESSENTIAL COVERAGES. UNFORTUNATELY, AN UNINTENDED RESULT IS THAT THE WEAPONS CHOSEN MAY BE MORE DESTRUCTIVE TO THE INSURANCE-BUTING PUBLIC AND TO ACCIDENT VICTIMS THAN TO THE ENEMY THEY WERE SUPPOSED TO OVERCOME.

ALREADY, RISK RETENTION GROUPS ARE FORMING TO WRITE THE MOST DIFFICULT, UNPREDICTABLE AND LONG-TAILED COVERAGES - I AM REFERRING TO COVERAGES SUCH AS MEDICAL MALPRACTICE - AT RATES AND WITH CAPITAL SO LOW AS TO POSE AN IMMEDIATE THREAT TO THE SOLVENCY OF THE GROUPS. FOR EXAMPLE, IN FLORIDA, ITS INSURANCE DEPARTMENT HAS ASKED THE FEDERAL COURTS TO ENJOIN ON GROUNDS OF HAZARDOUS FINANCIAL CONDITION A MEDICAL MALPRACTICE RISK RETENTION GROUP, FORMED IN ANOTHER STATE, FROM SELLING INSURANCE AT LESS THAN HALF PRICE, AN OFFER DOCTORS FOUND TOO TEMPTING TO REFUSE. THIS RESORT TO THE CROWDED FEDERAL COURTS APPEARS TO BE THE ONLY RECOURSE FOR REGULATORS IN CASES OF RATE INADEQUACY, AND THEN ONLY WHERE THAT INADEQUACY IS BLATANT.

I AM FEARFUL THAT TOO MANY OF THESE RISK RETENTION GROUPS WILL BE ILL-CONCEIVED, MISMANAGED AND PERHAPS EVEN IN THE CONTROL OF CRIMINAL ELEMENTS. IF THESE GROUPS THEN FAIL, THERE ARE NO SECURITY FUNDS TO PAY FOR THE LONG TERM LIABILITIES AND, UNLESS THE BUSINESSES INSURED ARE THEMSELVES ABLE AND WILLING TO PAY, INNOCENT VICTIMS WILL GO UNCOMPENSATED.

I AM LESS CONCERNED ABOUT INSURERS' LOSS OF BUSINESS TO RISK RETENTION GROUPS. THE BEHAVIOR OF MANY INSURERS TO THEIR CUSTOMERS DURING THE CRISIS EARNED THEM LITTLE RIGHT TO ANY LOYALTY. MY FUNDAMENTAL CONCERN IS THAT ANY ENTITY SELLING INSURANCE BE THERE WHEN LOSSES HAVE TO BE PAID TO ACCIDENT VICTIMS. THEREFORE, I URGE THAT LRRA BE AMENDED TO PERMIT RESPONSIBLE, NECESSARY STATE REGULATION OF RISK RETENTION GROUPS AND PURCHASING GROUPS.

I WOULD HOPE THAT MY COMMENTS TODAY ON NEW YORK'S RESPONSE TO THE RECENT LIABILITY CRISIS WILL GIVE THIS SUBCOMMITTEE AN INSIGHT INTO HOW STATE REGULATION OF INSURANCE WORKS EFFECTIVELY IN NEW YORK. AGAIN, I THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY.

Mr. FLORIO. Commissioner Hatch.

STATEMENT OF MICHAEL A. HATCH

Mr. HATCH. I do not have prepared testimony. I did speak to this committee previously.

I will make it very brief. The concerns I have with regard to State versus national versus NAIC regulation pretty much has already been summarized. I believe there have been comments that national, perhaps not Federal, laws or more authority is necessary.

Number two, there is an indication, perhaps contradicting, that the NAIC does do an adequate job and can address it.

The third point was raised with regard to some States having outmoded equipment, personnel, operations with regard to the ability to regulate.

The fourth point was made, States have to give reciprocity to other States, otherwise we are regulating the same 4,000 companies. There is a lot of redundancy if 50 States do that.

The Department of Commerce in Minnesota, regulates approximately 10 different industries, banking, savings and loans, real estate, insurance, securities, charities, franchises, a number of others. We are divided among functional lines by examinations, division of examinations, the division with regard to registration of policies and licensing and enforcement. We do have the opportunity of working with various other agencies in this regard, with HUD, the FDIC, the SEC, the Fed, to a degree the Comptroller's office, the NAIC, as well as other national-related associations or bureaucracies.

Very frankly, I don't think that the current situation with regard to the insurance industry works very well, and I think it has to be addressed at a national level, particularly if we perhaps follow some of the schemes, some of the devices that have been used in other areas of regulation, and I refer specifically, for instance, to the banks. After all, as we all know from reading in the newspapers and the complaints from various industries, they are all selling each others' products today anyway, and as long as everybody calls for a level playing field, there ought to be a level approach as to how they are regulated.

Indeed, as Commissioner Corcoran had mentioned with regard to life insurance, I think the issue with regard to the life insurance industry will make the property casualty pale by comparison in the future. It is a much bigger industry, it is selling products not normally associated with the traditional life insurance products, and that is good, there is nothing wrong with that. But it does mean it is a different type of product, and perhaps we ought to borrow from others, for instance bank-related products, security-related products, take a look at the type of regulation that ought to be applied.

I might add, with regard to the property casualty crisis, I note in the last 2 months, talking to general agents, in looking at filings, the rates have decreased substantially; you see competition coming back into the marketplace. Rates in the general liability area, insurance is being cut up to a third, to a half. Some anecdotal examples of a third being cut in some major CGL policies, the point of it being the same cycle would appear to be occurring, except much more rapid than the last time. This is the same type of thing occurring in other industries. It makes sense. We have gone through an age of deregulation, and that is what can be anticipated. You are not going to have the moderation that occurred.

Two points arise. As you see the cycle beginning to drop now, it will accelerate. Number one, was it really related to tort reform, all of a sudden juries start awarding less, or was it really market? And I think perhaps that ought to be considered, because for 2 years that is all we heard out of an industry with regard to its data. It is important because when I have attended—and I don't attend many NAIC meetings—I don't because most of the time I see it is the industry that has the data, there are industry advisory groups that supply the data to NAIC. The reason for that is obvious, and that is because they have the data, the OSI offices and other data servicing offices and as long as you continued with an antitrust exception, they will be the ones that ought to have the data, keep the data and give it to the departments.

I don't think there would be anything wrong with that data. If you are going to have a central exchange, have it done by either the States, the NAIC, the Federal Government or whatever. I find it unusual that data exchange ought to be going through the industry at a time when public opinion is particularly skeptical of both the regulator and the industry itself, in terms of credibility of what is going on over the last several years.

I don't think—I am jumping around here—but when you talk about the issue of solvency, in particular, I think it is very difficult to regulate that on a State-by-State basis.

I do think the enforcement area ought to be done State-by-State, as it is in other industries. Perhaps, registration of products, because States do have difficulties of opinion as to what ought to be in a policy, ought to be done on a State-by-State basis. But solvency, I think it is important that it is done on a national scale.

There is an issue as to credibility. We have different sized departments, very large and competent, such as New York, with 800 employees. Our department is very small, about 85 or 90 employees.

There are departments that have no examiners. We have an actuary in property casualty, we have an actuary in life and health. Many States don't have actuaries.

As anybody will tell you, the basic issue when you take a look at a balance sheet of an insurance is the reserves. The rest of the balance sheet is easy. It is nothing. But it is the reserves. That is where the play is.

And reinsurance, and you have to have actuaries to make that determination. All the examiners in the world aren't going to do much unless you have an adequate projection, because that is the easiest place to have play in the financial statement.

It is a State-by-State business, given the fact there are some problems, perhaps, with credibility between the States, as was mentioned by others here. The end result is that you really have to take primary regulatory responsibility for all companies licensed in your State. That means you have 50 States all conducting the same examination, or at least conducting them the same way.

I can think of occasions, I mentioned one 1 year ago, and it makes sense, where a regulator in its own State financing a company that had difficulties and, indeed, indicating to a local newspaper—this was in Iowa—that they had six or five companies on the problem list, when we called to find out which companies, they were not given the names.

The reason was that, perhaps, you have a conflict as a regulator to a degree, you want to make sure these companies turn around, you want to do it in a healthy way, yet you are under considerable pressure, if you do have a company that is a problem, because of what happens. And what I did with 85 companies in 1985 is booted them out of the State.

We simply said you can't underwrite in Minnesota anymore, which wasn't easy at the time when the market was tightening up. But, obviously, that does not do much for the health for those companies as you turn them off. It creates a run on the bank, so to speak.

The end result is that, basically, we had to call in companies, 84 of the 85 companies were from other States.

We asked them had they been called in by other departments including their own; 80 companies had indicated no. Five indicated they had.

That to me—we, basically, adopted the procedures followed by banking, cease and desist orders were adopted from that; examinations to a degree; the analysis was adapted by that.

The point I am getting at is that I think the NAIC does an excellent job in terms of the promulgation and analysis, but the barn is burned down by the time we get it. You have to be in there early, you have to have a free exchange of data.

You can't have that conflict with the domicile State. I would do the same thing if I had a company in trouble. I would work it for a while prior to waving a flag around the country on it.

We are very proud in Minnesota that companies have done very well, but we will be the first one to tell you it is not me that is doing it. Am I going to be the one that tells them you have to get your rates back up? No, it isn't going to do any good.

If I tell them to get their rates back up and they are conducting sales on an interstate basis, I will just end up subsidizing the sales in other States, because you don't have any control over how they sell in those other States.

Similarly, I don't know how many commissioners during the last time, or how many now, I am not going to be the first to run into the legislature and say, make sure they get their rates up there because these businesses are not paying enough. It just doesn't happen that way.

You have to have it on a little more removed basis. And I think that there are adequate organizations or at least systems that we can take a look at and examine.

This is not an attack on State-by-State regulations. It is not an attack on a NAIC-type regulation.

I am merely saying with respect to solvency not with regard to other issues, but certainly with respect to solvency, I think there has to be some distance and some very strong jurisdiction and authority in a centralized fashion to address those issues.

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Mr. FLORIO. Let me express my appreciation to the panel. You have obviously given us a lot that we can talk about.

I would just at the outset make an observation that when I first came to Congress, and I mentioned this to one of the commissioners, we had a meeting something of this sort and we had representatives from the NAIC, and the visible distinction between that group—they looked like refugees from a geriatric ward, as well as the less than aggressive approach that commissioners had at that time—as opposed to the obviously, vigorous, vital approach that this cross section of commissioners has, is something that is refreshing.

Likewise, the nature of some of the thoughts and proposals, I suspect, would be regarded by some as revolutionary as contrasted with the types of suggestions or nonsuggestions that had been made in the past from some of the State regulatory authorities.

What I would like to do is just touch on one or two general points then yield to my colleague, and I will come back to the specific points that I have and others have as well.

Let me ask the basic question that is of great concern to all of us; is the crisis over? Have there been sufficient structural modifications that have been incorporated at the State level so as to give any assurances that we are not going to see in the near future, the same type of crisis occur in the event of a business down turn or in the event of interest rates going up?

Have we, by virtue of the deregulation initiative across the board—I think one of the witnesses talked about this—almost insure that we will have more pronounced peaks and valleys in future crises we may experience, and, perhaps, to Mr. Washburn; what is the result of the evaluation of the watch list that the organization has just completed?

What is the result of that in terms of giving us some assurances that we don't have the same number of marginal companies that we had last year, so as to say that if there is a crisis, even if there isn't a crisis, are we going to see a substantial part of the insurance industry tumble over the edge?

Can I ask, perhaps, Mr. Washburn to respond to is the crisis over, has anything been done with regard to avoiding a recurrence of it; and what is the health of the industry now as reflected by insolvency concerns of your watch list?

Mr. WASHBURN. Well, I think the answer to the first question is partially. There are some lines that are still very difficult.

So for a general, what you would call, Mom and Pop store, they don't see the same problems. They certainly don't see the same disruptions. They probably don't think the price is down where it ought to be, but they are seeing competition back in the field.

But there are still some very difficult lines. They are still showing up, medical malpractice is still a very difficult line, directors and officers, there are still some problems out there in the liability lines.

In terms of have we got adequate structures in place, we have got structures in place, but we are evaluating them. We don't know whether they are adequate. And we are still looking at ways to attack the problem so it doesn't happen again.

For example, to make sure that there is not as much play in the reserving, in other words, see if you can do it by taking some of the capacity out of the system. There are still—I mean we are not done with our review of how you would attack this problem. I don't think that we have ended that. I can't assure you today that this won't happen again.

The health of the industry, we have had as many companies this year on the watch list as we did last year, and we have given you the numbers.

They are a little different mixture now, and you are seeing some companies—it is a different group. Some of it is due to reinsurance, it takes longer for that cycle to hit the reinsurance than the primary marketplace.

Mr. FLORIO. Is it my understanding there tends to be bigger companies troubled than was true in the past?

Mr. WASHBURN. I am trying to think—I don't have all the individual companies but, no, I think last year we had more bigger companies than we had in the past.

I think this year it is moderated somewhat. But we find we are still seeing problems with reinsurance, as an example, and we are still seeing problems on the collectibles on the reinsurance.

Part of that, to be frank, is not just insolvency, part of it is balance of trade problems. A lot of them have reinsurance who are foreign who can't get the money out. They may be solvent, but they can't get the money to the States at this time.

There are a number of different things that impact on worldwide reinsurance. But we are still seeing problems in the cycle still going through the reinsurance marketplace. I guess that is the first thing.

Mr. FLORIO. What is the number? Last year I think your organization told us that there were 300 or 400 companies that were on the troubled list. Does that remain relatively constant?

Mr. WASHBURN. It is very close, there are about 400 some companies still on the troubled list.

You have to understand there are more companies and there should be more companies on the troubled list than there are companies that are going to go down, and I am surprised that Mike doesn't have the list of the companies that were on the watch list——

Mr. HATCH. I do.

Mr. WASHBURN. They are sent to every State, the ones that are on the watch list. First of all they are told they are domestic, so they can start their action and 2 weeks later it is followed by all the companies operating in their State.

Mr. FLORIO. Why would you have to inform them about the companies that are based in their State as being on the troubled list? It is almost logical that they should be informing you about that.

Mr. WASHBURN. What you try to do, and you get the majority of technicians who are involved on the day-to-day building of the screens—really there are 23 different States on the group that devises the tests and the blank that is sent in. It is good to have it done on a cooperative basis.

We get the same information from all the companies. You can ask for additional information in your State, but basically the same information is sent in on every company that is licensed.

It is sent to the NAIC, and they process it. And it makes sense to coordinate that collectively, because, as it is, you saw that not every State has all the computer capability they should have, and they don't have all the examination capability.

They don't have all the analysis capability. So all the returns are sent to the NAIC. They do the initial screening, the ADP screening and they have a group of senior examiners who come in and do analysis of them. That is supposed to help the domestic State.

So I mean it makes sense to coordinate that because you get the best expertise from around the States getting together and taking a look at that whole watch list, so when you get the analysis, you have an analysis of pretty senior people.

You may have a department of 60 or 70 people, but the ADP capability that the NAIC possess, the screens they have been developing for years, and that really the senior people have been working on the screens, and the analysis from senior advisers, is there so it makes sense to coordinate that function.

Last, it makes sense to coordinate after this goes to the States, that they are doing something with it. That is, basically, what examination oversight does. That looks at the troubled companies on the watch list and says to the States, what are you doing with this? Do you need more resources? What is happening with this?

Mr. FLORIO. How long have you been doing this?

Mr. WASHBURN. How long has this been happening at the NAIC? I have been there for 4 years, to be frank, it has been happening before my time. You know, to be quite frank, a lot of this happens at the staff level that many commissioners don't see——

Mr. FLORIO. Not to be cynical or anything, but how do we get in the position that we are currently in, if this has been going on and we have been disseminating that information, disseminating the directive that somebody should be doing this, and yet we have the problem?

Mr. WASHBURN. We have insolvencies. One thing we are trying to do is revise our screens because of insolvencies we have seen.

We say this didn't work, or—we found in Iowa they had a company that went from one line of business to another line of business. They went into commercial casualty and went out of existence.

We said, wait a minute, our screens were not made to catch that, we have to develop a different method for that. We are looking at what happened to see whether the screens were inadequate, whether new methods have to be used. I mean that does happen and the business is changing, and we are trying to catch up to it in a lot of cases.

Mr. FLORIO. Why don't we ask the other gentlemen to respond?

Mr. CORCORAN. Mr. Chairman, you hit the key point, you saw what occurred.

As Michael has noted, the question here of cash flow underwriting is the essence, not necessarily solvency of the industry. You know, commercials are put in a very difficult position and any one of them, if a domestic company is about to go under, it is very good that the dynamic tense NAIC watch list keeps the commissioner candid in dealing with their own domestic as well. That is a good added dynamic.

What can the commissioner do to prevent it though? Prior to this in New York the only alternative was to declare the company insolvent which is draconian at best.

Now you are talking about which commissioners and directors will have the courage to say to a legislature or to a company that you have to raise your rates. We did in New York, in fact, as I noted in my testimony, find companies, but we only had the power to deal significantly after a hearing.

Now, in New York, the superintendent has been given the obligation, the power and the resources to make sure rates don't drop.

Mr. FLORIO. I am struck by this, and we have had this conversation with others, the idea that predatory pricing is illegal and inappropriate is not a revolutionary idea in the course of our governmental system.

Why regulators should somehow feel apprehensive about saying that pricing below cost is something that should be found upon if not prohibited.

I am also struck by the apologetic way that regulators come in and say it is a difficult concept to talk about that someone should not be allowed to price inappropriately.

Mr. CORCORAN. I have no difficultly talking about it. We had no difficulty in New York, under the old system, defining them or it.

The problem now is the adverse ability to deal with it in realistic fashion. That is what we are talking about. We are talking procedure, not substance.

We did fine the companies. Now, we have to be able to anticipate the resources and authority to prevent it from occurring, as opposed to holding a hearing, which under the privacy law in New York, we had to on each rate. Now, we can say you can't charge that rate within the bands unless you justify it and stabilize the market.

We are not apologizing. We are simply saying, was on the statute the superintendent have the ability to easily, or restrain it, not substantive, we are talking procedure. That is, when you talk data, you are not talking a lack of will to regulate.

Surely, I don't think the New York department and many other departments have lacked the will to do it, nor apologized for it, it is just a feasibility of dealing with 30,000 individual rates.

Mr. FLORIO. I would ask you, Commissioner Merin, didn't we, in New Jersey, have prior approval authority in 1981 or 1982, and then got rid of it? In some respects, we went in the opposite direction that is now advocated by some.

Mr. MERIN. To respond to the last point, that is correct. In 1982 there was a commercial deregulation act that was signed into law.

The GAO did a study of that and the GAO found that the crisis had equally affected it, whether there was or was not prior approval. That seems not to have been a factor in the crisis.

I agree with Jim and his comment that the regulators do lack the will to tell someone who is selling at too low a price to raise the price if we know about it.

I had a company that was writing auto insurance at a really low rate. That was a company in trouble and that is still in trouble, and we are keeping close tabs on it.

I am sure both you gentlemen know, if I had the will to tell the company it could not lower auto insurance rates in our State, then I could tell a company not to lower any kind of rate.

In fact, we did that. We kept them lowering their rates. The problem is, as Jim indicated, how are we made aware of what they are charging?

Right now where you have prior approval is on the rate, but a lot of companies don't charge the rate. They charge a price which is a deviation of the rate.

We need computers, we need the capability to allow us to find out what is going on, and if and when we get to the point, and we expect to have that computer capability in the next couple years, then we, in New Jersey, will be able to take a more active role in that. But we do not lack the will to tell the company that is getting into financial problems to stop lowering the rates.

Mr. FLORIO. Yes.

Mr. HATCH. One thing I am confused on, the 85 companies we called in, none had been told anything by anybody other than about 5 out of 85 companies.

Now, I have told companies within the State that operate within Minnesota to raise rates. I can think of specific examples, one auto and one malpractice company, but on an interstate basis, when I think, 84 of the 85 companies were out of Minnesota. They were domiciled out of the State.

What good does it do for me to say raise your rates in Minnesota? What good does that do in terms of solvency of the company when it sells in 35 or 40 other States? It doesn't do any good at all.

It is throwing water on the window, on the other 34 States, it doesn't do any good to shut my window. That is the problem of the State by-State approval to financial solvency regulations.

Plus, where do the data come from? I don't care what kind of computer you have, it is only as good as the information you have going into it.

If it is old data, up to 3 years old in some cases, if the data is only coming from the company, not from an individual examiner, if there are different policies being followed in different States with regard to reserve discounting, and so on, you've got all sorts of problems. You don't have any consistency. It is very difficult on the financial solvency side to talk about it on a State-by-State basis.

Mr. FLORIO. Mr. Merin, then Mr. Levinson.

Mr. MERIN. Again, it is a computer-driven problem; it is a resource problem. We are expanding the number of our examiners.

The 3-year examination cycle is not sufficient. With the computer-driven systems we will have a much more frequent analysis and check up of what is going on in New Jersey.

We will update companies' financial status to the minute. We will have plugins and linkups that will allow us to verify whatever we want whenever we want.

It is something not done by anyone right now, and we are embarking on a final stage of a 3-year process to get us to that point. So we need improvements in that area.

But also regulators discuss things with each other. Jim and I have been working together on a company in New Jersey which we both felt was not reserving properly and it has been about a 1½ year process to review the reserves for that company and we are taking action together. So regulators do talk with one another.

Mr. FLORIO. Is there national uniformity with respect to loss reserve calculations?

Mr. MERIN. Different actuaries view that differently. Actuaries are like lawyers, they are all looking at things differently.

You can have the same standard, whether the two will view the standard the same way——

Mr. FLORIO. We have three items here: you are talking about the technical capability of operating with computers, and then someone else is talking about the timeliness of the information; and then more relevant is the appropriateness, similarity of the variables that go into the information that may not be timely, that is not being kept track of because one is not into this generation?

Mr. CORCORAN. That does not give a real picture of what occurs. We, in no other department I know of, rely solely on the data given by the companies. Examiners look at the data, we don't rely on company data.

When we fine a company and previously in cash flow mechanism, each time they are fined they are required under the law to notify all 49 other States why they were fined and what action was taken.

So I assure you if Commissioner Merin gets notification from me that I made, "Z" company raise their rates, he will act on that information. They are compelled to do that. So there is a tremendous cross-pollinization of this information.

Mr. FLORIO. How about the validity of Mr. Hatch's point? You are conveying the impression of being vigorous and very aggressive, do all the other 49 States pay the price for your vigor and aggressiveness in cross-subsidization?

Mr. CORCORAN. No, Mr. Chairman, they reap the benefit. The information is available to them, the work-product of my actuaries is available to them.

We cross-pollinate in the NAIC meetings consistency, and if any action is taken by me to raise rates in one area—let's not forget, not all rates are national.

I assure you that the State of Minnesota does not want to have the same rate in medical malpractice as the State of New York, so we are talking broad generalities here. But I feel very comfortable responding to any particular. Any particular that my department acts on is available to all the States at their request, and available directly to NAIC as an immediate resource to them.

They reap the benefits. They don't pay the price.

Mr. WASHBURN. And every company knows it. You are dealing on a regulatory action and they are not fighting your regulation, they know when you take action everybody else will be watching.

They will take action, too.

Mr. HATCH. The data that goes into the computers comes from the companies. It is not the case that it doesn't come from the companies—it does.

Mr. WASHBURN. Where else will you get it? The fact is year-by-year information has come from the companies.

The people try and build screens, take loss reserves frequently. Everybody is worried about loss reserves, not like the NAIC doesn't realize—if you hire the actuaries, two different actuaries to look at two different loss reserves, you will probably get two different opinions.

Mr. HATCH. That doesn't mean you give up on it.

Mr. WASHBURN. What you are trying to do is build a screen so you can see where a company is consistently under-reserved. Indeed, they have a schedule that basically shows what was originally reserved for, how the pay out is going and what the new reserves are.

There is a penalty if they find you have consistently under-reserved. That is not to say that we think that that is perfect, but we are trying to build screens so we can catch the companies.

If they—and indeed, there is a uniform way that is done, it is through the NAIC. The majority of technicians who understand how to do these things are the ones that sit down and do them.

We are trying to get as good a screen as we can in reserves. Are we happy with them? No, I mean we are still working on reserves and we do it every year.

We try and get better, and better, and better at it. This year we are splitting out, for example, the reserves from primary and reinsurance business.

Why? Because the reinsurance business may start making problems with the primary business because the loss development is so much later in that. We will probably revise the screen next year because we are not happy with the one we have in place, but we realize we will have to have a better one in place next year.

It is not lik. we are not working with it or that we are completely happy with it.

Mr. FLORIO. Mr. Levinson, please, then I will yield to Mr. Lent.

Mr. LEVINSON. Mr. Chairman, I want to make a generalization and answer your specific question. Your specific question is was the liability crisis over? It is over in Delaware.

We passed the emergency legislation; that worked. We passed it on the foreign market assistance plan; that worked. And as of 3 o'clock this morning, we formed a Delaware mutual insurance company, with a bonding authority, and there will be no more unavailability of liability insurance in Delaware.

There will be no more mispricing of liability insurance in Dolaware. We will do it ourselves, if the industry doesn't do it properly, and that is the end of it.

I don't think it was much of a crisis to start with. I guess it depends on what your perspective is in life, sir. I think war with the Russians is a big crisis, if it occurs.

I think that the liability crisis was a blip in American history. And I think that insurance as a whole, there are much greater problems than that liability insurance crisis. We knew how to solve it, we did solve it in Delaware and that is the end of it.

Mr. FLORIO. You are forming a State——

Mr. LEVINSON. We call it a Liability Lake.

Mr. FLORIO. For bonded indebtedness?

Mr. LEVINSON. Formed a bonding authority, and with no full faith and creed by the State, the full faith and creed will be by the members of the bonding authority, the municipalities, and what have you. We have had a actuary study, it works; we have had the bill drawn, it passed; hopefully, the Governor will sign it in the next 120 days, and that is the end of it.

Mr. FLORIO. That is primary insurance or reinsurance.

Mr. LEVINSON. They have an assumption. They can, just as the pooling group, go buy the whole thing from the industry when it is priced properly. They can self-insure and buy a policy.

They can insure the entire thing themselves; they have the capacity to do it, the actuarial capacity, the bonding authority to do it, the taxing authority.

That is the end of it. It is is done. So as far as I am concerned, I think we ought to look at the real problems, as we have started to do here, which are the solvency problems in the insurance industry.

I think it is amazing that you have about as diverse views as you can probably get in this country at this table, among regulators, and we are focused in on how we go about evaluating the reserves, which is the key question; how do we go about evaluating the collectibility of reinsurance which is the key question—and it is amazing how much we have, indeed, focused in on exactly what the problem is and we are nitpicking over who should do it and who has the experience and who can do it best.

The reality is, sir, that insolvencies in the insurance industry are totally different than insolvencies in any other business. The words don't mean the same thing.

There is nothing wrong with companies going broke. That is the American way.

You let them compete and they go broke if they can't hack it. That is why we have something called "capital surplus reserves." The theory is not to keep companies from going broke, but rather to catch them in that inbetween stage when their stockholders have lost their equity but there is still enough there to pay the policyholders. We have companies in Delaware that we put into receivership.

I don't care that they went broke. That is the name of the game in American business, we are going to pay the policyholders 100 cents on that dollar.

We have had some that we have paid the policyholders 100 cents on the dollar. Regulations are there to protect the policyholders. Not the stockholders of the insurance company.

What we have done is to confuse ourselves by using the language of ordinary business in this country in the language of the discussion of the insurance industry. The words mean different things.

Let the companies go broke. That is competition. That is the American way. But catch them by checking their reinsurance, by checking their reserves, catch them before they get so low there is not enough there to pay the policyholders. We can do that.

Mr. FLORIO. Let me recognize the gentleman. You have raised obviously some very, very controversial points and I want to come back to the adequacy of the fail-safe system that we allegedly have to deal with that type of thing. I am not sure everybody subscribes to your philosophy. But I yield to the gentleman.

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

I sat up here and listened very patiently during the chairman's 5 minutes——

Mr. FLORIO. You are recognized for whatever period of time you wish.

Mr. RINALDO. Seriously, this is what I got out of this. Mr. Hatch says the current situation doesn't work very well. Mr. Levinson admitted that there were a lot of diverse views.

Some people feel that State-by-State enforcement is working well. Solvency, well, that should be taken care of on a national scale, but no one told me or explained what the Federal Government could do on a national scale that could be any better than what is currently being done.

The purpose of the hearing, of course, is to find out the end goal, to find out whether or not State-by-State regulation is working and whether or not the Federal Government should change this system and whether or not we should intrude into that system and whether or not we should take on additional or new regulatory powers.

Frankly, I detect no unanimity of opinion. What I detect are a number of diverse opinions on what should work and what won't work and what could work and what may work. Quite frankly, after 15 years in Congress I have come to the conclusion when you get repeated testimony of this type, generally there is a tendency on the part of Congress not to act, not to do anything, and it becomes very difficult to act. Of course, there is probably a lot of insurance industry opposition because people are generally somewhat skeptical of change and fearful of the unknown. I would like to ask a general question and maybe we can find out if there is any consensus at all here. Do you think there should be any additional Federal Government role in regulating the business of insurance?

I would like to know if there is any aspect of that question that the five of you agree on?

Mr. HATCH. Probably not.

Mr. CORCORAN. No.

Mr. RINALDO. Probably isn't? Would anyone like to respond or comment?

Mr. CORCORAN. There are two issues, clearly the Federal Government knows it has to respond to product liability and pollution. I think the Jones Commission in New York agreed that; was outside the magnitude. That is something we should have a dialogue on.

That is such a huge problem and it cannot be approached State-by-State because I think we pollute each other's backyards sometimes.

That is one area that Governor Cuomo's commission that——

Mr. RINALDO. Does everyone agree with that? You do.

Mr. CORCORAN. See, we can agree on that.

Mr. RINALDO. Do you all agree we need Federal product liability insurance reform, I mean?

Mr. HATCH. I think if you are going to have it, you ought to have the regulation with respect to the insurance, as well. My point is that I think that there has been an enormous misrepresentation made by the industry over the last couple years with respect to what has been going on.

I think the drop in the market recently underscores that and I think if you are going to address it, you have to address it as a whole and this business—yes, I think there ought to be Federal Government, but don't limit it to the claims side of something.

If you are going to get into it, get into the premium side, as well.

Mr. WASHBURN. You just lost our consensus.

Mr. LEVINSON. Mr. Chairman, it seems to me maybe the issue isn't whether we can all agree on something, but whether we can all compromise on something. What I have suggested is that a Federal—it is Federal legislation that would delegate to the NAIC, give the NAIC the authority to collect the data, to make sure that it is getting the proper data and not just to rely on the industry's production of the data itself.

We have, after all, 6,000 regulators already at our disposal through the States. To collect the data, to collect fees and finance itself so it will be completely independent and to have the enforcement authority to go into a company if it was not satisfied with the data, to collect the data independently and to charge the company for that and if necessary to pull that company's ticket nationwide if that company simply is totally out of line.

Now, there is the situation that I am suggesting there is a collection of expertise that exists already with literally tens of thousands of man years of experience and insurance regulation and an organization that is already moving on a voluntary basis in that direction and that all we need is some teeth in that system so that it can move forward more aggressively.

Mr. RINALDO. Mr. Washburn, you represent NAIC here this morning. What do you think of that suggestion?

Mr. WASHBURN. Well, I think that the NAIC is looking at how we get in a lot of ways the data we need. Let me tell you, it is not an easy matter.

We are talking about not only the traditional lines of insurance where I think we probably got adequate authority to get the data we need, but the excess and surplus market and reinsurance market.

We have a meeting of international insurance regulators every year. As a matter of fact, we just finished it in Chicago, it is in the middle of our meeting. One of the problems is when you start looking at this area on the fact that insurance is a worldwide phenomenon and a lot of our business moves overseas and comes back and everything, you have a problem in the fact that they have different accounting methods, different accounting systems.

We have to try and get some uniformity so we know really how to investigate some of the things that are happening.

I think that one of the main projects we have going is how we get a better handle on some other nontraditional market places, reinsurance market places and other market places.

I can't tell you that we need the Federal Government or how you could help us. I am not sure I even understand how David's proposal would work. But I do think it is an area that we find as frustrating as you and we are moving on it. He may have some things.

Mr. RINALDO. I don't think you need Federal legislation to implement Mr. Levinson's proposal. I think you can do that absent any Federal legislation.

Mr. WASHBURN. Yes, we have through the State mechanism pretty good authority on having the insurers do what we wish to do. We have indeed been using that for some time.

Mr. RINALDO. Has your executive group ever discussed anything close to or similar to what Mr. Levinson has proposed?

Mr. WASHBURN. Mr. Levinson brought this up with our executive group.

Mr. RINALDO. What was the reaction?

Mr. WASHBURN. The reaction is discussion. I don't think we have come to any conclusion, we are still chewing on it among ourselves, if I can use that phrase. I don't think we have come to any conclusion at all.

Mr. HATCH. Mr. Rinaldo, that harks back to 200 years ago when they debated the Constitution. You can't put 50 States together and have them vote as a unanimous group because there is no power to tax, no central authority among the NAIC.

That is why you people are here. That is the problem with the NAIC. You have to have a central authority to say we will be taxing you. Well, through the NAIC mechanism that would be fine.

I don't have a problem with it. The NAIC is different, but it ought to be separate from the industry. It ought to be separate, where they have their own data.

They ought to be able to hire competent examiners in a centralized fashion and do the examinations. If the various States want to do that, fine, as long as there is a board of Governors appointed by the Congress or the President or the States, whatever, there ought to be actuaries.

I don't know how many property casualty actuaries the NAIC have.

Mr. WASHBURN. I think we——

Mr. RINALDO. We heard testimony that some of the States don't have it.

Mr. HATCH. That is right, and that is the real train coming down the track which is what we ought to be concerned about. Maybe we should be talking about the real issue.

Mr. WASHBURN. Mr. Hatch is indeed correct on all the things he wants and, to be frank, at the last two meetings we do have the ability to collect. The companies are indeed required to file their statements with us and when they file their statements they pay a fee and that fee is going to be used to hire actuaries, to be used to enhance our data capability that will be independent. That is what we will use to buy the whole new data system.

We are working on that and in a way we have the ability to tax in the fact that we are able to charge a fee.

Mr. HATCH. They are not able to pull licenses.

Mr. LEVINSON. Mr. Rinaldo, it is interesting to me what is happening here today, because Mr. Hatch is saying he essentially agrees with my proposal, but does not have any problem with using the NAIC if it is independent of the industry which it would be if it had the power to tax, that is, charge a fee to fully fund itself from the industry and had the statutory authority to do that.

Mr. Hatch is saying he agrees with that.

Mr. Washburn is saying not that he disagrees with it, but the executive group is discussing it. I know that. I am a member of the executive committee of the NAIC myself.

So I think it is extraordinary that what we have here today is a coming together of the two, perhaps, absolute extremes. Narrowing and focusing at this point very, very carefully on a single proposal, on the single issue that is really relevant to the insurance potential crisis in this country.

I think something is happening that all these hearings that have been going on for the past few years, particularly the past few months, we are beginning not to discuss some of the nonsense, like repeal of the McCarren-Ferguson will solve the liability crisis when it has nothing to do with it. Now we are focusing on the real proposals and once you do that, you see the most divergent views in the industry coming very closely together.

Mr. RINALDO. I understand what you are saying. I might point out that I don't know how the Federal Government would give a private entity the authority to tax or levy a fee.

Mr. LEVINSON. There is a precedent. I will give you a legal precedent. Our attorneys have prepared the brief.

Senator Heflin asked me for it. We provided it to him. I will be happy to provide it to you.

I have the cites here. I would be happy to provide you the complete memo.

Mr. RINALDO. I ask unanimous consent that the record remain open for the citation and the memo that the gentleman just described so that we can see whether or not, in fact, such authority is available.

Mr. FLORIO. We will be pleased to receive from any of the commissioners their proposals on anything we have talked about today.

Mr. CORCORAN. I would like to respond to this. I might skip this wedding of extremes, but the real issue is a lot of misinformation going on. I have quite a few actuaries. They are very nice people and I regard them as independent.

I have a substantial staff of examiners. All of the financial statements and so on are public information, available to every commissioner in the country once done. So I am sure Congress would like to know how these things work.

I think it is imperative you provide a memo explaining many of these things that are, in effect, de facto to going on without any umbrella or blessing or anything else. I regard my department as independent.

I do have quite a few actuaries. I believe it is 24 the last time I counted. They are very nice people and they do a good job and we make that available.

So there might be redundancy here in this discussion, but surely we should open up a dialogue; but I, for one, might not attend the wedding.

Mr. RINALDO. Did you want to say something, Mr. Merin?

Mr. MERIN. Congressman Rinaldo, I think we do all differ on whether Federal regulation is necessary or to what extent it is necessary and in my statement I have enumerated concerns that I have. I do believe that within the next few years there is going to be a dramatic change.

I think that because of the increasingly vigorous attitude of the NAIC as a group and of the individual States, by the middle of the next decade the greatest pressure for Federal regulation will be coming from those people who currently oppose it with the most vigor, that is from the insurance industry.

It is claimed that the States are plants for experiments. In my opinion, there has been very little experimentation going on in the past decades. Now, all the States are concerned, all the States are doing something different.

I think that as the insurance industry has to cope with this greater diversity and the greater aggressiveness of State regulators, they will be looking to you to take the States out of that area and in my opinion within the next 10 years, possibly within the next 5 years, you will be receiving pleas from the industry to relieve them of the burden of State regulation.

Mr. RINALDO. Thank you.

Mr. FLORIO. Will the gentleman yield on that last point?

Mr. RINALDO. Yes.

Mr. FLORIO. Obviously the parallel is between product liability initiatives and the development you just described. It seems to me that is fairly obvious. Is there justification for linking those two approaches together? That is to say, the argument for uniformity in the context of product liability, that the various tort law developments are disruptive and, therefore, there is some virtue in terms of productivity in having a national system—the same point may well be raised by the insurance industry that disruption, for good or for bad, as a result of initiatives coming out State-by-State does not work in the health of the industry.

The relationship between tort law and insurance cost has been made ad nauseum by many. Can I get your thought as to whether there is any legitimacy for linkage of those two different and yet related areas?

Mr. MERIN. In my opinion, yes, with the caveat that we tend to think of insurance as this big generic field. In fact, insurance is a lot of different fields, there is medical malpractice, CGL, auto, I think there has to be, in fact, give and take. Many of the States that enacted tort reform did so without requiring a reduction in the premiums.

Some States did require some reductions. So that debate has been going on in the States. But I think that if there is Federal action, again, it would have to be viewed on the line-by-line basis. There ought to be that kind of analysis.

Mr. CORCORAN. Mr. Chairman, as a direct response on the Jones Commission regarding product liability, they simply concluded this was nothing a single State could do since most of the products move interstate.

So there would be no effect of tort reform that could be done by New York, for instance, that would help the insurance industry theoretically reduce rates because that tort reform would not be present in neighboring States.

The very simple doctrine they came forward with and said there is no point in the Jones Commission looking at product liability in

New York because there is no product sold simply in New York that doesn't enter interstate commerce.

Mr. RINALDO. I recognize my time is expired.

I want to thank you for the extra time.

Mr. FLORIO. The gentleman from New York.

Mr. LENT. Thank you, Mr. Chairman.

I want to thank all the witnesses here. This has been very informative, particularly my own State insurance commissioner, Mr. Corcoran, who I believe is a resident of Nassau County in my district.

Mr. CORCORAN. Right over on the other side, a block from your district.

Mr. LENT. Although you and I have had differences about risk retention and so forth, there are places in your testimony on which we could reach agreement. You say the Jones Commission recommended a Federal role in one area, that being Federal product liability tort reform. As you may know, I am cosponsor of H.R. 1115, along with Congressman Bill Richardson of New Mexico who was with us earlier and has left.

He is the primary sponsor of this bipartisan bill and Chairman Florio has been having a number of hearings on this whole issue of Federal product liability tort reform.

That bill has been referred to this subcommittee and we hope to have favorable action on it. Do you have any comments on that kind of a situation?

Would you encourage us to move forward in that?

Mr. CORCORAN. The only analysis I can give now about that particular bill is that that is one line of insurance that has to be priced nationally because of the nature of the coverage. So I think that is why we in New York endorse the fact that the Federal Government should look at that area.

Mr. LENT. Does anyone disagree that we should move forward on the issue of Federal product liability tort reform? You feel we should pursue this goal and objective?

Mr. WASHBURN. Yes.

Mr. HATCH. Yes.

Mr. LENT. One of the other areas is this question of health insurance. I think Commissioner Hatch indicated that that is one of the trains coming down the track that might bede ill for the insurance industry, and that is life and health.

On this area of health, I believe Commissioner Corcoran referred to the AIDS problem in his testimony at the bottom of page 19.

I just would like to ask, isn't it a fact that insurance companies selling health insurance usually charge a higher premium for those people who have a likelihood of a particular disease, you check for blood pressure——

Mr. CORCORAN. Most health insurance is sold on a group basis, about 85 percent.

Mr. LENT. Yet we understand that some States have adopted laws that prohibit, somehow impair the ability of health insurance companies to inquire about or test for AIDS.

Mr. CORCORAN. We have had a hearing in New York regarding health insurance only, not life insurance, about the propriety of using a blood test. I am the ultimate hearing officer for that, but let me give the background on it.

We have other public policy concerns, the confidentiality of the test, the accuracy of the test, whether or not there were adequate other means of effectively underwriting. In New York State we don't prohibit companies from effectively underwriting, but we have other, broader concerns, that is, what that particular situation is.

It limits itself to individually underwritten health insurance policies.

Mr. LENT. I would like to ask the panel this question: should insurance companies be prohibited from testing for AIDS and charging a higher premium for those persons who test positive?

Mr. HATCH. My opinion is that they ought to be permitted to do so. It makes sense. I do think the issue with respect to data privacy concerns is something that Congress has dealt with before and hopefully will keep that in mind.

But it makes sense. It has to be. I think you have to give the right to the company.

These are private companies, many are either policy holder owned or stockholder owned. They are not a public pool from which to be underwriting it.

On the other hand, we do have a rule in Minnesota, I think one other State has it, that you cannot ask about AIDS on the application. The reason for that is that it gets into the privacy issue again.

If you are going to lie about it, you will lie about it on the application whether it is there or not. We allow a broader question, do you have any deficiency or have you been diagnosed as having any disease affecting the immunity system, or something like that.

It is a broad one. The idea is for it to be broad enough so that person is encouraged to tell the truth as opposed to getting into the sensationalism.

We do prohibit that underwriting, although we know it occurs, because I talk to people within companies who do this, not agents, but we think their companies do this.

They underwrite on the basis of lifestyle. Now, you will never find a company admitting to this, but they will say, the questions are there, your name, if you are a male living in the metropolitan area, between the ages of 20 and 40 and single, you will have a tough time finding insurance by many companies.

They will figure a way, it won't be because of the lifestyle, but they will figure a way just to say no.

At least on the life side. I don't know about health insurance. But there is nothing you can do.

No matter how well you regulate and tell them they can't do it, things will occur. But that is an issue you can't legislate.

Mr. CORCORAN. I would like to stress that at our hearing the industry admitted numerous times that this test, unlike any other test, has dire consequences to the individual. I assure you that if the world found out that you and I failed a high blood pressure test or a sugar blood test, it would not have the social impact on our lives that disclosure that we took and/or failed or proved zero-positive on a blood test.

There are broad public policy questions that have to be addressed and there is no doubt if it became public information it might well have consequences on your job, the possibility of your career and social and other things.

It is atypical of any other medical test. That is the issue.

That is why we had the hearings. We have not made our determination yet, but I assure you that there is sensitivity that is required to address this issue as is being done in the State of New York.

Mr. LEVINSON. Mr. Lent, we have dealt with this issue already in Delaware. We have had hearings, we have issued regulations and both the gay community and the insurance industry mutually agreed on a trial basis to the solution we came up with.

What we said was that—we distinguished predictive tests and questions from diagnostic questions and diagnostic tests—the AIDS test in question being predictive.

Just because you have the virus doesn't necessarily mean you will get the disease or even get sick.

What we have said is that the industry may ask questions and give tests of a predictive nature, if and only if they give tests and ask questions of a predictive nature regarding other diseases that are life-threatening and use them equally in the underwriting process.

If you ask a female does your mother have breast cancer, you have one aunt with breast cancer, if you ask questions like that, which means you have a 95 percent chance of developing breast cancer, if you ask questions like that and if you use that in an underwriting way and do that with all significant life threatening diseases, then you can do it with AIDS, too, because then the AIDS person is not being discriminated against and will not bear the entire burden of this incremental cost.

Everybody has something. So it will end up being spread fairly throughout society.

Mr. LENT. It seems that the main problem with testing for AIDS seems to be that there would be a public disclosure of this and the boss would find out. Isn't there some way perhaps through State regulation that confidentiality of medical examinations could be provided to applicants?

Mr. LEVINSON. Absolute confidentiality is built into our system.

Mr. CORCORAN. In the State of New York——

Mr. LENT. If that is the case, then why, Commissioner Corcoran, do you raise that?

Mr. CORCORAN. Because there are not adequate confidentiality precautions in place with adequate teeth. The industry at the urging of the commission is coming around to supporting a confidentiality bill and has acknowledged this need for legislation.

Even the bills they had up, there were no consequential damages given to the individual in case of a violation. There should be a form, and I will give you a memorandum of law, Congressman, that there is a need for legislation. There is no set course of action for individuals where confidentiality is breeched in this situation.

Mr. LEVINSON. I have told the——

Mr. LENT. All the evidence indicates that the number of AIDS victims is on the upward curve and there is going to be—there is using a blood test. I am the ultimate hearing officer for that, but let me give the background on it.

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Mr. LEVINSON. I have told the——

Mr. LENT. All the evidence indicates that the number of AIDS victims is on the upward curve and there is going to be—there is now, but even more so down the road, an explosion in the number of people who have AIDS, and ATZ and other drugs that will prolong their lives beyond the present 2-year expectancy, and therefore, the burden on the health insurance company that writes the policy perhaps, for a couple hundred dollar premium, is enormous.

Mr. CORCORAN. Congressman, the part about this that is educational—first of all, we are limiting it to health insurance and only to a particular test. We are not saying they can't underwrite.

California has had this statute in effect for 2 years now and the same companies are still writing business in California. You have to balance the equities in these situations.

But I am not at liberty now—we have not closed the record on our hearing, but I am giving to you what we found out during our hearings. The same companies——

Mr. LENT. Public hearings?

Mr. CORCORAN. Yes.

Mr. LENT. Did you testify?

Mr. CORCORAN. I was the hearing officer.

Mr. LENT. You were the hearing officer. So you have not formed an opinion yet.

Mr. CORCORAN. We have to wait until the record closes.

Mr. LENT. One last area. We were talking about in some of the testimony here about the problem of pollution insurance and the high cost of pollution insurance.

Perhaps some of this problem is caused by the unpredictability of insurance contract interpretation by the courts. I understand there was a recent decision in *New Jersey Summit Associates* v. *Liberty Mutual Fire Insurance Company* involving a claim for pollution cleanup coverage under a special multi-peril policy.

And the court found that "the health, safety and welfare of the people of this State must outweigh the express provisions of the insurance policy in issue. As a result, the exclusion clause in the policy which pertains to excluding coverage where the damage to the policy holder land must be held inapplicable."

The court went on to find that Summit Associates, the landowner, which had to pay cleanup of hazardous substances, had no knowledge that these substances were in the land that they had bought. Therefore, I assume that the insurer also had no knowledge of the hazardous substance that was in the land.

Yet the insurer now has to pay.

What effect do you think this kind of ruling has on insurers' willingness to write toxic coverage. We all know it is very important that they write toxic coverage but we seem to be frightening them away.

Mr. CORCORAN. We are addressing these issues in the legislation being proposed and discussed, actually defining the terms by statute and bringing stability to that, but there is no doubt this is an area that is a problem.

I think Director Washburn might want to address it.

Mr. WASHBURN. You can see it in the unwillingness to write that type of coverage at any price, and when I.S.O. came out with their new form, one of the exclusions was pollution and the reason was they were not sure how to define what their areas of coverage were.

There was a real thought that they would constantly be faced with claims and they couldn't price the product at the front end.

Mr. LENT. Commissioner Levinson, as I recall your statement, it was that insolvency is one of the great problems and that is what we ought to be looking at. With these insolvencies, some suggest that that is the result of the fall out from the last severe cycle, but what happens when coverage for environmental cleanup at Superfund sites is litigated? What happens to the solvency of a company that writes a little policy years ago and then finds out, when they lose their coverage fight as this company in New Jersey did, they have to pay a huge award or perhaps a series of huge awards?

Mr. LEVINSON. In the first paragraph of my testimony, sir, I said there are societal problems that nothing any regulator can do will solve. You just nailed one of the biggest ones.

Clearly, the whole environmental pollution area is something that has got to be dealt with and no regulator in Delaware or anywhere else can deal with that problem.

Mr. LENT. Mr. Merin.

Mr. FLORIO. Would the gentleman yield just for an observation and then you can go on. I suspect everyone is aware of the fact that the temper of the times is such that when we attribute responsibilities to societal problems usually that means some public responsibility to take on those problems.

It is clear that the temper of the times over the last number of years has been to go in the opposite direction, saying that the market place should deal with these things, user fees should deal with these things, so that to a certain extent to acknowledge that is nice, but almost irrelevant to the dynamics we are faced with at this point.

One almost has to make a choice. Are we going to go back to the point of saying that societal problems should be dealt with some way in the public sector way, or if we are going to keep moving in the direction that we appear to be moving, we are going to have to say that those societal problems are going to be faced—will it be AIDS health insurance or environmental pollution with governmental funds?

Mr. FLORIO. We are going to have a serious dilemma trying to reconcile the direction that we are moving in with some of the obvious observations people have made. Let me make the observation which I think is relevant.

Mr. WASHBURN. It is certainly relevant but I think something Commissioner Merin said earlier is extremely important. We tend to start talking about insurance as if it is all one thing, and it is a lot of things. And there are a couple of pieces in there—and maybe others will develop that—that have to be handled differently than we are basically structured to handle the problems now.

That doesn't mean because one or two pieces have to be handled differently, you throw out the baby with the bath water. We are on track, we are moving in the right direction with most of these pieces. And there is a piece or two that has to be dealt with in some other way.

Mr. LENT. I would like to get some clarification from my colleague when you are talking about a problem like this being a societal problem or whether the private sector ought to pay for it. We are not saying, are we, that it is fair to have the insurance companies which never assumed the risks, never collected a premium for that risk, who have to dig into their pockets and perhaps render themselves insolvent?

Mr. WASHBURN. How can we protect their solvency, if we have been testing against knowable obligations and suddenly in a major, vast area, an unknowable obligation appears?

Mr. HATCH. Mr. Lent, I think it is important in some of these cases—in the pollution area, people point to them and say they didn't know there was pollution or hazardous waste being thrown around at the time. They should be off the hook. It was there, they didn't cover it and it is unfortunate. I think we may all be in agreement on this. It is probably not an insurance problem. When you talk about environmental impact insurance, you are going to find companies not getting into it, nor should they, unless you are going to get a heck of a premium for it. It is a governmental issue.

Mr. LENT. I think in this case I am talking about, the insurance company didn't agree to cover it. In fact, there was an expressed provision in the contract and the court acknowledged that in writing the decision. The court had to come up with someone to take care of it and they said even though the contract says they didn't have to pay and even though they didn't collect a premium for it, there is an express exclusion in the policy, we just think there is a greater public good out there. We are going to overrule what the contract says and sock it to the insurance company.

The question—let me give you the exact language in there:

"The courts found that the health, safety and welfare of the people of this State must outweigh the express provisions of the insurance policy in issue. As a result, the exclusion clause in the policy which pertains to excluding coverage where the damage is to the policyholders' land, must be held inapplicable. So they just achieved this."

We have got judges like this in New York, too. I don't mean to single out New Jersey. They think they are doing a good thing and send the injured party home with a big award. In the meanwhile, no one wants to insure against pollution or is very nervous about it.

Mr. HATCH. Mr. Lent, my point is not—I don't know what the judge did there. I haven't read the whole opinion. I think it would be bad taste for me to comment on it if I haven't. Regardless of that opinion, I don't think you will find a company in the EIL business, nor should they be. You are dealing with a great unknown. Unless they are going to get one whopping premium for it, I don't think you can expect companies to be taking that kind of risk.

Mr. LENT. You are agreeing with me——

Mr. HATCH. Independent of that court decision or not. It is an area government—it is a societal problem government will have to address. Frankly, I think with AIDS, you can't push that off on to the private sector.

Mr. WASHBURN. I think there are—we set up a risk retention group, that got licensed about a month ago, to deal with pollution. I think—and my sense is they are going to be discriminating what they buy. When you buy it, you buy it all. Don't try to build it into the contract.

I don't have in front of me how the contract was worded. There are going to be attempts to deal with it. They have to come up with a price. Somebody has to figure out what the bottom line on this thing is. I don't think we are to the point where insurance is able to price the product yet.

Mr. MERIN. A couple of points.

First of all, I am not sure which court that was in in New Jersey, whether it was superior court. There was a case in Arizona a couple of years ago where a superior court, a lower level court, came out and said that the coverage is not for what is contained in the contract but it is for whatever the purchaser reasonably thought was in the contract. That was a lower court decision. I believe that was overturned on appeal.

We find across the country there are a great many lower court decisions on insurance that are later overturned completely on appeal or the level of damages are reduced. That is the first comment on that decision.

The second comment. There is a concern about tort reform and without making a blanket endorsement or statement of opposition to tort reform, certainly it is an area that should be looked at.

One of the areas in which we, New Jersey, have had some differences with some of the other people in the NAIC is that we believe we should move forward not only on tort reform, if we do move forward in that area, but we should also move forward in risk management. The insurance industry used to be very, very strong in the area of risk management, used to spend a lot of time and a lot of money looking at ways to minimize risk. We feel that the insurance industry should continue to perform that function.

At one point in time high rise buildings could not be erected because the elevator industry was not capable of producing elevators that would work, that were safe. The insurance industry came on board and helped resolve those safety issues.

We believe that again environmental issues, in some cases are possibly insolvable at the present time, but there are a great many environmental problems that are solvable. We believe the insurance industry should be given the power to enforce the insurer to follow certain guidelines. I have spoken with CEO's of organizations and asked them why they didn't do that. It is the same thing we talked about before about loss of market share. They say if we do this, the company will not stay with us, they will go to somebody else that won't force them to do that.

One of the things we are proposing in New Jersey is that the Department of Insurance be given the authority to compel insurers to demand entities that follow certain safety practices. The best way not to have an environmental liability problem is not to have the environmental pollution in the first place, and that is what we are aiming at.

Mr. LENT. Well, if you know of a problem like that—the elevators don't work right, environmental problems—shouldn't the proper remedy be to lobby the State legislature for an appropriate law to cover safety aspects? Why put the burden on the insurance company to go out and perform a function that perhaps rightfully is a function of the government?

You indicated the insurance company should have the power to enforce safety practices. In effect, through the marketplace, they have the right, do they not, to refuse to insure if they look at the building or the machine and decide they don't want to get involved?

Mr. MERIN. They have the right to refuse to insure, but that creates a lack of availability kind of problem. We believe the private sector, the insurance industry has the information, has the data, they have the knowledge, they go out and look at the insured entities. The New Jersey Legislature doesn't do that. My department isn't big enough to do that. But the insurance industry does have a good on-site view of what is happening with the entities they insure.

If you look at particular problems like in the gas station industry, I am aware that in your area, for instance, Long Island sits over a—is it the Magati Aquifer——

Mr. LENT. Yes.

Mr. MERIN. If you have gasoline leaking out of the underground storage tanks it is going to pollute that aquifer. That is something that should not happen. We know there are certain technologies safer than others. We also know those storage tanks wear out over a period of time. Why not have the insurance industry be able to say to gasoline stations, we are not going to insure you at all unless you use a certain technology and you replace those tanks on a periodic basis?

The State government does not have the size or capability to do that, the insurance company does. And by saying to the insurance industry, you have to do this, we are not going to have the gas station going from one insurer to another. That way, rates should come down, the environmental problem goes away, and we don't talk about lack of availability.

Mr. LENT. I understand you theory. I think your facts may be wrong about the gasoline tanks on Long Island, because there we have an active Department of Environmental Conservation, which is acting under the aegis of Federal laws we have passed in this subcommittee. They are the ones who are pressuring the digging up of the old tanks and replacement of them with the new modern tanks. So I am not aware that the insurance companies are really the stimulus for this kind of environmental activity. It is coming more from the government.

Mr. MERIN. My point is the government becomes a stimulus once it becomes aware of the problem. I think the insurance companies have an ability to become aware of the problem a lot earlier in this stage than State government.

Mr. LEVINSON. We are about to announce in Delaware a cooperative industry-government program that will enter the worker's comp area, create a two-tiered system, two-tier approved rate system—one rate for those employers who pay for and pass work place health and safety standards tests approved by the State, and another tier of rates for those who do not. It took a lot of arm twisting to get the rating bureaus to agree to this and all the companies to agree to it.

Mr. LENT. Why did it pass, the State or——

Mr. LEVINSON. There will be people licensed to do it and they will be licensed by the State and the rating bureau will have a system on which we both approve the individuals who can do the test. They have agreed to this voluntarily. I mean, their arms are broken, their legs are broken—I mean they voluntarily agreed to it. It will be a unique testing ground to see if a marketplace approach to in essence use the industry to force its own clients into this health and safety approach, works.

Mr. FLORIO. Will the gentleman yield?

Mr. LENT. Sure.

Mr. FLORIO. You say the marketplace forces will push people in that direction. Why would they do that if there is no sense that anybody who is in competition with you is going to do it? I mean, I have tried to convey this concept Mr. Merin has talked about to the insurance people, saying if you are really concerned about environmental problems, why don't you condition your policies on having ground water monitoring systems at landfills?

They say, that is not our responsibility. That is not something we want to be involved with and nobody else out there that is competing in the industry has to provide that. Therefore, I think Mr. Merin's suggestion about the need for some requirements to be doing things of that sort to minimize risk, are absolutely essential.

I am a little bit taken back by the suggestion that has been made that somehow that is a governmental responsibility as opposed to trying to induce the insurance industry to do it, because again, it relates to my point before about those who say these are societal problems. The temper of the times here in Washington is to literally shred agencies that are supposed to be doing some of this monitoring.

The Consumer Product Safety Commission is a joke. We don't see those agencies doing anything about trying to abate risks, before the fact, so that the governmental presence in this area is just not happening, and therefore, the choice is nothing happens or we hope that somebody in government does something, or the third alternative is to require the insurance industry, which one would think would have a self-interest in trying to minimize risk, so as to minimize the payout.

But we don't see that happening. I understand when you say the marketplace forces are dictating this should take place——

Mr. LEVINSON. What we are doing is a combination. We have the government in effect—I guess I am the government in this instance, requiring the industry to set a dual line of rates for those who in fact pass this safety inspection and those who don't.

Mr. FLORIO. Commissioner Merin is advocating I think on a broader scale than just the workmen's compensation.

Mr. LEVINSON. We are using this as a test.

Mr. FLORIO. That is not marketplace forces, that is governmental dictation, which some may dislike——

Mr. LEVINSON. I view that as a combination. It is government, requiring the government to specifically set two rates. We approve the rates, have two rate levels. You then—I believe the American people are capitalists. If you want them to do something, pay them to do it. We are paying through the insurance system. We are paying employers to run a safe work place.

Mr. FLORIO. I am not offended by guided marketplace forces. I think that is what you have just described, as opposed to hope for the best, that if somebedy wants to come in and make changes, they will do so. I think in a sense what you are suggesting is a variation of what Mr. Merin suggested.

Mr. CORCORAN. There is power now under the system that exists and if the companies were writing pollution it would be more applicable. When they file their writing plans they cannot discriminate in pricing. If X,Y and Z garage has a hazardous site, they cannot give appropriate discount as, for example, a home that has a fire system or burglar alarm system gets reduced rates.

The same thing can be done in the pollution area too, and they cannot discriminate in pricing if there is a garage that is complying with extraordinary safeguards, and they shouldn't be charged the same price.

Mr. FLORIO. Is that regarded as discriminating as opposed to pricing in accordance with risk?

Mr. CORCORAN. If you and I are insuring two different things and one of them is riskier than the other and for some reason, you don't particularly like me and I am a safer operation, you charge me the same rate, you cannot discriminate. You have to have a rating plan and if X,Y, Z, company fits into that plan, that is the rate they should be charged.

There is a mechanism to look at it to make sure they are engaged—and that is the fluctuating system, which requires them to file not only their rates but rating plans. It is a mechanism which is looked at as a critical tool. Commissioner Merin is correct, lack of mismanagement, the industry was supposed to be the fail safe when the Federal Government enacted all the safety mechanisms.

They assumed underwriters were going to walk into those sites and look around. They didn't show up. There is testimony over and over again by municipalities, yes, we had a toxic waste site, no one ever showed up. We had all this insurance all these years, no one ever showed up to look at it, no one gave us any suggestions on how to make it safer, so we are talking here, we are right on the button as far as what the insurer underwrite can do.

What we can do is look at the rating plans files and make sure if you are charging someone less it is based on some risk management aspect, that is why it was that rate.

Mr. FLORIO. Let's talk about for solid waste resource recovery facilities, incinerators. It would be inappropriate for an insurance company to say we will provide you with this amendment of premium if in fact you have emissions reductions in certain amounts that you have a monofill for the ash——

Mr. CORCORAN. I am assuming there are other sites being charged the same or different rates. Based on what? Based on the law of unfair discrimination. If you are charging me less there has to be a basis, not just that you are charging me less.

Mr. FLORIO. So it is a question of legitimacy of the basis for charging?

Mr. CORCORAN. Correct.

Mr. FLORIO. I don't have any difficulty with that. I think that is what you are advocating.

I thank the gentleman for yielding.

Mr. LENT. I have no further questions, Mr. Chairman.

Mr. FLORIO. Let me go back to one of Mr. Lent's questions to you, Mr. Corcoran, on the AIDS issue he raised. Did I understand you to say that in group policies, health insurance policies, which are the dominant I would think——

Mr. CORCORAN. Eighty-five percent.

Mr. FLORIO. The practice in those situations is not to be inquiring about specific conditions, you don't ask black people if they have sickle cell anemia?

Mr. CORCORAN. Their policy doesn't allow that in many States.

Mr. FLORIO. So what is the significance? I am not sure I understand what the issue is, if the major health insurance concern is in group insurance and you don't ask those types of questions, what is the issue that——

Mr. CORCORAN. The issue is, well, the issue at our hearings, we may well start to, but the practice is not to, so there is no issue on those limited policies, but individually underwritten policies, where they do in fact require or might well ask you to undergo serious underwriting, we are saying that the blood test, because of its unpredictability and question of confidentiality, is not appropriate.

We are not saying you can't underwrite it. You can use other tests, but because of the significance, as I pointed out, it is an atypical test. This is a test that has dire consequences on the individual if there are confidentiality breaches. Many of those cases and health plans are self-administered by employers who might well have access to the data. So there is a great sensitivity to it.

It is an issue that is limited in its focus though. The focus is just on those cases where the companies do actively underwrite for the health insurance.

Mr. FLORIO. Do all of the commissioners have jurisdiction over health plans, medigap insurance, cancer insurance and things of that sort?

Commissioner Merin.

Mr. MERIN. We have some jurisdiction over health insurance but in the early 1970's a bill was enacted which gave the Health Department in New Jersey jurisdiction over many of the entities that many of my colleagues regulate.

I have had discussions with the Health Commissioner and we plan to propose legislation that would transfer that authority back to the New Jersey Department of Insurance, because I know that some of my colleagues have been very active in pointing out some of the problems that exist with HMO's, PPO's, and we see those same problems. I want to get authority over those entities again.

Mr. FLORIO. A couple of witnesses made reference to the fact that though we focus on property and casualty insurance, the big problems that may be coming are in other areas. Life insurance as well as health insurance. This committee is doing some preliminary work toward the end of holding hearings in the area of health insurance, the medigap insurance. Likewise in the life insurance areas, we are going to be looking, and have a hearing planned on the junk bond question, so that we are going to be fleshing out our committee's review of the insurance questions.

One of the things that I will just tell you. We have done a preliminary hearing on this cancer insurance thing. Quite frankly, it almost appears to be fraudulent. That is the information we have, and frankly, and I guess I would ask you this question:

How have we allowed this to occur in this country?

Mr. CORCORAN. It is not allowed in the State of New York or other States.

Mr. FLORIO. We have got people paying amounts of money that are large for which there is no return. Likewise, in some of the medigap areas. I saw something in the newspaper yesterday—the State of Washington raised a question about a company paying out 15 percent of the premiums it is collecting in medigap. So this area, it seems to me, is one of a need for very, very close scrutiny, and there is a logical extension of what we are talking about today.

Mr. LEVINSON. Most of those products sold that way, we spend probably 40 percent of our consumer resources just making sure, (a), the products are good products, and (b), that they are sold right. I mean, we spend a great deal of time in that area because of the nature of that business and the nature of the buyer. So, indeed, we do spend a lot of time and try to coordinate that through——

Mr. FLORIO. Ironically enough, in the aspect of fraud, we hear from the Attorneys General, who I assume have a similar perspective to yours, but in some respects don't—there is a need for absolute Federal laws to be passed and the Attorneys General would like to have responsibility delegated to them because they are not overly confident in the FTC and other governmental Federal Agencies to deal with these problems.

They are suggesting a need for Federal laws in some of these areas, particularly the medigap and some of the other insurance promotional fraud areas.

Mr. WASHBURN. About 1 year ago we, with our Attorney general of Illinois, instituted a RICO action against a company that was selling an annuity type product to 80-year-old people that was a product they never needed or would be able to use. We collected all the premiums ever paid, plus a penalty on them, and actually we found three different companies doing it and we collected from all three.

Mr. FLORIO. You refreshed my recollection, the HOP's indemnity programs are also ones that deserve some scrutiny?

Mr. CORCORAN. The approach we have in New York is requiring 65 to 70 cents of every dollar taken. Medigap is not a problem in New York State, because of that approach. The States are looking at it seriously. I think they can do whatever they think is appropriate. It is a way we have of dealing with it and I think the loss ratio approach is the way we have taken. It has worked very effectively.

Mr. LEVINSON. I think you can see many commissioners are doing that. When they get nailed by a few commissioners that puts an end to it. However, the proposal I made with regard to both financial and market data being collected by the NAIC and the ability to pull a ticket in certain circumstances, would fit in with the concern you have.

Mr. FLORIO. One of the reasons the Attorney General advocates that law is because of the problem you touched on. They maintain somebody working out of Beaumont, TX selling something in New Jersey, or whatever State, causes a great amount of disruption in trying to focus on the problem in the State, unless you have some degree of Federal——

Mr. HATCH. To give you an example, there is a company sending out these nice government looking envelopes and the return address was Capitol Hill, Washington, DC. In fact it was a company—I am pleased to say the company's stock, when we took action against it, dropped about $40 million. Acadmian Life I think it was called. They sent out government looking envelopes. They would come back here to a post drop, go to Oklahoma City. They would send those agents from Oklahoma, Iowa, Minnesota. And they go around from the Dakotas going down through Nebraska. It is a migratory pattern and they will go State to State and unload. Out of Texas as well. I am sure we have got them. You never do it in your own State, you do it outside.

We have a rather crude expression about that, but you never do it in your own State, you go outside your State, unload, get back. Phenomenal amounts of abuse occur, particularly those senior citizens, who are very, very trusting. They get into window dressing. One lady had 65 policies and it is all redundant, only one pays.

Long-term nursing care is an absolute fraud in this country. The insurance being sold, an absolute fraud. Not a lot has been done to address that either.

Mr. FLORIO. Let me just say we are into that subject and hopefully will be able to make a contribution in that area.

Let me shift to a couple of mundane questions and more mechanical questions. The whole idea of financial statement credit for reinsurance is one that has been brought to our attention that there is apparently no degree of uniformity that is being applied in determining what in the area of loss reserves, what system we will use in terms of determining whether reinsurers have a history of good paying or not. My understanding is that the commission, the National Association of Commissioners, has suggested the enactment of stronger laws would be appropriate, regarding financial statement credit for reinsurance, that could be able to solve the problem of uncollectable reinsurance.

Mr. WASHBURN. A couple of years ago, we passed—in order to take credit for nonlicensed reinsurers you had to get a letter of credit on an American bank, or you had to hold the premiums yourself. You couldn't send the premiums out of the State. We have tried to regulate the reinsurance industry through the primary industry, and the amount of credit we allow them.

We find we are having problems in terms of how much reinsurance they have on the books compared to their capital and surplus, and there are several States that are trying a number of different tests. Illinois has tried two different tests to start investigating reinsurance terms of—just for our information—Illinois has its own testing. We have been doing computerized tests since 1965. Initial to the IRIS tests, we have our own series of tests we run.

Mr. FLORIO. The distinctions largely being geographic, payout, history or what? What are the variables that go into evaluating whether a reinsurance company is deserving of——

Mr. WASHBURN. Type of capital, location, what they have done in the past, types of assets that we can find. These are things we can find out.

Mr. FLORIO. How many States have the model act?

Mr. WASHBURN. The model act, in terms of the letter of credit? I don't know.

Mr. FLORIO. The majority of them?

Mr. WASHBURN. I think the majority of States have dealt with the requirement for the letter of credit. It is a new requirement, by the way, which doesn't cover a lot of reinsurance prior to 1985.

The problems we are fighting now are reinsurance credits from the early eighties on through 1985. So, we are late on this one, but the reinsurance industry changed dramatically from 1979 on, so we were just a little late catching up. But we are now trying to get a better handle on how reserves are put together on reinsurance, how can we start vesting reinsurance, how we may be able to invest them nationally, and we are trying to find out how others do it, and how we get cooperation among the different international regulators over what is happening in their country with the reinsurer.

Is it bought, in other words, has a good one turned bad on you? How do you get data from year to year? How do you keep them going? We have to understand that there is a lot of international reinsurance that is very, very good, the largest reinsurance companies in the world are from overseas.

They indeed take a lot of American risk, but by the same token, there was a large period of time when conglomerates got into the business because it was easy to get into. You don't need a sales force, you don't need a claims force, you get the primary company to do all the work.

They lost a lot of money and folded their tent, and left a lot of unpaid claims.

Mr. FLORIO. Didn't they go through a cash flow underwriting problem?

Mr. WASHBURN. There was an easy way to get into financial services when investment income was high. You could set up an insurance company in the islands for a couple of million dollars. If you were affiliated with a large national company, you used the reputation of your company basically to sell policies.

The theory was the company would not desert the reinsurance company. You don't need a sales force, because you just sell through intermediaries who are always looking for reinsurance. You don't need a claims operation, because the claims management is done by the primary company. You don't need that expertise inhouse for reinsurance. It is a very easy system to get into.

You have what was called the interest capacity and these people were selling reinsurance to pools and others and they lost a great deal of money.

Mr. FLORIO. Let's draw a worst-case scenario. You describe something that sounds much like a business operation. Let's assume you are talking about hustlers that are off in the islands somewhere and there is no regulation at all.

As you say at certain parts of the cycle, it is a very lucrative business, one can get in and collect and get out and no one is monitoring.

Mr. WASHBURN. The way to get at that is not give credit to the primary company for the reinsurance. Look at the primary company as if it does not have that reinsurance available.

Mr. FLORIO. You say that only half the States have even accepted that concept through the model act.

Mr. WASHBURN. I don't know whether it is half. I would suppose the majority of States have adopted that.

Mr. FLORIO. Mr. Merin, if I recall, you have advocated Federal licensing for offshore reinsurance companies; is that correct?

Mr. MERIN. I am not sure it is licensing. I think the Federal Government ought to investigate it and consider licensing them. I have concerns that they are just logical inferences one can draw.

I am told that net, we have over 1 billion, to 1.5 billion going overseas in reinsurance. Once you extract the premium, we are sending out the claims paid, amount of reinsurance written here for people written overseas, it adds up to $1 billion that we export in capital.

In most cases, it is invested overseas, probably. When they have to pay off and pay off in American dollars, if there is a fluctuation in their own economy, it makes it more difficult for them to meet their requirements.

Mr. FLORIO. Does anyone know what the payout ratio would be in that situation?

Mr. MERIN. I don't know, but the——

Mr. FLORIO. Do you think anybody knows that in terms of any publicly responsible entity, anywhere at all?

Mr. MERIN. Without accepting that last comment, there is a lobbying group called the Reinsurance Association of America. They might have some information.

But on top of that, if you look at the regulatory regimes overseas, they vary. The Caribbean in my opinion is pretty much a joke. There are some countries down there that are better than others, but if you look at some companies—long before I got involved in the insurance regulation area, I took a fishing trip down to the Cayman Islands.

Why anybody would start up an engineering company in the Caymans is beyond me. There are tax advantages offered all over the Caribbean. There are a lot of places that it seems more logical one would go to rather than the Caymans.

If you look at Latin America or the Republic of China, not to pick on that country, but they have some very fine examiners, but I understand they have retired government employees that get an honorary title as an insurance company examiner with no training in that area at all.

How is a company supposed to know whether the assets of an overseas company are good or bad? Reinsurance is to the insurance industry as Latin America is to banks. I think that is true in a lot of cases.

Mr. CORCORAN. I would like to point out one aspect of this. It is very important that you know that the primary is the way we regulate. You cannot protect a fool who violates the law. We have had serious insolvencies triggered by inability to get reinsurance recovery because, in fact, the primary violated the laws of New York.

There is a way of dealing with this, letters of credit being posted, making sure that the unlicensed or excess line company has assets in the State or in the country. So, but there is no way to protect a fool. You talk about ratios, the fact of the matter is——

Mr. FLORIO. Who do you describe as the fool?

Mr. CORCORAN. The primaries.

Mr. FLORIO. The real problem—my understanding is California is suing for $150 million in uncollectible reinsurance on Mission and you can say Mission was a fool but the people that purchased the insurance, out of State as well as in State.

Mr. CORCORAN. That is right. In the loss ratio should be a dynamic of the pricing between the reinsurer and the primary and we have no way of telling that dynamic.

Mr. FLORIO. The question is should we?

Mr. CORCORAN. Sure.

Mr. MERIN. It is more than just insurance. If we are sending all that money overseas, there are tax implications to that, international crime aspects, all those things. Then we, and I would use Jim's language, we collectively are fools if we do not take a look at the broader aspects of this than just the mere: "Is the reinsurance collectible?"

Mr. FLORIO. Doesn't that go to a Federal presence?

Mr. MERIN. Yes.

Mr. HATCH. Look at banking, Mr. Chairman, by analogy. The whole problem of Penn Square and a number of other companies was participation. It is the same issue. It is no different. Reinsurance participation is the same thing. There is nobody regulating it. Nobody. Yes, you cannot do it on a State-by-State basis and you cannot dismiss it by saying these are smart people and big people and they are able to negotiate on their own.

It impacts all sorts of people. There are companies that go broke because their insurance company went broke and they don't have coverage, or the guarantee funds only go to $300,000 or in some States it is very, very small.

Mr. FLORIO. Let me develop that point that you raised. In our State at one point the commission was the Commission of Banking and Insurance. We have separated it. I think we know from the newspapers today committees of the Congress are attempting to reconcile in the context of FSLIC what are the appropriate lines of responsibilities in the financial services industry.

I detect from a few of you that you do regulate banks and reinsurance companies in the entity.

What do you foresee in the near future in terms of parallel regulation? And then some people have talked about the marketplace forces—are there marketplace forces in the financial services industry that will dictate at the State level breakdowns in some of the barriers that have traditionally prevailed, even as we at the Federal level now are debating what the barriers should be or what they should not be?

Do you see any hope or problems associated with marketplace forces being allowed to operate in a larger context than any one of these single components of the financial services industry?

Mr. CORCORAN. I am chairing a group of the NAIC that is directing itself to that question. We have reached out to regulators in other areas to see what techniques they have. It is really an anticipation, not a policy decision whether banks and insurance do the same business. Most, I believe, believe in functional regulation, not parallel regulation. But the issue here is we are looking at that actively by the special interests groups which I chair.

It is only a recent appointment and we are looking at this and we will be reaching out to the other regulators to look at the techniques to list the anticipated problems so that if a public policy decision is made in Congress or in the State legislatures to do this, at least we will have raised the issues before we step forward and make sure there is not a cross-over especially.

Assets of insurance companies should not be exposed to the liabilities of the banks.

So we are looking at it and we are anticipating within a year to have some report.

Mr. HATCH. Mr. Chairman, we do that in our department and there is a lot of—there are advantages for us at least in dealing in some areas. It doesn't necessarily have to be that way but we do it that way. There is not a whole lot of difference between many of the products sold by the life insurance industry and the bank products. They are very similar, and security products for that matter. Mutual funds, annuities. Bank deposits, et cetera.

Depending on what annuity you are talking about or single premium, whole life or whatever, it is a similar product. You have to regulate differently. Between securities and banking you have overlaps. There are overlaps all over the place.

Mr. WASHBURN. Mr. Chairman, in Illinois—Jim mentioned what we are doing on the national scene. In Illinois we have been looking at this for a couple years and we are trying to find out whether there ought to be a merger of the different regulatory functions. But I must mention that as an example, my examination teams are split between life and property casualty. There are enough differences between the two on how they do things that I have different examination teams for both of them. I don't know how Mike is set up, it may not be completely functional but it is something we are definitely looking into to see whether the techniques—before we believe that on the reinsurance thing, every State is involved in that because it comes through the blank. You are not able to take advantage of reinsurance on the blank from a nonlicensed company unless you have, or you keep the premiums yourself. So it deals with every State because it is in the reporting document that values your net worth to the NAIC.

The problem with reinsurance of an insolvent insurer is the reinsurer's view of insolvency is viewed differently in the ongoing operation. Suddenly you get more complaints when a company goes into rehabilitation or liquidation, you get more complaints over whether the policy was taken in good faith by the primary company and a series of things, and they don't pay as quick. That is one of the reasons you have so much trouble with Mission in collections.

Mr. HATCH. I assume Mission isn't, the LOC didn't solve the Mission problem.

Mr. WASHBURN. The LOC didn't exist at the time of the Mission problem.

Mr. HATCH. But you are talking big bucks.

Mr. WASHBURN. You are talking litigation, I think, in terms of how they deal with licensed insurers.

But it has been my experience with the liquidations we have had in Illinois that you find more difficulties collecting from an insurer in rehabilitation or liquidation than you do from an insurer who is an ongoing operation and ongoing with the reinsurer. That is a sort of natural tax.

Suddenly they are a little slower. You have to go after them a little more.

Mr. FLORIO. The problem is compounded if you find they are reinsurers as well as primary insurers as with Mission.

Mr. WASHBURN. There are always compounding problems where you have insolvencies of reinsurers—we have one in Illinois—because there is a ripple effect of insolvencies of reinsurers and you have to understand what you are doing. You find them participating in a number of things just trying to understand exactly what it means. There are always enough differences trying to understand how insolvent an insurance company is or whether an insurance company is or is not insolvent anyway. When they get to reinsurance it exacerbates the problem because the loss development is so far away from reality, it is several years down the track and the other thing is just trying to understand what their participation is, who the reinsurers are.

Mr. FLORIO. My understanding is that last week at your meeting you reflected a proposal to require primary insurance companies that conduct reinsurance business to report reinsurance business financial information separately?

Mr. WASHBURN. We adopted that.

Mr. FLORIO. You did?

Mr. WASHBURN. That is right.

Mr. FLORIO. Is that flowing from the Mission case?

Mr. WASHBURN. That is one of our answers to the Mission case. One of the answers to Mission is we think the reinsurance, the fact they collapsed the receivers together, may have caused problems with the primary receivers. So we adopted that.

Mr. FLORIO. Let me, on this question about liquidations, and when we have them and insolvency, the State guarantee fund law is an area we are concerned about. The payment is generally premised on residence of the insured. It is my understanding that there aren't uniform guidelines in all of the States to define that.

My recollection is we had a problem in New Jersey with Ambassador insurance out of Vermont in terms of who was the appropriate claimant in accordance with Vermont's law when we had more claimants in New Jersey than they had in Vermont and yet our people were left holding the bag so to speak.

Can anybody address this issue of the need for some degree of uniformity on the question, a very fundamental question, of residence? And as I say, this is not going to be an academic problem if your trouble results in resort to the guarantee plans that exists or may not exist in the States. This is something we may well be facing before too very long.

Mr. WASHBURN. There is a model act at the NAIC on both the property-casualty/life, accident/health, and we will be working on one for HMO's, to be frank. So there is a model that can be used. The differences State to State are where the States decided they want to do it differently and it is something that they choose to do when they pass the legislation. Some of it happened, to be frank, a long time ago, because some of the States had it before the national models were put together. But for the most part, there is a standard definition that is available to all the States, and that is usually attempted in all the States, but the differences are where the general assembly wishes to do it differently——

Mr. FLORIO. Isn't that a philosophic thing we have discussed most of the day? We were talking about a marriage earlier. The marriage was on the philosophical point that there is some virtue in uniformity. Uniformity occurs through everybody adopting the same model act, whether it comes from the Federal law that authorized the association to administer some degree of uniformity, or whether uniformity comes from Federal action, in this instance. And again, I suspect some can point to where the absence of uniformity and the definition of something as fundamental as who is a resident for the purpose of claiming under the guarantee plan—absent uniformity, you have a system that breaks down.

Mr. WASHBURN. What you have is you have the ability to define on a State by State basis what you wish to cover through a guarantee fund.

Mr. FLORIO. Right.

Mr. WASHBURN. The State general assemblies do this. There may be no conventional wisdom as to what all should be covered or how it should be covered, but, for example, say this year we have noticed that Chicago has a very competitive market for HMO's and there are HMO's getting in trouble. So this year, we passed an HMO guarantee fund in Illinois because we feel it will be needed in the next year.

To develop a national model for HMO's may take us another couple of years. We have got a model for Illinois that we think will work in Illinois, but the State is able to pass that in one legislative session. It came up earlier this spring and we got it passed 3 days ago. So there are advantages to having the State have the ability to make their own decisions for the citizens of their State.

Mr. FLORIO. For example, in the context of the Ambassador example, what about the New Jersey residents who don't have control over Vermont——

Mr. WASHBURN. The guarantee fund is the New Jersey guarantee fund and the New Jersey guarantee fund defines New Jersey residents and fees a resident of New Jersey, under the New Jersey guarantee fund residency requirement, collects from the New Jersey guarantee fund.

Mr. FLORIO. Isn't that the only example of that—let me defer to Mr. Merin—the example there was New Jersey responded to the Ambassador problem and provided for its guarantee fund to be able to reimburse the citizens?

Mr. MERIN. We created a surplus fund. The Ambassador was writing a New Jersey surplus line.

Mr. FLORIO. Is that exact statistics of what we have across the country?

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Mr. MERIN. We are the only State in the country with the surplus lines guarantee fund and most people think we are kind of nuts for doing it.

Mr. HATCH. If I can inject with respect to the uniformity, because you are talking about insolvency as well, what happens when a company goes under? Generally the domiciliary State appoints a liquidator, but a number of other States—this is where it becomes competitive and some States are very aggressive, they appoint ancillary liquidators to grab the money and you have the fight between the States as to who has the money.

Mr. FLORIO. Let's assume the money is in the domiciliary State.

Mr. HATCH. It is not always there. There will be——

Mr. FLORIO. Assets somewhere else?

Mr. HATCH. General agents have tons of money out there somewhere else. A lot of these companies you find the general agents, that is one of the reasons why they go under.

Mr. FLORIO. Where is the lawsuit filed to make the determination as to who has claims?

Mr. HATCH. The local court. Generally you get removed by the agents, the agents get sued and they get sued with the local jurisdiction and they have to drive or fly to another State. A lot of hometowning is alleged to have occurred. I don't know if it does occur. But there is a great deal of problems, because you end up in every one of these insolvencies with all sorts of State involvement.

Not particularly, certainly the guarantee funds have different issues. But from the receivership side of it, a lot of litigation. Those agents are sued left and right. You have got claims being filed. States grabbing the money and wanting to direct it within their own State. It does create some havoc.

I do think the one way to address that is to—thought whatever—I don't really care what the model, whether it is FDIC or whatever you call it, but that that model with regard to solvency also be responsible with regard to the insurance side. That is the ultimate police power. That is the ultimate concern, your measurement of success being how much you are saving in the process. I think that is a distinct difference between the FSLIC and FDIC, and why they take different approaches.

Mr. LEVINSON. Mr. Chairman, two points:

One, the NAIC is dealing right now through a special task force committee, with the issue of the relationship and developing a uniform relationship between the receiver and ancillary receivers and to go one step beyond that, between receivers of insolvent companies that have cross issues with each other in separate States. So the NAIC right now is dealing with that very problem and has a committee working on it to develop a uniform approach.

My second point I would like to make is that with regard to who the guarantee association pays, that in the model I suggested to you is a classic example of a State issue, not a national issue. After all, Delaware made a decision with recent legislation that regardless of the line of business, we are going to take care of Delaware residents, period, and we are not going to take care of anybody else, period.

Now, Delaware residents like that decision. They will reelect those who made it. If they don't like the decision, they will elect someone else. If a different kind of decision is made by legislators in different States, the only people who are going to get hurt by that decision are their own citizens if they vote not to protect them.

I think that all States are now beginning to move in that direction, which is to protect their own citizens regardless of the State of domicile of the insolvent company, and not to go outside of their States, as was typically done in the life and health area until regional covering everybody in the world if the domiciliary company goes broke.

Mr. Florio. I can see Mr. Merin's objections earlier coming to pass very quickly if everybody—about the insurance industry coming to Washington saying we want Federal registration and we want you to preempt the field so that all of these—they may regard you as radical approach—all these radical approaches are not going to be able to be implemented, and I commend you and I understand. I didn't realize that you were elected. How many insurance commissioners are elected?

Mr. Washburn. Eleven.

Mr. Levinson. Eleven of us.

Mr. Florio. That is an interesting concept. I am not familiar with that concept. I suppose it seems to me it is almost the concept of electing attorneys general—another one that troubles me a bit. But I can understand your concern and sensitivity to the people in Delaware.

The question is, what happens about the other people who have purchased the policies from the companies that might be satisfied—might be based in Delaware?

Mr. Levinson. If their guarantee associations, if their legislators have not voted to have their guarantee associations cover them, if an out of State company that has sold them goes broke——

Mr. Florio. They don't regulate the company that is based in your State?

Mr. Levinson. Oh, yes they do. Of course they do. I have 200 domciliaries, but I regulate 1,300 companies that are licensed to do business in my State, and if I am not satisfied with them, I will pull their ticket. I don't care if John or anyone else wants to let them domicile in their States.

Mr. Florio. You have confidence that you have access to information you need from those other States to regulate with the same degree of scrutiny that you do over the companies located in your State?

Mr. Levinson. If I had total confidence in that I wouldn't have recommended a model in which the Federal Government passes a statute giving the NAIC the power to do this on the national basis. I would like to see still more teeth put into the NAIC activities. I think they are doing a fine job now and I am fairly comfortable with it.

I would like to see it tightened up, I would like to see them have the right to charge that fee, everyone who insures or reinsures, even if an alien, have the obligation to file with the NAIC. I would like to have more teeth put into what the NAIC powers are.

Mr. Florio. Let me ask a question about information that was provided to us from the California Insurance Commissioner's office.

It is represented that the commissioner has ordered companies to raise their rates without using ISO projections. Does this in any way support the idea that the anti-trust immunity is no longer required or was necessary?

Mr. CORCORAN. The fact is in reality very few companies follow the filed rate. That was one of the problems. As far as directly connecting to the rate filed, I think it is cosmetic and that is substantive, but it is not something you can directly relate to the crisis.

Mr. WASHBURN. Let me say they have not been able to file advisory rates in Illinois since 1969 when we no longer had the law. We think McCarron-Ferguson is needed.

Mr. FLORIO. If you can develop that for a moment—absent the anti-trust immunity there would be some problem in coming to joint——

Mr. WASHBURN. We allow them to put together the loss data, trend it and look at loss adjustment expenses, but we don't allow them to come up with an advisory rate which would include their operational expenses.

Mr. HATCH. Mr. Chairman, I would ask that——

Mr. WASHBURN. From our standpoint we think that that is important.

Mr. FLORIO. Mr. Hatch.

Mr. HATCH. I am somewhat confused because that is just exactly what the bill is. The bill is what the NAIC apparently opposes but which is what the bill proposes.

Mr. WASHBURN. No, it is not.

Mr. FLORIO. You are talking about the repealer.

Mr. HATCH. At least the bill I testified to in the Senate allows that, allows the loss data part. That is why I am surprised to hear of their opposition.

Mr. WASHBURN. Repeal of McCarron-Ferguson will do more than hit advisory rates. I think it will impact on how our laws and actions are looked at basically. The State action doctrine is not all-encompassing as McCarron-Ferguson. You have to have a clear purpose for State action to work, you have to have a lot of State involvement. To be frank I could not have set up the MAP program I had in Illinois under the State action doctrine. The companies that I asked to participate in that program would have said to me, you are putting me at risk. I am sitting down with my competitors on risk that may come through my company. I have a series of problems with this, but because I was involved even only partially, they were able to do it.

What McCarron-Ferguson does is give you a different level and a different ability to impact things regulatorily than you have under just the State action doctrine. That is why I think it is very different.

Mr. FLORIO. Let me ask Commissioner Merin, you suggested a number of areas relating to insurance in which the Federal Government may have a role to play. These include reinsurance, monitoring companies based abroad and investigating the effects of stock ownership and conglomerate ownership. Can you amplify a bit on that last concern?

Mr. MERIN. There are questions that we have, and we have no answers to those questions. When we look at companies, how they weathered the last crisis, we know during that crisis many of the insurance companies that were not writing insurance for various reasons were still paying dividends to parent corporations. It is a phenomenon that has occurred in the last few decades.

There are a great many companies, Sears, Allstate, in our own State Xerox owns Crum & Foster. ITT owns one of the companies, I think Hartford, up in Connecticut. It is a phenomenon that needs to be looked at.

There are two types of companies, mutuals and stocks, and I am not prepared to say that there is something untoward that is going on out there, but I do think it ought to be looked at. I don't have the capability to do that at our Department.

Mr. FLORIO. Commissioner Corcoran, I know Mr. Lent had mentioned earlier you and he have had some discussions on the Risk Retention Act, particularly the implementation. My understanding is that you have made some public statements that you were concerned about other States carrying out their responsibilities under the Risk Retention Act, and that is what prompts your lack of enthusiasm for the implementation. Am I stating what your concern is?

Mr. CORCORAN. Well, many things—we have all had hearings, we have all agreed cash flow underwriting caused the crisis. Tort reform maybe we can discuss. But here is an entity that can do cash flow underwriting freely with no regulatory oversight. If that was Congress' response to the crisis, I have serious concerns about what we are doing here talking about new initiatives.

Mr. FLORIO. Oversight by the domiciliary State?

Mr. CORCORAN. If you are going to form a risk retention group, as evidenced by what has occurred in the State of Florida, where Florida came after a company in medical malpractice, if someone is going to form a risk retention group, they are not going to go to a State like New York, New Jersey, Delaware, with their vigorous regulators. They are going to go to a place where they think there is not the staffing adequacy.

What the Congress has done is created an entity and told the States to regulate it with no budget.

Mr. FLORIO. Doesn't that go full circle back to where we started? If we don't have some minimum degree of uniformity in the primary insurance area, as well as in risk retention groups, you are always going to shoot—somebody is going to shoot for the lowest common denominator?

Mr. CORCORAN. Unlike any other thing, Congress hasn't made me accept that one. Years ago, you might well have formed for X, Y, Z State, but New York would say "You are not coming in." You forced it down the throat of the State of New York by saying you have to let them in. That is where this is different. You have created an entity where I have to let them in, where historically if a State—sure, if they came into my State, I wouldn't give them a license because of inadequate reserves, and in my view they are not meeting criteria.

Mr. FLORIO. My recollection was we put in some secondary authority for a State, such as your own, to take some actions in the event you determined the domiciliary State was not in any way——

Mr. CORCORAN. There was a good-faith effort to negotiate that. It is after-the-fact authority. It is chasing them authority. You are telling me, let them in and watch them. You are not giving me the budget to watch them, you are not supplementing my budget. They are coming in in troubled areas, saying "I want to sell medical malpractice"—what am I going to do—"50 percent lower than a qualified company. What are you going to do about that?"

It becomes a question of whether or not they become insolvent. It becomes an Atari game of regulation.

Mr. FLORIO. We are anxious to receive from not only you, but other associations, specific information about bad experiences, if there are ones that are starting to play out, in the course of our oversight responsibilities over this act. We would be happy and enthusiastic to receive that type of information.

Mr. CORCORAN. We will be happily, enthusiastically giving it to you.

Mr. LEVINSON. You might be interested in this. When this hearing started, Mr. Lent congratulated me because of my attitude toward the Risk Retention Act. When the act was passed, I said publicly Delaware is going to be the American capital of risk retention groups. We took a delegation of 14 people to the meeting, we said "We want risk retention groups to form in our State, and we are going to regulate the dickens out of them so no one is going to have to worry about it."

We had 200 requests for application. Mr. Chairman, we don't have one single operating risk retention group as a result of that because they were flakes from top to bottom. What happened was that there were very few, at least so far, very few reasonable solid groups that wanted to form risk retention groups. What happened was the hustlers out there saw this is an opportunity to grab at Congressional law and run all over America and sell garbage. When they found out Delaware, who said we are going to be the home of risk retention groups, was going to regulate the daylights out of them, and we were going to do it right, they didn't want anything to do with us.

Mr. FLORIO. Mr. Washburn, how many States have passed legislative authority to establish risk retention groups?

Mr. WASHBURN. You don't need legislative authority. They get licenses from the insurance company. Basically, what the States had to pass was regulatory authority over risk retention groups coming in.

Mr. FLORIO. How many have them?

Mr. WASHBURN. I think most of the States have passed that by now. Most of the States have to do that in order to respond. What we are finding is less retention groups and purchasing groups. We are finding a lot of purchasing groups requesting to come in.

Mr. FLORIO. Are there any States—I don't want to describe them as havens—are there any States that have consciously attempted to attract—the gentleman from Delaware indicated he tried to and attempted to go forward with rigid regulation that didn't get any takers. Is it fair to say there might be some States that would try to attract and not be as vigilant in terms of regulation that could be serving as a magnet to bad operators?

Mr. WASHBURN. There are States that had captive bills, Vermont is one, that had a captive bill that allowed capitalization for an insurance company at a much cheaper price than most other States and with less restrictions on the company, and many of the risk retention groups are looking at Vermont because of their capitalization requirements and the lower amount of regulation that is available through their law. That was passed when the original groups went through, and it has not been changed.

One of the things we had going at the NAIC was basically to take a look at the different States and different laws and see where we as a system have to set things up better because of the Risk Retention Act. There is no doubt we have to address a new type of regulatory thing with the Risk Retention Act, and we are in the process of trying to develop a system that will handle it.

Mr. FLORIO. Let me ask one last question. As a matter of fact, this hearing has been so long, I can't remember if I asked you this question, Mr. Merin, but let me ask you again, even if I asked it before. In the context of automobile insurance, verbal threshold, of course modification of the tort laws, tort law reform proposal legislation has been discussed, although it hasn't been passed, that would mandate a premium reduction if certain actions were taken. As I think I have talked to you privately, that came as a surprise to me because the representatives from the insurance industry have always taken the position that you can't quantify premium reductions off of tort law revisions, they always make the point, yes, it will improve the situation, that we can look forward to premium reductions if you change the tort laws.

You went so far, as I understand it, as to literally quantify the premium reduction that would flow from this modification of the tort law. And I was a bit surprised that you had sufficient confidence that you could advocate to the legislature that with this modification taking place, "X" number of dollars can be saved, and, therefore, the premiums should be reduced.

Do you have sufficient confidence in your methodology that we could do the same thing in other areas of tort law reform? If we change product liabilities at a State level or if we do it at the Federal level, is there the methodology out there that can quantify the savings to the insurance industry that could be rolled into premium reductions?

Mr. MERIN. It would depend upon the nature of the line of insurance, and it would depend upon the type of tort reform. We are fortunate we had the experience in Michigan to look at, which has the same type of threshold, so we had some means for comparison, we had some pre-existing data. We did hire five different actuaries, consultants. We also used some company actuaries, several different companies, we had our Department actuaries looking at the survey that we had done, we priced it.

Interestingly enough, all of the actuaries, there were independent actuaries, consumer oriented actuaries, company actuaries or the Department's actuaries, all came out in the same basic area. Auto insurance is one of the simplest forms of property casualty insurance. I am confident that our numbers are correct. The industry is in general agreement that our numbers are pretty much in the ball park. The way that could be done for something like medical malpractice, I think it probably could be, because it is a limited area. Could it be done for a CGL or some more esoteric line? I don't know.

Mr. FLORIO. How about specific components. The product liability bill we are talking about, there is a strong consensus that is starting to evolve that punitive damages would not be appropriate in areas that were regulated by the government, if we were talking about specific areas. The pharmaceutical industry as an example, that was regulated; therefore, we would never almost be capable of involving reckless disregard, if they went through the whole regulatory morass.

Do you think there is methodology out there to be able to say that if an industry was not susceptible to being sued for punitive damages that that can translate into dollar quantification so as to be able to have premium reductions for a pharmaceutical company?

Mr. MERIN. I think you could make projections. You would have to take a look at how much has been paid out, how much the companies were setting aside in reserves. I hesitate to say. I don't know on a line-by-line basis, I think in certain lines, you can come up with——

Mr. FLORIO. I will recognize the gentleman in a minute except to say obviously much of the impetus for product liability reform is coming from business people, particularly small business people who are saying my insurance rates are outrageous; therefore, we would like to make these changes under the assumption the changes will translate back into reduced insurance premiums.

Now, some of these who are not offended by the whole equation, but we want to make sure the equation really results in a quid pro quo result for the business people. I have not had conveyed to me sufficient information that there is the methodology out there to quantify those things.

Mr. HATCH. Mr. Chairman, I am not sure how many States have this. Most policies—in Minnesota, we permit companies to exclude punitive damages on their policies, and they all do it. I would assume in most commercial policies, they have a specific exclusion for it. It is not really an insurance issue. In our State, we permit them to exclude it.

Mr. FLORIO. I use that as the one example. I could have used joint and several liability. I don't find a whole lot of deep-pocket arguments. A Company has been put on the hook for the entire bill that it was only marginally responsible for. We have a lot of anecdotes that come in, we haven't got a body of knowledge, and, therefore, I don't know how we will give anybody any assurance if we change the law it will translate into reduced premiums at some point.

Mr. WASHBURN. One of the problems of trying to come up with direct numbers is so much of this is done by settlement, when they settle it rather than a court case. When they settle it, they do not necessarily break out how much of this would be due to a particular type of change in the law. I think there is an attempt to look at this, I am not sure how effective it is going to be. They did a closed name study in Texas to find some of this stuff out, and I think they may be better able to answer this.

But it is probably very difficult to come up with a particular dollar decision, and, of course, the end product everyone says is in the competitive environment, less cost should translate into less price. They are not sure anybody is going to be able to come up with a direct cost where you would have such a composite of how the actual settlements are made.

Mr. MERIN. There are two issues in tort reform. One certainly is price. The other is availability. In some areas, the environmental area may be a good example, just enacting some tort reform may not drastically reduce the price. I think in some areas where you do collateral source, joint and several, it will increase to some degree availability. There are two reasons for doing it. It depends on the line. In some cases you will have increased availability and lower price. In other areas, you might have just increased availability.

I think for some lines it would be possible to come up with a ballpark area.

Mr. LEVINSON. We have eight bills in the Delaware Legislature right now in a package, all having to do with the automobile industry. Each one of those bills has a rate roll-back attached to it, anywhere from 1 to 10 percent. These are all things the industry wants.

But the rate roll-back is only for a period of 24 months. There is a short tail in these claims. So, in essence, what we are saying is, no, we don't know for sure, is it 1 percent, is it 2 percent? We don't know, it is a best guess, but it is only going to last for 2 years and phases out over the 2-year period as the actual experience phases in.

If, in fact, these bills don't save money, then the public hasn't been hurt and in terms of what they have collected, and the premiums aren't going to go down——

Mr. FLORIO. The public can be hurt. We passed no-fault in our State and mandated a 15 percent reduction. At the end of the period there were astronomical increases, because nobody had thought through the consequences of the mandated 15 percent reduction. I think in some respects if one guesses, I guess one hopes for the best, but missing in your calculations can come back and hit you, can come back and get you fairly substantially.

Mr. LEVINSON. The numbers are not that great. We had our actuaries go through how far off can we be in a worst-case scenario, and the numbers simply weren't that great. We can't be that far off. If we are off a little bit, it phases out over a 2-year period anyway. An automobile, it is kind of easy—in automobile insurance, it is kind of easy to do this.

Mr. MERIN. The other point is, again going back to Mitch, they passed a verbal threshold. The number of lawsuits in Michigan dropped by 50 percent. In New Jersey, the $200 threshold had no impact. As a matter of fact, lawsuits increased dramatically since the $200 threshold was enacted. Of course, I don't have the data——

Mr. FLORIO. It is not fair to imply that it has increased as a result of the $200, but there are a lot of other forces at work over this period of time that have resulted in increased litigation. I subscribe to the thought that a dollar amount is going to automatically be a target for somebody to get above so as to be able to go to court if somebody wants to.

Mr. MERIN. On the basic principle of whether we can price certain things, I think, depending on the line of insurance, it is possible to price it. It is an extensive operation. It takes time and personnel to do a good closed claims study, but I think that that could be done.

Mr. FLORIO. Let me conclude by saying I certainly appreciate the panel's participation, your generosity with your time. It has been extremely helpful to the committee, and we look forward to working with all of you collectively and individually as we try to continue to address some of these problems. Thank you very much.

The committee has no further business. The committee stands adjourned.

[Whereupon, at 1:45 p.m., the hearing was adjourned subject to the call of the Chair.]

[The following letter was submitted for the record:]

REINSURANCE ASSOCIATION OF AMERICA
Washington, DC, July 8, 1987.

Representative James Florio,
2162 Rayburn House Office Building,
Washington, DC. 20515

Dear Congressman Florio: Several questions about reinsurance were raised at the recent hearing you chaired on State regulation of the insurance industry. The RAA would like to clarify and supplement some of the responses in the interest of improving Congressional understanding of our somewhat unique business.

You asked how many States had adopted the NAIC model credit for reinsurance law, and Commissioner Washburn responded that a majority had enacted such legislation. The 1984 model act, as you may know establishes minimum standards. To our knowledge, only seven States passed that law but a majority are in compliance since they already enforce equivalent or stronger standards. There are several States that have no or weaker credit for reinsurance laws on their books, and fortunately that number is much lower than it was, say, 10 years ago. The substantial interest in reinsurance collectibles has, as you might understand, moved some of those remaining States to consider legislation this year. We will certainly update your staff on the result when those State legislative sessions end.

The discussion on the model act focused on letters of credit, and Commissioner Washburn indicated that the NAIC Blank essentially unified LOC standards. First, nearly all States require LOC's when business is ceded to a foreign reinsurer whether or not other provisions of the model act are enforced. Since the U.S. market relied so greatly on foreign reinsurers in prior decades, regulators have long been developing and enforcing LOC requirements. The major exception to the LOC rule is where a State can approve a foreign reinsurer, either by placing it on an approved list or allowing credit on a contract by contract basis. Some States, to our knowledge, do approve foreign and U.S. insurers for credit purposes. They substitute their own review of the foreign reinsurer for the LOC, and if the company meets certain solvency and reliability tests, approval is given. If not, the LOC or other security is then required. We note that this approval is distinct from the more permanent and comprehensive licensing process, but that some regulatory review is conducted.

With regard to the Blank, it does not override State law but rather unifies reporting under those different laws. Nevada, for example, now prohibits domestic insurers from ceding business to foreign reinsurers without express approval by the Commissioner. Since it is likely that only Lloyd's will be so approved, unlicensed foreign reinsurers are essentially barred from doing business in Nevada. The Blank has a provision for LOC's with foreign reinsurers, but Nevada insurers cannot use this provision. Conversely, the Blank cannot upgrade weaker State laws. Rather, the Blank requires insurers using LOC's for credit purposes to highlight them in the list of deposits and funds securing unauthorized reinsurance, thereby alerting regulators to the extent of reliance on LOC's.

On the subject of foreign reinsurers, there are sources of information other than the RAA. The Commerce Department prepares an annual report on the amount of reinsurance premium paid abroad; the next report is due later this month. Best's

LIFE INSURANCE COMPANY SOLVENCY

WEDNESDAY, JULY 29, 1987

HOUSE OF REPRESENTATIVES, COMMITTEE ON ENERGY AND COMMERCE, SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION, AND COMPETITIVENESS,

Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2322, Rayburn House Office Building, the Hon. James J. Florio (chairman) presiding.

Mr. FLORIO. The subcommittee will kindly come to order. I would like to welcome all to the hearing which will address the question of the solvency of life insurance companies.

Incidentally, Mr. Waxman and I today are releasing a GAO report that we previously had requested that has just been provided to us, that involves questions surrounding matters of insolvency of property and casualty companies, which obviously is somewhat related.

The report confirms previous information we had that this is a growing problem over the last number of years. The report confirms that there have been higher payouts from guaranty funds associated with property and casualty insurance insolvencies and notes the conflicts between the States in the implementation in carrying out of the respective responsibilities of the States in the context of the interaction of the States on the guaranty plans that exist in the different States.

I would suggest that those of you who may be interested might want to review the report that we will be turning loose today.

Today, as I said, we are going to focus on insurer investments in high-risk/high-yield bonds, sometimes known as junk bonds, and the operation of State guarantee funds.

During the last 2 years, the subcommittee has held a great number of hearings on insurance with principal emphasis on the property and casualty insurance industry because that has been the focal point of the crisis that we have been perceived to have been in.

The liability crisis has been one that I suspect is still out there, although some of the pressure on Members of Congress has moderated over the last number of months. In recent months it has been suggested to the subcommittee that problems are developing in the life insurance industry as well, problems that could be at least as damaging as the problems we have had in property and casualty insurance.

One issue that has been brought to our attention is a growing tendency for some insurance companies to invest heavily in junk

LIFE INSURANCE COMPANY SOLVENCY

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Mr. FLORIO. The subcommittee will kindly come to order. I would like to welcome all to the hearing which will address the question of the solvency of life insurance companies.

Incidentally, Mr. Waxman and I today are releasing a GAO report that we previously had requested that has just been provided to us, that involves questions surrounding matters of insolvency of property and casualty companies, which obviously is somewhat related.

The report confirms previous information we had that this is a growing problem over the last number of years. The report confirms that there have been higher payouts from guaranty funds associated with property and casualty insurance insolvencies and notes the conflicts between the States in the implementation in carrying out of the respective responsibilities of the States in the context of the interaction of the States on the guaranty plans that exist in the different States.

I would suggest that those of you who may be interested might want to review the report that we will be turning loose today.

Today, as I said, we are going to focus on insurer investments in high-risk/high-yield bonds, sometimes known as junk bonds, and the operation of State guarantee funds.

During the last 2 years, the subcommittee has held a great number of hearings on insurance with principal emphasis on the property and casualty insurance industry because that has been the focal point of the crisis that we have been perceived to have been in.

The liability crisis has been one that I suspect is still out there, although some of the pressure on Members of Congress has moderated over the last number of months. In recent months it has been suggested to the subcommittee that problems are developing in the life insurance industry as well, problems that could be at least as damaging as the problems we have had in property and casualty insurance.

One issue that has been brought to our attention is a growing tendency for some insurance companies to invest heavily in junk bonds. According to one estimate, the industry now holds $30 to $40 billion worth of junk bonds and it has been reported that at least a few companies have had anywhere from 10 to almost 60 percent of their assets invested in these high yield/high risk securities.

Some observers argue that a properly managed investment portfolio of junk bonds is not unduly risky and that junk bonds are an extremely important source of capital for the American economy. Others, however, say that some insurers have gotten too heavily involved into junk bonds, neglecting their fiduciary responsibilities to their policy holders. In this view, excessive investments in junk bonds threaten the solvency of life insurance companies.

A related concern is that the burden of misguided investment strategies might fall on other insurers and their policy holders. In States that have guarantee funds, solvent insurers have to contribute to the fund to pay claims for an insolvent company.

These problems raise fundamental questions about the future of the life insurance industry. The high level of junk bond investments appears to be in certain instances one manifestation of the industry's response to rapidly changing economic conditions, including volatile interest rates and competitive forces resulting from deregulation of financial markets in general.

These forces have transformed the industry and I am not sure the public perception and understanding has kept pace with these changes. I am hopeful that today's hearing will begin the process of improving our understanding.

The life insurance industry contributes in a number of ways to important aspects of our economy, providing security to individuals and capital for American businesses. We need to find out whether the ability of the industry to perform any of its functions is in any way jeopardized and whether adequate accountability exists to ensure the public interest continues to be served.

Millions of Americans have staked their wellbeing on the life insurance industry. If problems exist, we need to ensure that they are addressed, so that the crisis of which some have warned never occurs.

Our witnesses today are extremely well qualified to address these issues and we are grateful for their participation and look forward to hearing from them.

Mr. FLORIO. I would like at this point to yield to my friend and colleague from New Jersey, Mr. Rinaldo.

Mr. RINALDO. Thank you very much, Mr. Chairman. I want to begin by commending you for convening this hearing on the insolvency of insurance companies and, in particular, how their solvency could be affected by investment in junk bonds or high yield bonds as they should properly be called.

Although this is a subject in which I have deep interest and I want to make a number of comments about the hearing, I will be unable to stay for the hearing because the Subcommittee on Telecommunications and Finance of which I am the ranking Republican member has begun hearings on legislation to amend the tender offer process and one of the issues which has been talked about there and will be discussed this morning is junk bonds and their role in takeovers.

That subcommittee scheduled that hearing quite some time ago and I have witnesses that I have invited there so unfortunately I will have to leave. However, I am particularly interested in the issue that is going to be discussed this morning and Mr. Chairman, I would like to share some of my own thoughts with you and the witnesses before I leave.

There is no question in my mind that we should do everything possible to see that insurance companies are solvent and pay the benefits they should. That is a continuing responsibility, however, of the State insurance commissioners and I commend them for their efforts to see that consumers are protected.

I strongly feel, however, that when we broach the subject of so-called junk bonds, we must do so with care. Not many people are intimately familiar with Wall Street. Not many people understand how the name junk bonds came about but in my opinion, the name "junk" is a misnomer.

Contrary to popular belief, junk bonds are not just an investment tool used by slick investment bankers in a tender offer report. It is true that they have been used in tender offer fights and in our other subcommittee we have heard testimony to that effect but even there, it is admitted by everyone that that has occurred only in a minority of instances.

In my opinion, it is much more appropriate to regard junk bonds as a tool for capital formation that is finding an increasingly accepted role in the marketplace. The financial services industry has changed dramatically over the last few decades and commercial banks which formerly were a common source of long-term fixed rate financing for small companies are decreasingly involved in this function.

That void has been filled by junk bonds or high yield bonds. Mr. Chairman, in our own home State of New Jersey there are 1,052 companies headquartered there with sales of more than $25 million. Of that number, over 95 percent, 1,003, are noninvestment grade companies that would have so-called junk bonds if they went to market as junk bonds are commonly defined.

These companies employ three-quarters of a million people worldwide. They generate $94 billion in annual revenues. They raised $11.6 billion of capital in the public markets from 1980 through 1986, including $4.1 billion of common stock and $7.5 billion of fixed income from so-called junk securities.

Nationwide, fewer than 800 companies have investment grade bonds. If you compare that with the noninvestment grade companies, investment grade with the noninvestment grade companies, you get some interesting facts and I think they should be laid on the table here.

The over 1,200 companies rated less than investment grade which have issued public debt junk bonds have increased revenues by 32-percent and employment by more than 24-percent over the past 3 years.

By contrast, the 800 investment grade companies have increased revenues by less than 12-percent during the same period and have actually lost jobs. These are indisputable facts and figures.

So, therefore, Mr. Chairman, I once again deeply regret not being able to stay here but I would urge you and I would hope that the subcommittee would take a close look at this issue and I know you are going to do that before reaching any conclusions about the undesirability of junk bonds.

I would hope that no member of this subcommittee would jump to any hasty conclusions. So once again, Mr. Chairman, I want to commend you for scheduling this hearing and I yield back the balance of my time.

Mr. FLORIO. I thank the gentleman for his comments and just for purposes of clarification, through the course of our entire set of hearings actually over the last session of Congress and this session of Congress into the insurance industry, the motivation has been to try to learn as much as we can about the insurance industry because it is a matter of common knowledge that the Congress has not been involved in matters of insurance legislation that frequently or insurance regulation, but it is within the province of the Congress to regulate the business of insurance.

But it is a fact of life that the gentleman's constituents, I suspect, as well as my own and everyone else's, are coming and saying that there are some serious problems in the insurance industry.

Of course, the GAO report today and other evidence that we have had in front of this committee is that there are some objective problems out there that are manifested, I suppose, most dramatically by the growing insolvencies that we are starting to see.

What it is that we are trying to do is to understand about the industry, we are trying to understand what the problems are and quite frankly and quite candidly, some of us at least are trying to formulate appropriate responses at the time that I suspect the responses are going to be demanded by the American public. If the current wave of insolvencies continues and if the evidence that has been presented to us that the existing patchwork quilt of guarantee plans that we have around the States is not going to provide appropriate remedies for individuals, then it may be that at some point there will be the need for some type of remedial response and such a response can only be a meaningful one if we understand the fundamentals of the industry and the fundamentals of some of the problems associated with different aspects of the financial services industry, one of which, of course, is the insurance industry.

So with our responsibility of gathering facts, this is part of a continuing effort for us to find out those facts and the gentleman's observations and the observations of other members and witnesses over the last series of hearings are all legitimate and we are hopeful that as we gather more information about each and every facet of this very important business, that is, the insurance industry, for the health of the country, that we will be better prepared to take whatever action that the committee and the Congress ultimately deem required to make sure that the public interest is being served by a healthy and viable insurance industry.

So I want to express my appreciation to the gentleman for his observation and certainly for his participation. I know that we are all pressed to the limits but the gentleman from New Jersey has made a specific effort to try to be present at each of these hearings, notwithstanding the fact of his multiple responsibilities and we certainly acknowledge this.

We are pleased to have as our first witness the Superintendent of Insurance for the State of New York, the Honorable James Corcoran and Mr. Superintendent, we are pleased to have you. Your statement will be made a part of the record in its entirety. We would ask for the record that you introduce your colleague and please feel free to proceed.

STATEMENT OF JAMES P. CORCORAN, SUPERINTENDENT OF INSURANCE, STATE OF NEW YORK, ACCOMPANIED BY TERENCE LENNON, CHIEF, LIFE INSURANCE BUREAU, INSURANCE DEPARTMENT, STATE OF NEW YORK

Mr. CORCORAN. Good morning, Mr. Chairman, and thank you for this opportunity.

I would like to introduce the gentleman on my right. He is Terence Lennon, the Chief of the Life Insurance Bureau of the New York State Insurance Department.

Mr. FLORIO. We welcome you to the committee.

Mr. CORCORAN. He's the real expert. Superintendents come and go, but chiefs are forever.

It is my intention today to outline to you the principal concerns of the New York State Insurance Department about life insurance investments and in particular the reasons behind our promulgating in June of this year Regulation 130 to place limitations on the concentration of high-yield, high-risk obligations that any one—and that's a key point—any one New York domiciled life insurance company can have invested in.

Now I can sum up the department's underlying philosophy here towards life insurance investments as consumer protection. But also there's another important element that we haven't stressed, in my view, enough in the statement. It's called fair competition. You're going to hear an awful lot of witnesses talk about competition; you won't hear a heck of a lot about fair competition.

The regulation plays that role of creating an environment of fair competition. And as the chairman has noted, there are life insurance guaranty funds. I have in my possession—I'm sure other States have had similar complaints about people soliciting insurance products or selling insurance products and noting to the prospect that our promise or our projection of a high return on this product is not to be worried about, because after all, there are life insurance guaranty funds, and you might well have the situation, as perhaps the analogy of Baldwin-United could stress, of a company going out and taking a big share of the market, making promises of a higher return to the individual and then defaulting on that return, going into bankruptcy, and the competitors who have lost that business get the privilege of paying for the liabilities in the long run. So that's why we have to talk about fair competition.

Now it's important in recent years to note that the life insurance companies have faced stiff competition for a consumer dollar that seeks the greatest possible return in addition to financial security. Consumers no longer want death insurance; they really want life insurance. They want their money to work for them now.

Now in the late 1970's, we saw an explosion of new products being offered by banks, stockbrokers, and other financial institutions, all of them luring away traditional life insurance dollars. The life insurance industry responded with a complete new generation of interest-sensitive products that offered a wide variety of investment incentives, together with the insurance contract.

And I would like to note that we had a meeting on a totally unrelated issue yesterday with some of the CEO's in the life business, and they stressed over and over on that particular issue their new thin margins of profit in light of these new interest-sensitive products.

Now this drive to offer greater and greater returns has compelled life insurers to focus new attention on their investment portfolios. It is through such individual investment strategies that life insurers are able to compete with other financial service companies for the increasingly sophisticated consumer dollar. However, in this drive for greater returns, life insurers must be reminded that they are fiduciaries and not investment bankers.

The Cuomo administration, in particular the New York State Insurance Department, has been supportive of the life insurance industry's search for innovative ways to remain competitive while continuing to promote growth for companies of all sizes. Most notably in that effort, in 1983 the Life Insurance Investment Bill in New York, after careful consideration and much debate, we have tremendously liberalized the investment restraints on the life insurance industry.

Now prior to the Cuomo administration's liberalization in 1983 of the investment restraints on life insurance companies, no domestic life insurer could make any investment in junk bonds, except under a basket which permitted a maximum of a 4 percent allowance for investments not otherwise permitted. The law of 1983 removed the qualitative standards in the New York insurance law which had limited life insurance company investments in bonds to those issues and issuers meeting certain restricted earnings tests.

Now because of the changes in 1983, life insurance company investments in unsecured obligations became limited only by the "prudent person" rule. Although the diversification standards and aggregate limits were retained in the new investment law, other types of investments—it must be stressed over and over again that other types of investments are restricted, very similar to the proposal in 130. None were included for junk bonds in 1983, because junk bonds were not perceived as a significant investment vehicle at that time. Even today, the vast majority of life insurers appear to feel that, as fiduciaries, prudence dictates either no position or a very modest position in junk bonds.

Nevertheless, a few insurers—and I think their number is two—have chosen to concentrate heavily in these investments.

Now the Department's new regulation on junk bonds, which became effective June 24, was not a response to any hysteria in the press about any scandals. In 1985, I wrote to the Governor stressing with him in my annual report that a review of the investment policies of domestic life companies has indicated that a few companies, in an effort to gain a competitive advantage for their interest-sensitive products, have markedly increased their investments in lower quality bonds in order to offer higher interest rates or increase their profits. The effect of such investment policy will require continuing monitoring.

That was back in 1985, so I believe the arguments you will hear from many people saying that this is some kind of hysterical, knee-jerk reaction to Wall Street scandals is totally unfounded.

The Department's new regulation on junk bonds, which became effective on June 24, is consistent with the concept that life insurance companies must be able to explore every avenue of investment, while making a diversity in their portfolios that minimizes their exposure to economic downturn, downturn that could cripple a company or lead to a default on its obligations to policyholders.

As I stressed numbers of times publicly, when someone buys a life insurance product, they do not feel that they are taking any risk, and it is important to note that we have to assure, from a regulatory perspective, that they are accurate in that concept.

The principal provisions of Regulation 130 require that no domestic life insurer, without the prior approval of the superintendent, invest in excess of 20 percent the prior year's admitted assets in publicly traded high-yield, high-risk bonds, bonds issued in connection with LBO's, or in jumbo private placements, those over $50 million.

In addition, the regulation requires that the Board of Directors of domestic life companies investing in high-yield, high-risk obligations adopt a written plan for making such investments. The plan must contain diversification standards including, but not limited to, standards for issuers, industry duration, liquidity, and geographic location.

Junk bonds constitute a category of investment which has been a significant innovation in recent years. It has been estimated that as of March 1, 1987, approximately 30 percent of the total of low-rated obligations were issued as investment grade and were substantially downgraded, so-called "fallen angels." The other 70 percent were originally issued as below grade investments.

It is this latter category that has been experiencing dramatic growth in the past 5 years and for which there is no adequate historical record with which to project their behavior in all types of economic cycles. The New York State Insurance Department is concerned, therefore, that changes in the economic conditions and other market variables could adversely affect domestic life insurers which have had high concentrations in these investments.

The department concluded that a limitation on the percentage of total admitted assets that a domestic life insurer may prudently invest in such obligations without the prior approval of the superintendent is reasonable, necessary, and required in order to carry out the department's responsibilities under relevant statutes, especially solvency.

The department's concerns are primarily in the areas of credit risk, liquidity risk, and reinvestment risk in connection with longer-term liabilities that have been aggressively priced, utilizing high-yield, high-risk interest rate assumptions.

Now a Dr. Edward Altman of the New York University, one of the country's leading experts in high-yield, high-risk obligations, in a recent update of a study that was done for Morgan Stanley, delineates the default experience of low-rate debt. Dr. Altman's report indicates that the average default rate in high-yield, high-risk bonds from 1970 to 1986 was 2.2 percent. In that period, the highest default rate was 11.4 percent in 1970 out of a much smaller base of lower-rated debt outstanding.

In 1986, the default rate was 3.4 percent, which Dr. Altman characterized as high for a nonrecession year. Dr. Altman also indicates that the default rate would have been higher—this is a very important point—were it not for successful refinancing of the debt by a number of distressed companies.

The point is that in pricing the product, some default rate must be assumed. What rate will be actuarially assumed is difficult. If one assumes that the average default rate over the past 16 years, which was 2.2 percent, there are at least three questions that must be answered:

Will the company's Investment Department be able to mirror the low-rated debt universe in the diversification of the company's portfolio, or will they fail and produce much lower or much higher default rates?

Will the average rate be adequate, given that the 16-year average is weighted toward fallen angels, which today comprise only 30 percent of the low-rated debt universe?

And will the refinancing that has kept the default rate down be possible in the future? That is a very acute point.

The department is not forecasting gloom and doom scenarios; however, no one can predict the behavior of this class of investments over the next decade as the economy goes through its normal cycles. If the default rate remains stable or improves, everyone will rejoice. If they worsen, however, a company with a heavy concentration of its assets in these obligations would come under extreme stress.

Now the one liquidity risk that will always almost certainly arise is because of the flight to quality, which invariably occurs in a severe economic downturn. If this takes place at a time when rising interest rates are causing policyholders to withdraw their funds, the problem will be compounded.

This, in brief, outlines our principal reasons for promulgating Regulation 130. We live in a time when our economy has become extremely complicated with great potential for sudden upheaval.

Recently we confronted the consequences of the New York property and casualty insurance industry's irresponsibility and the irresponsibility of that industry throughout the Nation, several years of cashflow underwriting and the abandonment of basic insurance principles which resulted in a wrenching disruption of our local government's operation in virtually every segment of New York State's economy. Our response in New York was a comprehensive legislative package that renewed our commitment to effective regulation.

I believe the public has a right to and indeed expects State insurance regulators to anticipate potential problems in the marketplace and to act to solve them before they become a disaster. With the new liability regulations, we now have the tools to act on the property and casualty side.

I also believe we are wellequipped to confront the new challenges of the life insurance industry, provided there is no loss of the will to regulate fairly, effectively, and efficiently. There should be no misunderstanding as to what is at stake in Regulation 130. As difficult as the liability crisis was and continues to be in some sectors, it is nothing compared with what would happen if one of the major life insurance companies that market any of the new generation of products would find itself unable to meet its obligations. The prospect of hundreds of millions or billions of dollars worth of policy obligations being thrown into the maelstrom of insolvency is simply unacceptable.

The New York State Insurance Department, in addition, of course, to this committee, is not alone in its concern over the concentration in junk bonds. I notice there's an article today, which we'll discuss in a minute, but it notes that the Federal Home Loan Bank Board currently limits Federal savings and loan institutions to no more than 11 percent of assets in junk bonds.

Of special interest, there's an article which appeared in the New York Law Journal on October 8, 1986, discussing tort reform legislation signed into law in New York on July 30, 1986. The article endorses the position of structured settlements as a key part to helping us in the medical malpractice crisis and notes that the beneficiaries of both the plaintiffs and defendants in providing protection to an injured person at a slightly lower cost to defendants through structured settlements. However, the article includes the following cautionary comment: "Hopefully the Superintendent of Insurance of the State of New York, who must determine those companies which are suitable to write these contracts, will prohibit junk bonds from the investment portfolios of insurance carriers. Securities backing personal injury victims' payments should all be of investment grade."

More importantly in my view is an article by Louis Lowenstein, Professor of Law at Columbia University, an article entitled "Three Reasons to Fear Junk Bonds." It cites an issue of paramount concern, namely the increasing number of corporations that are terminating employee pension plans to recapture excess assets or alleged excess assets.

Professor Lowenstein goes on to state: "If we fund these pension obligations at the lowest cost, employers often purchase single-payment annuity contracts from those insurance companies that can offer the best price. Of course, the companies that offer the best price are those that have invested heavily in high-yield bonds. Once the plan is terminated and the annuity contracts purchased, the employer may have no further responsibility to the pensioners, so that it has every reason to extract the last dollar of, "excess assets," unquote, from the trust. But the greater the savings for the employer, the greater the risk for pensioners. Those unsuspecting retirees and employees, who typically have no role in the bargaining and get none of the savings, are left to depend on an insurance company of uncertain worth.

"The risk of default on these annuity contracts may come from both ends of the investment spectrum. The least profitable junk bond issuers, being most vulnerable to the economic chill, may default on their obligations, and those that are most profitable will try to redeem their high-coupon bonds and replace them with new securities with lower yields. An insurance company relying on junk bonds to sustain higher than ordinary levels of income might, therefore, see its income sharply reduced in both cases."

Now the net effect of the assumption of these obligations by a life insurance company in New York or any other State is a potentially catastrophic shifting of exposure from the Federal Pension Benefit Guaranty Corporation to the various State life insurance guaranty funds, this at a time when for the first time in 30 years, defined benefit pension plans are paying out more than they are receiving in contributions.

A criticism often heard is that the limitations we are discussing today on buyers of junk bonds would also impose limits on issuers, which would ultimately hinder job formation and economic growth. This statement demonstrates a lack of understanding of the limitation we have placed on junk bonds. Under our regulation, our licensed companies could make general account investments in excess of $100 billion with unlimited separate account investments. This provides a market for publicly traded high-yield, high-risk bonds of nearly $200 billion just in the life insurance industry in the State of New York. This represents almost three times the total amount of new high-yield, high-risk debt issued from 1978 through 1986.

Accordingly, the Department's proposed regulation and the regulation which is now in effect imposes no practical limitation on the issuers of junk bonds. It simply requires that no one company is so heavily concentrated that they become overly exposed.

Junk bonds may be an appropriate investment vehicle in a diversified portfolio. Prudence dictates, however, that when risks associated with a form of security are relatively high, principles of diversification and portfolio balance should be the guides to the amount invested. We believe that Regulation 130 leaves all life insurers the authority to invest a substantial portion of their assets in junk bonds, but prevents excess concentration in this form of investment by any one company.

In conclusion, I want to say that the process of developing Regulation 130 involved the broadest possible consultation with interested parties, intense staff review of data, and, of course, opportunity for public comment. The regulation is neither anti-junk-bond nor narrowly restrictive. It is aimed at protecting against dangerous levels of concentration in a rapidly developing type of investment.

Regulation 130 is a straightforward effort to protect the life insurance buying public. It is consistent with the tradition of our Department.

Thank you very much, Mr. Chairman, and I'd be happy to answer questions.

[Testimony resumes on p. 128.]

[The prepared statement of Mr. Corcoran follows:]

TESTIMONY ON LIFE INSURERS INVESTMENTS
IN HIGH YIELD-HIGH RISK DEBT OBLIGATIONS
BY SUPERINTENDENT JAMES P. CORCORAN
BEFORE THE U.S. HOUSE SUBCOMMITTEE ON
COMMERCE, CONSUMER PROTECTION AND COMPETITIVENESS

Good morning. My name is James P. Corcoran and I am Superintendent of Insurance for the State of New York. I wish to thank Chairman Florio and members of the Committee for the opportunity to appear before you today.

It is my intention to outline for you the principal concerns the New York State Insurance Department has about life insurance company investments and in particular, the reasons behind the promulgation, in June of this year, of Regulation 130 that placed limitations on the concentration of high-yield, high-risk obligations, that any one New York domiciled life insurance company can have in its investment portfolio.

I can sum up the Department's underlying philosophy towards life insurance company investments in two words "consumer protection". The central role of the New York State Insurance Department has been the effort to make certain that the promise of the insurance contract is kept. We have long been concerned with the content of insurance companies' investment portfolios because therein lies a substantial part of the answer to the fundamental insurance question - will the money be there?

For most of this century the life insurance industry has been comparatively stable. The Department's development of standards for licensing, for market conduct, for policy provisions and for investment portfolios, has permitted the industry to experience tremendous growth in New York with virtually no disruption in the marketplace. It has been a highly profitable industry that has always met its obligations. While this remains true today, the threats to the industry's stability have never been greater.

In recent years, life insurance companies have faced stiff competition for a consumer dollar that seeks the greatest possible return in addition to financial security. Consumers no longer want death insurance that only promises to pay off when they're gone. They want their money to work for them now. In the late 1970's we saw an explosion of new products being offered by banks, stock brokers and other financial institutions, all of them luring away traditional life insurance dollars. The life insurance industry responded with a complete new generation of interest-sensitive products that offered a wide variety of investment incentives, together with an insurance component.

This drive to offer greater and greater returns has compelled life insurers to focus new attention on their investment portfolios. It is through such individual investment strategies that life insurers are able to compete with other financial services companies for the increasingly sophisticated consumer dollar. However, in this drive for greater returns, life companies must be reminded that they are fiduciaries, not investment bankers.

The Cuomo administration, in particular the New York Insurance Department, has been very supportive of the life insurance industry's search for innovative ways to remain competitive while continuing to promote growth for companies of all sizes. Most notable in that effort was the 1983 Life Insurance Investment Bill. After careful consideration and much debate, the statutes regulating life insurer investments were substantially liberalized.

Prior to this Administration's liberalization in 1983 of the investment restraints upon life insurance companies, no domestic life insurer could make any investments in junk bonds, except under a "basket" which permitted a maximum of 4% allowance for investments not otherwise permitted. Chapter 567 of the Laws of 1983 removed the qualitative standerds in the New York Insurance Law which had limited life insurance company investments in bonds to those issues and issuers meeting certain restrictive earnings tests.

Because of the changes in 1983, life insurance company investments in unsecured obligations became limited only by the prudent person rule. Although diversification standards and aggregate limits were retained in the new investment law for other types of investments, none were included for junk bonds because, at the time, junk bonds were not perceived as a significant investment vehicle. Even today, the vast majority of life insurers appear to feel thet, as fiduciaries, prudence dictatas either no position or a very modest position in junk bonds. Nevertheless, a few insurers heve chosen to concentrate heavily in these investments.

The Department first expressed concern about junk bonds in life insurance company portfolios in 1985. Allow me to quote from my report to the Governor and tha Legislature of May 31 of thet year:

> A review of the investment policies of a domestic life companies has indicated that few companies, in an effort to gain a competitive advantage for their interest sensitive products, have markedly increased their investments in lower quality bonds in order to offer higher interest rates and/or increase their profits. The effects of such investment policy will require continued monitoring.

The Department's new regulation on junk bonds, which became effective June 24th, is consistent with the concept that life insurance companies must be able to explore every avenue of investment, while maintaining a diversity in their portfolios that minimizes their exposures to economic downturn -- a downturn that could cripple a company or lead to a default on its obligations to policyholders.

The principle provisions of Regulation 130 require that no domestic life insurer, without the prior approval of Superintendent, invest in excess of 20% of prior years admitted assets in publicly traded high yield-high risk bonds, in bonds issued in connection with LBO's or in jumbo private placements (those over $50 million). In addition the Regulation requires that the Board of Directors of domestic life companies investing in high yield-high risk obligations adopt a written plan for making such investments. The plan must contain diversification standards including, but not limited to standards for issuer, industry, duration, liquidity and geographic location.

High yield-high risk obligations, sometimes referred to as low rated or "junk bonds", constitute a category of investment in which there has been significant innovation in recent years. It has been estimated that as of March 1, 1987, approximately 30% of the total of low rated obligations were issued as investment grade and were subsequently downgraded (so called "fallen angels"); the other 70% were originally issued as below investment grade debt. It is this latter group that has experienced dramatic growth in the past five years and on which there is no adequate historical record with which to project their behavior through all types of economic cycles. The New York Insurance Department is concerned, therefore, that changes in economic conditions and other market variables could adversely affect domestic life insurers which have a high concentration of these investments. Accordingly, the Department concluded that a limitation on the percentage of total admitted assets that a domestic life insurer may prudently invest in such obligations, without the prior approval of the Superintendent, is reasonable, necessary and required in order to carry out the Department's responsibilities under relevant statutory law.

The Department's concerns are primarily in three areas: credit risk, liquidity risk and the reinvestment risk in connection with longer term liabilities that have been aggressively priced utilizing high yield-high risk interest rate assumptions.

Credit risk is managed through diversification. That is, if you are well diversified your portfolio should approximate the average default rate. Thus diversification does not immunize the investor from default but rather assures an average default rate.

Dr. Edward Altman of New York University, one of the country's leading experts on high yield-high risk obligations, in a recent update of a study he had done for Morgan Stanley, delineates the default experience of low rated debt. Dr. Altman's report indicates that the average default rate on high yield-high risk bonds from 1970 to 1986 was 2.2%. In that period the highest default rate was 11.4% in 1970 (on a much smaller base of low rated debt outstanding). The 1986 default rate was 3.4%, which Dr. Altman characterizes as high for a non-recession year. Dr. Altman also indicates that the default rate would have been higher were it not for the successful refinancing of the debt of a number of distressed companies.

The point is that, in pricing the product, some default rate must be assumed. What rate will the actuary assume? If one assumes the average default rate over the past 16 years (viz. 2.2%) there are at least three questions that must be answered:

(1) Will the company's investment department be able to mirror the low rated debt universe in the diversification of the company's portfolio or will they fail and produce much lower or much higher default rates?

(2) Will the average rate be adequate given that the sixteen-year average is weighted towards "fallen angels" which today comprise only 30% of the low rated debt universe?

(3) Will the refinancings that have kept the default rate down be possible in the future?

The Department is not forecasting a gloom and doom scenario. However, no one can predict the behavior of this class of investment over the next decade as the economy goes through its normal cycles. If the default rates remain stable, or improves, everyone will rejoice. If they worsen, however, a company with a heavy concentration of its assets in these obligations would come under extreme stress.

The current marketplace for high yield-high risk obligations appears adequate, but not deep. Drexel Burnham, which has been the leading issuer of these obligations, remains embroiled in a swirl of controversy stemming from the Boesky affair. Should Drexel's ability to provide a market for their issues become impaired, the liquidity of such issues could be affected. Some claim that other brokerage houses would rush in to fill the void; it is more likely that a significant temporary disruption would occur in the market and that most, but possibly not all, of the liquidity would be restored.

However, the one liquidity risk that will almost certainly arise is that caused by the "flight to quality" which invariably occurs in a severe economic downturn. If this takes place at a time when rising interest rates are causing policyholders to withdraw their funds, the problem will be compounded.

On risks with longer term liabilities, such as pension close-outs and structured settlements, the assumption of reinvestment rate can be more problematic when the liabilities are matched with low rated debt. The first problem is the duration of the assets. Low rated debt issued in 1986 had an average maturity of eleven years. However, call provisions are common among these issues, thus making durations even shorter and more uncertain.

The relatively short duration of the assets matched against long term liabilities places greater emphasis on the reinvestment rate assumptions. Aggressive pricing through the utilization of a high range of reinvestment rates can be troublesome and, indeed, dangerous.

This, in brief, outlines our principal reasons for promulgating Regulation 130. We live in a time when our economy has become extremely complicated, with great potential for sudden upheaval. The foreign debt of banks, the trade deficit, the price of oil and many other issues are all cause for worry. The concern is compounded when you consider the number of people who are capable of creating mayhem in financial markets through mismanagement, irresponsibility or sheer greed.

The job of the Superintendent of Insurance is to do everything in his or her power to make certain that those who have been granted the privilege of a New York license to sell the promise of insurance, do so in a manner that upholds the highest standards of professionalism and financial responsibility.

Recently, we confronted the consequences of the New York property and casualty industry's irresponsibility. Several years of cash-flow underwriting, and the abandonment of basic insurance principles, resulted in a wrenching disruption to our local government operations and virtually every other sector of New York State's economy. Our response in New York was a comprehensive legislative package that renewed our commitment to effective regulation. I am proud to tell you that our Department has received inquiries about our new regulatory framework for liability insurance from every region of the country.

I believe the public has the right to, and indeed expects, its state insurance regulator to anticipate potential problems in the marketplace and to act to solve them before they turn into disasters. With the new liability regulations, we now have tha tools to act on the property and casualty side. I also believe we are well equipped to confront the new challenge the life insurance industry presents, provided there is no loss of will to regulate fairly, efficiently and effectively. I take this opportunity to assure you, and the public, that the New York Insurance Department does not lack that will.

There should be no misunderstanding as to what was at stake in the promulgation of Regulation 130. As difficult as the liability crisis was and continues to be in some sectors, it is nothing compared to what could happen if even one of the major life insurance companies that market any of the new generation of products were to find itself unable to meet its obligations. The prospect of hundreds of millions or billions of dollars worth of policyholder obligations being thrown into the maelstrom of insolvency is simply unacceptable. It is in this context that we have promulgated Regulation 130.

The New York Insurance Department is not alone in its concern over concentrations in junk bonds. The Federal Home Loan Banking Board currently limits Federal savings and loan institutions to no more than 11% of assets in junk bonds. Congressman Dingell (D-Michigan), Chairman of the House Energy and Commerce Committee, has demanded that the SEC investigate the degree to which life insurers invest in junk bonds.

Also of special interest is an article which appeared in the New York Law Journal on October 8, 1986 discussing the tort reform legislation signed into law here in New York on July 30, 1986. The article endorsed the position that structured settlements, in certain cases, can be beneficial to both plaintiffs and defendants in providing protection to any injured person at a slightly lower cost to a defendant. However, the article concludes with the following cautionary comment:

> Hopefully, the Superintendent of Insurance of the State of New York, who must determine those companies which are suitable to write these insurance contracts, will prohibit 'junk bonds' from the investment portfolio of insurance carriers. Securities backing personal injury victims' payments should all be of investment grade.

Louis Lowenstein, Professor of Law at Columbia University, in an article entitled "Three New Reasons to Fear Junk Bonds," cites an issue of paramount concern, namely that increasing numbers of corporations are terminating employee pension plans to recapture excess assets. Professor Lowenstein goes on to state:

> ...To refund (sic) those pension obligations at the lowest cost, the employers often purchase single-payment annuity contracts from those insurance companies that can offer the best price. Of course, the companies that offer the best prices are those that have invested heavily in high-yield bonds.
>
> Once the plan is terminated and the annuity contracts purchased, the employer may have no further responsibility to its pensioners, so that it has every reason to extract the last dollar of "excess assets" from the trust. But the greater the savings for the

> employer, the greater the risk for the pensioners. These unsuspecting retirees and employees, who typically have no role in the bargaining and get none of the savings, are left to depend on an insurance company of uncertain worth.
>
> The risk of default on these annuity contracts may come from both ends of the investment spectrum. The least profitable junk bond issuers, being most vulnerable to an economic chill, may default on their obligations, and those that are most profitable will try to redeem their high-coupon bonds and replace them with new securities with lower yields. An insurance company relying on junk bonds to sustain higher than ordinary levels of income might, therefore, see its income sharply reduced in both cases.

The net effect of the assumption of these obligations by a life insurance company in New York is a potentially catastrophic shifting of exposure from the Federal Pension Benefit Guaranty Corporation to the various state life insurance guaranty funds. This at a time when, for the first time in 30 years, defined benefit pension plans are paying out more than they are receiving in contributions.

A criticism often heard is that limitations on buyers of junk bonds would also impose limits on issuers, which would ultimately hinder job formation and economic growth. This statement demonstrates a lack of understanding of the limitations contained in Regulation 130. Under the Regulation, our licensed companies could make general account investments in excess of $100 billion with unlimited separate account investments.

That provides a market for publicly traded high risk-high yield bonds of nearly $200 billion just in the life industry licensed in New York. This represents almost three times the total amount of new high risk-high yield risk debt issued from 1978 through 1986. Accordingly, the Department's proposed regulation imposes no practical limitation upon the issuers of junk bonds.

Junk bonds may be an appropriate investment vehicle in a diversified portfolio. Prudence dictates, however, that when the risks associated with a form of security are relatively high, principles of diversification and portfolio balance should be guides to the amount invested. We believe that Regulation 130 leaves all life insurers with authority to invest a substantial portion of their assets in junk bonds, but prevents excessive concentration in this form of investment by any one company.

In conclusion, I want to say the process of developing Regulation 130 involved the broadest possible consultation with interested parties, intense staff review of the data and, of course, the opportunity for public comment. The Regulation is neither anti-junk bond nor narrowly restrictive. It is aimed at protecting against dangerous levels of concentration in a rapidly developing type of investment.

Regulation 130 is a straightforward effort to protect the life insurance buying public. It is consistent with the tradition of an Insurance Department whose commitment to consumer protection runs deep and strong.

Mr. FLORIO. Thank you very much. I was just struck by one of your last comments about the fact that your regulation does not impose any limitations on the issuers of junk bonds. I suppose technically that is true, in the sense that you are attempting to limit the use of junk bonds by life insurance companies.

But from the perspective of someone who is a supporter of junk bonds, effectively it does impose a limit on the issuers of junk bonds, because what you are doing is cutting out part of the market capacity to absorb junk bonds.

The point that Mr. Rinaldo made before, in raising the use of some junk bonds in terms of industrial development and things of that sort, I would think that technically he might, and others might, say that you are being somewhat disingenuous in saying that you are not limiting the ability of the issuers of junk bonds to issue junk bonds, because you are cutting off one of the sources.

Maybe it is an academic point, but for those who believe strongly in the value of these financial securities, they would, I suspect, argue that you are impacting upon the ability of issuers to go forward and develop capital, and all the other points that they would make.

Do you concede?

Mr. CORCORAN. No, I do not. I think the only time I have conceded was with a nun. The fact is that anyone would think that dialogue is forgetting to identify the roles, and who we are talking about here. We are taking life insurance fiduciary funds.

We are not inhibiting anybody's ability to issue; clearly that is not an accurate statement. We are simply saying that if they are of such value, if they are a value of their own, why should we sit back and let one or two companies, or three or four companies, be so heavily concentrated, when some of the largest companies have very small percentages.

Have we ever been accused of limiting the real estate market? Yet we limit the ability of these companies to purchase real estate.

Mr. FLORIO. I am not sure it is productive. I understand what you are saying, and I suspect you understand the interpretation that we put on that.

Mr. CORCORAN. I understand; I agree with the interpretation of it.

Mr. FLORIO. Let me ask a specific——

Mr. LENNON. Could I just give one quick response to that?

Mr. FLORIO. Certainly.

Mr. LENNON. In a sense, it is true; in the sense that, if I take a pail of water from the ocean, I have reduced the ocean. There is, right now, about $70 billion of junk bond debt out there. We have left, just in life insurers licensed in New York, a capacity to buy $200 billion.

When you consider that New York licensed life insurers are not, by any means, the sole source of junk bonds—you have all the mutual funds that buy it, you have got pension plans that buy it—we are in fact, while we restricted it, we are not restricting it in any measurable way.

Mr. FLORIO. I understand. What would you designate as the major motivation or rationale for your regulation? You mentioned a couple; one was you were concerned, I suspect legitimately, about what would almost be a fraudulent marketing policy of attempting to sell insurance on the basis of the guarantee plan being out there.

That is obviously one legitimate concern that you might have.

Mr. LENNON. Absolutely.

Mr. FLORIO. But I guess the more basic one is your concern about the financial integrity of insurance companies that might, in your opinion, be overextended into the junk bond. Is that overextended from the perspective of future, unknown economic conditions changing? Or current conditions?

Mr. LENNON. Yes, it is basically——

Mr. FLORIO. Yes what?

Mr. LENNON. Yes, it is basically—I was about to add—a concern for the future. Our economy, basically, does go through cycles. You will find many experts that will claim that, in the next severe recession, many of these junk bond payers will have a difficult time paying.

I am not totally concerned with the credit risk, which is the default risk, because if you do buy enough diversification—although we don't know how this body of investments will act in a severe downturn—diversification usually limits, to some extent, what happens.

However, a life insurer, especially a life insurer with certain types of products, has to remain liquid. The values of junk bonds will go down; that is, they will become a liquid. You will have to sell them at much less, because there will be fewer buyers out there in a severe recession.

It is known that in a severe recession there is a flight to quality. People want to be holding the top graded stuff, rather than the lower graded. That reduces the value of those.

Mr. FLORIO. Let me ask a fundamental point. I assume this is almost a given. The apprehension for junk bonds, almost generically—as opposed to just in the area of the insurance industry—is that, in the event of an economic downturn, what you are going to be having is less profitable operations, people that will be expected to make payments on the junk bonds may very well become marginal, and not have the cash flow to satisfy their security obligations; therefore, those obligations will become less valuable.

In some instances, you will be having companies, perhaps, go into default; sort of a domino situation with regard to the holders of the securities. Is that roughly the apprehension?

Mr. LENNON. That is the credit risk. It is not the liquidity risk. What happens in an environment where, say, interest rates would be rising, a lot of the products now allow people to take the money out of the insurance company. To withdraw it, much as they would in a bank, and roll it over to some other investment that pays them a higher rate.

If that happens, the insurer will have to sell assets to pay them. If, at that point in time, the value of that asset is severely reduced from what they acquired it at, they have to go into their surplus to make up the difference.

That runs out, after a while.

Mr. FLORIO. Isn't it a more likely scenario, in a downturn, that interest rates would go down as a result of less demands for the economy?

Mr. LENNON. It did not happen in the 1970's. The point is that today we cannot predict anymore what will happen and what won't happen.

Mr. FLORIO. But I suppose that would be the argument—and let me just play the devil's advocate—that's the argument of those people who say, how are you making these determinations in situations that we can't predict.

Again, those who would say that government regulation is notoriously bad, would say better that you not make these determinations, and let the market place play out.

Mr. LENNON. The important point here is that in 1983 they could not make any investments in these kinds of products. Why don't we give them a reasonable time to build up a history? As a regulator, you know we have had great dialogues. I agree with the perspective of not anticipating a problem.

We are saying here you can invest 20 percent of your assets in these products; and let's give it a history. You are not on Wall Street, people are not giving you the money so you can speculate it. They are giving you their life savings.

So what is not reasonable about saying we cap every other type of investment; 20 percent is a relatively large amount. Let's build up a history; let's build up a history and your experience with it, and then we will look at it again.

It is not a rigid approach to regulation. We are simply saying you have never had, and we have not had—these products are relatively new—let's build up a real scenario. I think all these things about studies are really not accurate, because studying the economy, and the fact of what is going on now is quite different.

As a regulator, you want this thing to build up a history with the insurance industry, and see what occurred with their dealings, and their ability to deal with these products.

Mr. FLORIO. But I understand that you said in 1983 other types of investments—I assume other than junk bonds— were restricted?

Mr. CORCORAN. And still are, to a great extent: real estate, common stock.

Mr. FLORIO. What are examples of the types of investments?

Mr. CORCORAN. I think it is 10 percent on common stock.

Mr. LENNON. No, 25 percent on common stock; 10 percent on invested real estate. These are what were always in the law. But when the law was changed with respect to individual investments, the aggregate limits—to maintain diversification of the portfolio—were retained.

However, at that time, junk bonds were not on the scene. So nobody ever thought of them as something that needed an aggregate limit. At the time the drafting was being done for what became the 1983 change in the law, there was not the dramatic growth in original issue, high-yield high-risk investments.

Mr. CORCORAN. As a piece of history, also, the State of Arizona, very similar to New York, 2 years later decided to liberalize your investment restrictions. Junk bond was on the scene, and many of the industry—including some who would now oppose our regulation and create another cap in Arizona—20 percent was reasonable.

It was a matter of timing, to a great extent.

Mr. FLORIO. Executive Life of New York, it is my understanding, had, at one point, 57 percent of its assets in junk bonds at the end of 1986.

Mr. LENNON. At that point, yes. It had 57——

Mr. FLORIO. That's extraordinary, isn't it?

Mr. LENNON. It was actually more between 70 and 80 percent, and that was why we say, though, the times now were not bad. That was the concern we had for the future. I had no other company that had any category of investment, other than Treasury Bonds, that even remotely approached that concentration.

In other words, nobody held anything else in that kind of a concentration, with the exception of Treasury Bonds.

Mr. FLORIO. How have they adjusted from 70 percent down to 20 percent?

Mr. LENNON. The regulation does not require them to divest. It says that you cannot purchase new ones until you are down to 20 percent.

Mr. FLORIO. What are they today, if we know?

Mr. LENNON. At this point in time, that figure—the 57 or the one that actually comes higher than that—was December 31, 1986. At this point in time, I am waiting for the June quarterly to come, which is August 15, to get the latest reading.

Mr. FLORIO. You are looking for your history, your case history. You are going to have a fairly good example of what I assume most people would regard as an extreme example of over-concentration. It will be interesting to see—we would appreciate you sharing with us this particular information as you get it—to see what it is that is happening in this area.

Obviously, we are going to have a case study; presumably that company is going to have a difficult time, if they have any intention of getting down to a 20 percent cap. Which I suspect they probably don't.

Mr. CORCORAN. I presume they have the intention of complying with the regulation.

Mr. FLORIO. But didn't I understand you to say that there is no requirement, that anyone——

Mr. CORCORAN. They do not have to divest, and there is no disruption of their portfolio. Simply, they cannot purchase new ones until they get down to the level.

Mr. LENNON. As new money comes in the door, they cannot purchase new ones. What happens is that they get larger, and the percentage shrinks, so that over time, as long as you have not bought another one, and you continue to grow, your concentration will reduce.

Mr. FLORIO. We are going to be hearing some testimony later in the day that opposes the idea of what you have done, and offers the argument that life insurers have much riskier investments in real estate, oil, and gas partnerships—and even art works—and the argument is saying that if there is logic in putting limitations on risky investments, if junk bonds are risky, why shouldn't you be putting limitations on these other things?

Do you have a policy——

Mr. CORCORAN. They are limited.

Mr. FLORIO. Do they have limitations?

Mr. CORCORAN. On all of them.

Mr. LENNON. Yes.

Mr. CORCORAN. They are limited, except the Treasury notes.

Mr. FLORIO. Do those limitations require reserves? And are they—those types of limitations on those other types of securities——

Mr. LENNON. No. No, and the reserve——

Mr. FLORIO. Why not?

Mr. LENNON. The reserve that has been addressed is called the Mandatory Securities Valuation Reserve. It is required in the national blank that is used in reporting for insurers, and has been developed nationally.

It was established in 1951. What it was established for was to insulate the surpluses of life insurers from the vagaries of the market. In other words, it added capital gains when you had them, and capital losses came out of it.

The effect of this was that your surplus did not bounce up and down by what you were doing with your investments. It responded more to what happened with your underwriting and your underlying business. That was the purpose of that.

Since the advent of junk bonds, people have begun saying it is a special reserve for junk bonds. In point of fact, that reserve has been in place since 1951, long before junk bonds were even thought of. So it is really not a special reserve put in place.

It is required on government bonds; it is required on all of them. Life insurers, you must understand, are allowed to carry their bonds at what is called amortized value, which is not always consistent with market value.

This, again, serves as a cushion for the variances that the market might have in those bonds in the event that they had to sell them at some point in time. It would not impact their surplus. Instead, it would impact this other reserve.

Mr. FLORIO. Let me just ask this one question, and then yield to the gentleman from Texas. Is there any data, with regard to any insurance company that has got into financial problems as a result of junk bond investments? Not only in New York, but any that you may know of anywhere else?

Mr. LENNON. No, sir. But I think regulation is always criticized for waiting until the cow is out of the barn to do something. I think we try to stay a step ahead. We have done that with a whole raft of recent regulations.

Mr. FLORIO. I have other questions, but let me yield to the gentleman from Texas.

Mr. BARTON. Thank you, Mr. Chairman. I appreciate your holding this hearing so we can learn about the insurance industry. I have a question I would like to ask Mr. Corcoran or his assistant.

It is my understanding that you said there is potential for $125 billion worth of high yield bond purchases by State insurers. How much has been invested so far, do you know?

Mr. LENNON. I do not think I could give you a figure on that but let me put it this way, on the studies of the 1985 year end figures which I had on the computer, 25 percent of our companies didn't have $1; 95 percent of our companies had under 5 percent of their assets.

Mr. CORCORAN. I would presume, Congressman, that it is a very small percentage.

Mr. LENNON. There was a heavy concentration in a few insurers. However, at the end of 1986, my early returns are beginning to show that there are—and by the way, we don't think that junk bonds are bad for a portfolio, we think they have an appropriate part in a portfolio—so there are other companies that are beginning to invest in it.

I might even hazard the guess at this time that by the end of 1987 even with this regulation, the licensed life insurers of New York will have greater investments in junk bonds than they had at the end of 1986 before the regulation was put in place.

Again, that is a projection based on what I see happening, that people who were not involved are getting up to the 5 and 6 percent level and it is broadening, which is fine with us.

What we are telling the issuers is, "Don't stop selling it to the life insurers, just stop concentrating on a few insurers."

Mr. BARTON. Is there any hard evidence that the insurers that have not yet entered the high yield bond market in a significant way are planning to do so in the near future?

Mr. LENNON. Not evidence, no.

Mr. CORCORAN. We have no knowledge of that.

Mr. BARTON. Why is there an exemption in the regulation for private placement bonds?

Mr. LENNON. Because at this point we have no problem with private placement bonds. The measurement of the 57 percent junk bonds is applied also to all private placement holdings and the figures that I gave you of most people at very low percentages included private placement holdings. Those ratings that are put on the junk bonds are also put on the private placements.

We simply did not have any concentrations or problems with private placements.

Mr. CORCORAN. I must also point out, Congressman, that the insurance companies themselves directly deal with private placement. They do it themselves, no intermediary broker, investment banker. That is something they traditionally do and have the expertise and feel comfortable with.

Mr. BARTON. Aren't those theoretically riskier than high yield bonds?

Mr. CORCORAN. I wouldn't venture an opinion on that. I would simply point out that the insurance companies traditionally have done private placements themselves and have expertise in that area that has long been recognized.

Mr. LENNON. There are usually special restrictions and covenants put on the private placements. They are more liquid. They are not necessarily more risky.

Mr. BARTON. Mr. Chairman, I have some other questions but I understand you are going to have another panel and I will yield back the balance of my time.

Mr. FLORIO. Thank you. I would like to acknowledge the presence of one of our distinguished senior members of the Full Energy and

Commerce Committee, the gentleman from California, Mr. Moorhead.

Mr. Corcoran, the proponents of junk bond investments argue that insurers cannot achieve an adequate spread relying on government instruments that yield only 7 percent. What is the average return for a single premium annuity, universal life?

Mr. LENNON. That is interesting because at the time we had our hearing, the junk bond proponents were saying that the public was going to be given this opportunity to share in this. So I had a street study done of what was available in SPDA's at the time. Now the numbers I am giving you are probably 9 months old at this time but I wouldn't think that the position has changed.

The junk bond issuer at that time was offering or was investing at probably 12 or 12.5 percent and was offering the public 8 percent which was about a half to a quarter percent better than the companies that did not have concentrations in junk bonds.

They were high. They had the 8 percent but major companies like Prudential were offering 7.75. Other companies were offering 7.25 or 7.50.

Mr. FLORIO. So what is needed to be competitive with alternatives?

Mr. LENNON. Again, it depends on the expenses of the company and how inefficient you are. That is what dictates the overhead.

Mr. CORCORAN. There is an important point here in these figures that I want to stress. If a company is generated 12 percent or 12.5 percent based on a junk bond portfolio, you are going to hear many arguments about how this helps the consumer and our survey demonstrates what they are giving the consumer is 8 percent, the consumer for the additional risk is getting ½ of a percent. The shareholders are getting the lion's share of the benefit and you, the policy holder or the public, get to take the risk.

It is a very important point. When you look at these figures and you hear people tell you how junk bond investments are going to help the consumer more directly, who is it helping. the owners of the company or the consumers who are assuming the risk?

It is a very important dialogue that is going to take a number of years but let's go beyond the fluff and snuff and say, "OK, how does that benefit consumers directly?" and from these figures, although you can't crystallize them at this stage, it is demonstrated as benefiting the shareholders and the owners of the company or the executives through compensation.

Mr. FLORIO. I would assume that the opponents or the people on the other side of the issue would make the argument that the consumers, the policy holders, are not in any way helped if you are not competitive with alternative instruments because the viability of the company is jeopardized. Is there anything to that?

Mr. CORCORAN. If you are allowing 20 percent, surely they are in the marketplace being able to do that. We have gotten many letters when this dialogue began from consumers saying that they were not aware that their company had junk bonds. What does the consumer know? Do they really know what is in the portfolio?

They are being promised a certain return on investment and at that point they are being told in some situations, we have complaints at the Department, "Don't worry about it. We are able to give you a little more" and it is a little more because of State guaranty funds.

So we are here to make sure that the consumer knows what risk they are assuming and making sure that the guaranty fund is not being used as a competitive tool unfairly.

Mr. FLORIO. Let me ask one last question and it relates to the question of guaranty funds. After the collapse of Baldwin-United, you apparently, that is, your State led the way in improving the National Association of Insurance Commissioners Holding Company Model Act.

Mr. CORCORAN. Right.

Mr. FLORIO. And you also apparently have rules requiring actuarial opinions supporting the viability of all annuities. Do you know if other States have adopted the provisions of the Holding Company Act?

Mr. CORCORAN. Why don't you answer that?

Mr. LENNON. My understanding is—and I asked in between but I could not get a concrete number—that a number of other States have adopted the Model Holding Company Act that we basically rewrote a couple of years ago.

At this point in time, you are referring to our Reg 126 which requires asset matching on annuity business, asset and liability matching. I think we are the only State that has required it.

However, at the NAIC in the actuarial technical committee it is now being studied and I would presume will become some sort of a model at the NAIC before too long.

Mr. FLORIO. My understanding is that 12 States don't even have guaranty plans. Is that your understanding?

Mr. CORCORAN. There are States that do not, yes. I don't believe there are a substantial number.

Mr. LENNON. California and New Jersey.

Mr. CORCORAN. New Jersey does not have one.

Mr. FLORIO. Some of us think those are substantial States.

Mr. CORCORAN. I always thought it was a suburb of New York.

Mr. FLORIO. We will take your baseball team away.

No one likes, and I think you made reference in your testimony that you don't like, to be the gloom and doom prophet and that certainly is not anything anyone should relish. But I think we do have responsibilities to, first of all, take a look at some of the objective information that is out there that does indicate a picture of a degree of fragility in part of this industry, and if that problem that may occur as a result of the Mission Insurance Company insolvency in property and casualty and other has always been purported to be addressed by certain safeguard mechanisms that we have, guaranty plans or whatever, and you almost can objectively perceive deficiencies, you can almost objectively perceive gaps that someone is going to fall into, there has to be at least some preliminary thinking about how you are going to deal with a conceivable worst case scenario.

As of this point, there is a lot of feeling out there that the Federal Government should go away and I understand that traditional approach.

But if someone goes away and then the worst case scenario plays out and you have increasing insolvencies and you have what appears to be obvious inadequacies in the safety net nonsystem of relying upon State guaranty plans, there is going to be a serious dilemma.

So I am suggesting that this committee has a responsibility to understand and maybe even do some preliminary planning to at least have on the shelf at some point proposals that can come forward and offer some suggestions and some remedial effort to insuring, that is, people who are holding policies that may very well be left in a very bad situation.

The guaranty plan, we have talked about a number of proposals. Can you share with us just briefly some of your thoughts as to what would be appropriate types of remedies if you agree that they should be adopted at a national level so as to be able to deal with the admitted deficiencies of State-by-State implementation or nonimplementation of different systems?

Mr. CORCORAN. I welcome this dialogue by the way with the Federal Government because it is very important and I welcome these hearings because I agree with you 100 percent. We have to anticipate. The public no longer will tolerate crisis management especially when you are talking in this particular case about life savings.

At Baldwin-United, we were very fortunate in New York because the Holding Company Bill in New York prevented Baldwin-United from inflicting its agony on New York.

Mr. FLORIO. Let me just interrupt you for one point to disagree in one respect. You are saying that we will no longer tolerate crisis management. Quite frankly, around here and I don't think this is that different from the State operations, it is only crisis that provides the catalytic force to get anything comprehensive done.

Mr. CORCORAN. Correct.

Mr. FLORIO. What I am suggesting is that we ought to be preparing for what I regard as the inevitability of some of these things happening, and then at that point we are not starting from square one in trying to learn what the causes of the problems were. We will have some options and some things available to be able to respond to the impetus and the momentum that the crisis might provide.

There isn't a lot of even attention being paid to this problem that I regard as equally as important as the savings and loan crisis and the bank crisis as a result of banks going under. The uniqueness here is that we don't have any historic role for the Federal Government to play at the time that a crisis does go into effect.

I am sorry to interrupt but I think it is important to distinguish between the fact that saying the public will not tolerate crisis management and therefore, we should do something that we haven't even got a consensus on an understanding of the fundamentals at this point.

I am hopeful that these hearings will allow us to have that and then to formulate response capability when the public mood demands some sort of action.

Mr. CORCORAN. I would suggest that probably we have been responding as regulators to many crises lately. I think my first year in office, we had the Baldwin crisis as you know and now we had a property/casualty crisis, so I guess it is crisis management.

Here we are trying to anticipate what we have learned from that area to see what we can do. Now in guaranty funds, the question you directly asked, it is a major problem. It depends on what approach you want to take to the insurance industry. It is very difficult for me to see in an environment that has guaranty funds where you don't have strong regulation because, after all, you are automatically creating an unfair competitive environment by imposing a guarantee fund and then letting it find its own level of competition.

That is why regulation oversight becomes such a key part. Now I personally have been amazed by the industry's reluctance to realize that because of the guaranty fund they are partners with the regulators even in the smaller States that have inadequate budgets.

Perhaps rather than approaching it from the guaranty fund, and we had our dialogue about McCarron-Ferguson and issues about liability crisis, we have to look at the will to regulate and what kind of oversight you have on that issue.

I hate to deal with guaranty funds; people on Baldwin-United in New York were spared it, the $9 million as returned in 3 months—but there are people, I think, and there is someone testifying here today, I believe, that have waited years to get their money back.

So it is not necessarily an effective system relying on guaranty funds. I much prefer we look at the regulatory response and the oversight.

Mr. FLORIO. Obviously, your approach is a responsible approach but quite frankly, I think it is going to work the other way.

Mr. CORCORAN. That would be unfortunate.

Mr. FLORIO. I think it is going to work the other way, that when the problem is there, the insolvency crisis is on people, then you are going to have a demand that you deal with the problems that cause the problem as you deal with the remedial actions and that will be the opportunity for you to deal with things responsibly.

I would hasten to add that just in private conversations that I and I would suspect that other Members of Congress have had with people in the insurance industry, there is a division, there is a division in that there are some people in the insurance industry that I guess you might roughly characterize as more responsible rather than less responsible that are saying that there is a need to start dealing with these problems because they perceive what you have stated, that those who are responsible in a sense end up bailing out those that are not responsible.

Those who are responsible find themselves at a competitive disadvantage to those that are not responsible and therefore, the stability that let's hope all business people seek as a good atmosphere in which to operate, the stability is sought after and that sort of a wild, unfettered market place, anything goes, mentality is not perceived of by an awful lot of business people in general, and I think some insurance people, as something that should be the end goal.

There is a sense that there is a need for us to get some mid-point to insure that responsible competition that you talked about and that atmosphere of stability within which people can make appropriate marketing decisions.

Mr. CORCORAN. I hope our continued dialogue reaches that midpoint and I hope we go on with these hearings because it is very important. I am not one and I am sure many of my fellow Commissioners feel the same way, these dialogues, making us come forward, making the industry come forward to explain the system, put a lot of people at ease and also compel a lot of people to act who might well not have acted.

So I encourage these hearings. I think it is excellent. Terry, do you want to add something?

Mr. LENNON. Yes. I could only add that there are two ways obviously, and you suggested crisis management is the way that this city is galvanized. I don't particularly subscribe to it because I don't think necessarily the best things get done in crisis.

We have taken in the last 3 years three major regulations now that in a more calm environment addressed what we saw as very serious potential problems because of the changing nature of the life insurance industry, and those three coupled with the Holding Company Act in New York, which has been in place since 1969, I think addressed the four major danger areas in life insurance today.

The junk bond one was more controversial. The two prior ones, one having to do with phony reinsurance, the regulation and the other one having to do with the matching of assets and liabilities, were absolutely critical to the stability of the life insurance industry.

I think that was recognized and we got cooperation and acquiescence by the responsible members of the industry. So I would submit that there is a way of acting beforehand. It doesn't always have to be in a crisis and I think very often that the problems are addressed more. What you need is the experts to understand how the problems are emerging so that they can act.

Mr. FLORIO. You say that only six States have adopted this Holding Company modification. What is it out there that you feel is going to work on the Congress to adopt or to direct anybody to do uniformly across-the-board what 44 States have not seen fit to do for themselves?

Mr. LENNON. There are two comments I can make. One is that I was making a comment about process. I think a better process is to study the problems as they emerge and to try to correct them before you get there. I am not saying that it is done in 50 States.

I will add, however, that of the companies that are licensed in New York, you are probably right, about 80 percent of the business in the country, and with respect to two of those major things, the matching of assets and liabilities and the reinsurance, they are subject to our regulations for their whole company. So in that respect, we are getting some coverage.

Mr. BARTON. Mr. Chairman.

Mr. FLORIO. The gentleman from Texas.

Mr. BARTON. I have one followup question to the question that you asked. In New York or any other State that you are aware of, are there any insurers that have gotten into trouble because of investments in high yield bonds?

Mr. CORCORAN. To date?

Mr. BARTON. Yes.

Mr. LENNON. The trouble is not something that would show up immediately. It is something that you embed in your book of business. It has to do with the assumptions you have to make when you set up your reserves.

Mr. BARTON. But the answer to that is no.

Mr. LENNON. Oh, no, and there was nobody in trouble with regard to asset matching at that point in time either. Yet, I know that I had a raft of companies out there that weren't matching their assets to their liabilities which is suicidal over a long period. But there was nobody doing it then. That is the point.

If you wait until somebody does it, then everybody says, "Oh, you sat around with your finger in your mouth until something went wrong and then you acted."

Mr. BARTON. But as of today the answer is no.

Mr. LENNON. Exactly, and I would encourage the entire government to act in that way rather than waiting until things go wrong and doing something,

Mr. CORCORAN. I would point out that other States do have restrictions as well as New York. Arizona and Texas, and I believe California has been looking at it.

Mr. BARTON. The company that you were discussing with the chairman, Baldwin-United, is their problem related to high yield bonds?

Mr. CORCORAN. No. When we talk about Baldwin-United, we are talking about the marketing method and not necessarily what occurred in the holding company structure.

Mr. BARTON. Thank you, Mr. Chairman.

Mr. FLORIO. Let me express our appreciation to you for your participation.

Mr. CORCORAN. Thank you.

Mr. FLORIO. Thank you very much. We are now pleased to have a panel of witnesses that is made up of Mr. Herbert Kurz, President of Presidential Life Corporation, Mr. John Tweedie, Senior Vice President and Chief Actuary of Metropolitan Life Insurance Company, Mr. Ralph Ingersoll, II, the Chairman of Ingersoll Publications and Mr. Michael Taylor representing the Piedmont Area Mental Health, Mental Retardation and Substance Abuse Authority.

I would also hasten to note that Mr. Ingersoll is here on behalf of the Alliance for Capital Access.

Gentlemen, I welcome you to our committee. We are pleased to have you here. Without objection, any formal statements that you have will be made a part of the record in their entirety. You may feel free to proceed in a summary fashion. We would ask that those of you who have brought colleagues with you, for the record, introduce the colleagues.

Mr. Kurz, we would be happy to hear from you.

Mr. KURZ. I have brought Mr. Weinberger, as I indicated to you earlier.

STATEMENTS OF HERBERT KURZ, BOARD CHAIRMAN, PRESIDENTIAL LIFE INSURANCE CO., ACCOMPANIED BY HILLEL WEINBERGER; JOHN TWEEDIE, SENIOR VICE PRESIDENT AND CHIEF ACTUARY, METROPOLITAN LIFE INSURANCE CO.; RALPH INGERSOLL II, ON BEHALF OF ALLIANCE FOR CAPITAL ACCESS; AND MICHAEL W. TAYLOR, ON BEHALF OF PIEDMONT AREA MENTAL HEALTH, MENTAL RETARDATION AND SUBSTANCE ABUSE AUTHORITY

Mr. Kurz. Mr. Chairman, I want to thank you and the members of the committee for affording me the opportunity to discuss high yield securities which are perceived in many quarters to have a negative impact on the solvency of life insurance companies. I do not believe this to be true.

Incidentally, coincidentally, there was an article in this morning's Wall Street Journal——

Mr. Florio. We read it.

Mr. Kurz. May that be part of the record?

Mr. Florio. It will be incorporated as part of the record.

Mr. Kurz. This is a subject of extreme interest to me since any problems that might occur in life insurance companies have a substantial effect on the level of our business and the cost of acquiring it.

I find the subject of this hearing ironic since high yield bonds have not been a factor in the financial problems of those life insurance companies which have had troubles.

We have had discussions about Baldwin, which everyone agrees, was not a—the debacle was not caused by the investment in high yield bonds.

Charter was another company which had financial problems in the annuity business. As a matter of fact, prior to the problems of Charter, they advertised in full-page ads that their entire portfolio consisted of buying of bonds that were rated "A" or better.

The investment performance of our industry is far better than that of other financial institutions, such as banks and savings and loans. The losses in foreign loans, real estate and agriculture of the banks dwarf the default rate on high yield corporate bonds.

One of these may well be the antiquated investment climate in which they operate; and, as an aside, I recently noted when we talk about the spreads in high yield bonds of 400–500 basis points, that First Chicago recently concluded a loan agreement with the Soviet Union lending them $200 million at ⅛ of a point over LIBOR.

For two major reasons, I do not believe that high yield bonds will be the major factor in life insurance insolvencies. In fact, these investments tend to stabilize the companies.

One, the performance record of wellmanaged, diversified portfolios of high yield securities have been stronger than portfolios of investment grade securities over many decades. This is true for the many 70-plus years that the investments have been studied and continues to the present.

Two, the life insurance industry requires a special reserve that offers a more than adequate cushion for the impact of bond defaults and bond volatility.

I would like to explain this; by law, all life insurance companies establish a reserve known as the Mandatory Security Valuation Reserve (MSVR). There is a separate reserve for bonds and preferred stocks and a separate reserve for common stocks.

The Security Valuation Office (SVO) of the National Association of Insurance Commissioners is empowered to evaluate all bonds and places them in one of three categories, which they do each year. These categories determine the value and level of reserves.

A "Yes" bond requires a 2 percent reserve. There is a 10 percent reserve, and a 20 percent reserve.

There is no reserve required for obligations of the U.S. Government or its Agencies.

Companies are required to place funds in the MSVR over a 10-year period. Thus, a high yield of 20 percent security would be reserved at a 10 percent rate for 10 years unless the insurance companies' ratio of total reserves established, actual reserves required, is below certain levels, in which case the reserve is accelerated by 2 times or 3 times basis, which is 4 or 6 percent per year.

Most of the smaller or medium-sized companies that invest in high-yield bonds would fall in these categories. Thus, in 3⅓ to a maximum of 10 years, there is a 20 percent reserve for possible default of high yield bonds.

Add to this the interest rate premium of 400–500 basis points that these investments receive and over time a fund is created that is many times larger than any default rate in the long history of high yield bonds, which for the past 4 years has averaged 1.63 percent for recoveries.

Let me explain this in numerical terms; assuming a portfolio of junk bonds, and assuming the company would be in the 4 percent category, at the end of 3 years, you would have had a 12 percent reserve established.

Assuming the interest rate spread was 400 basis points, and after payment of taxes, you would have an additional 7.4 percent accumulated, so you would have a reserve fund for this group of bonds at the end of 3 years of 19.4 percent.

Each State has statutes that delineate the allowable investments for life insurance companies domiciled in their State. Since Presidential is a New York company and I am familiar with their requirements, I will use the New York requirements in my discussion.

Not so incidentally, New York is purported to have the most stringent investment law for life insurance companies in the country. Yet, New York law permits many investments which often are illiquid and fraught with risks.

And, by the way, I would like to separate life insurance from casualty since the MSVR does not apply in investment restrictions, and are not the same for life insurance companies as they are for casualty companies.

A New York domiciled life insurance company can invest 10 percent of its assets in personal property, including paintings, artwork, books, valuable documents, coins, and EDP equipment without a reserve.

Similarly, it can invest 30 percent of its assets in real estate with no reserve, despite the fact that real estate has greater leverage and comparative illiquidity than bonds.

A New York domiciled company can invest 20 percent of its assets in partnerships such as venture capital, oil and gas explorations without a reserve. And it can invest most of its assets in mortgages without a reserve.

Government bonds are guaranteed for principal repayment but not for market risk. Recent fluctuations caused a 17 percent drop in the value of the Treasury long bond in a 3-month period. Investments in these bonds can be virtually unlimited with no reserve.

It is my judgment, Mr. Chairman, that the mechanism of the MSVR more than adequately protects the high yield bond purchaser against default, which cannot be said for the spectrum of other investments. Contrast this reserving with that of commercial banks whose loan loss reserves are established after a problem and not always then.

However, there are other areas of concern that affect the stability of life insurance companies. I would just like to mention them.

The inability in some States to fully underwrite for AIDS can result in significant underwriting losses.

The frequent changes in taxation of life insurance companies—we have had three changes in the last 4 years—have produced inordinately high software expenses for many of the smaller and medium sized companies, particularly and they are the ones that most likely might have financial problems.

Also, recent changes in life insurance products have created a possibility of substantial withdrawal risks during the period of interest rate volatility. Companies must be sensitive to the matching of assets and liabilities to avoid this disintermediation—and Mr. Lennon has referred to, and I endorse Regulation 126, which in New York requires a matching of assets and liabilities.

While capital formation is not the direct thrust of my mandate for today, I must comment, if but briefly. The ability of small and medium-sized companies, the many thousands that are not investment grade, to access our capital markets is of vital importance to job formation and the growth of our economy.

There is a delicate balance of market forces, and even the slightest restriction on the ability of life insurance companies to purchase these noninvestment grade bonds, can close this market to many companies requiring capital.

I'd like to point out that there are approximately 700, and only 700, investment grade companies.

I believe the statutory or regulatory limits on high yield bonds in a life insurance company's portfolios are counterproductive. And that includes Regulation 30, which recently was promulgated by the New York Insurance Department.

They can create situations whereby companies are precluded from investing in the convertible bond of a company, but can invest in its common stock or can invest in its preferred stock.

Mr. Chairman, good investment management can develop a prudent portfolio of high yield obligations. Regulation and legislation never has created good management.

Should problems develop with the investment portfolios of life insurance companies, they will arise not from the high yield portfolio, but from the nonhigh yield obligations in the portfolio, investments not requiring reserve which I have outlined above.

The focus for a solvency study should be these nonreserve areas rather than the high yield bonds whose inordinately high reserve levels are tantamount to a subsidy of these other investments.

And I maintain, Mr. Chairman, that the mechanism of the MSVR be fine-tuned to cover other investments and provide the necessary protection for life insurance companies.

If I may, Mr. Chairman, I would like to condition my remarks to comment on some of the statements of our previous speakers.

This committee is concerned with consumer protection and the benefits to the consumer. I maintain, Mr. Chairman, that companies such as Presidential, which does invest in high yield bonds, and at the moment pays an 8.35 percent rate on its single-premium deferred annuity, help the consumer. We have forced the larger companies to increase their level of payouts. Not too many years ago, on cash value policies, the credit rate was 2.5, 3, 4 percent; and, now, as Mr. Lennon indicated, it's approaching 8 percent, some at 8 percent.

We have lifted the level of rates available to the consumers. Mr. Lennon indicated on the—Mr. Corcoran—that the policyholder takes the risk. I maintain that the owners of the companies which have a large equity stake in their companies do take the major risk.

In the discussion of Regulation 130, Mr. Lennon and Mr. Corcoran referred to the exclusion of investments of over $50 million in a single entity. That by definition in Regulation 130 is not a junk bond. I maintain that this was put in to benefit the larger companies. I believe everyone on this panel would agree that, given the choice of one $50 million investment, or 10 $5 million investments with 10 partners in each investment creating greater liquidity would be a more prudent manner of spending $50 million.

In addition, Regulation 130 carves out another exclusion, which again benefits the larger companies. It defines a high yield bond as having noninvestment grade or not a "Yes" bond but a Security Valuation Office, and also a high yield bond must be publicly traded so that essentially an obligation of a company which is not publicly traded, private placement, is not a junk bond; whereas, the publicly traded one which has greater marketability, I think, makes a better investment and is considered a junk bond.

Professor Altman's study was referred to. I might point out that Professor Altman, in a study done for LICONY, the trade association in the State of New York, done after discussions with the Insurance Department, indicated there is no need for Regulation 130; there were mechanisms in the insurance law which would handle any problems with insolvencies.

An allusion was made to the Federal Home Loan Bank's 11 percent limitation on high yield bonds. Again, banks do not have a Mandatory Security Valuation Reserve.

If there were a mechanism in place whereby banks were required to set up a reserve, such as life insurance companies, I am sure the Federal Home Loan Bank would not impose that kind of limitation.

Thank you. I will be happy to answer any questions.

[The Wall Street Journal article referred to follows:]

THE WALL STREET JOURNAL WEDNESDAY, JULY 29, 1987

Life Insurance Industry Needs Junk Bonds

By Douglas Hallett

New York insurers are prohibited from investing more than 20% of their assets in junk bonds—the high-yield, non-investment grade securities that were the cornerstone of Fred Carr's First Executive Corp.'s rapid climb to the ranks of the top 20 life insurers. This restriction was recently pushed through by state insurance superintendent James Corcoran, who likens such investments in junk bonds to the property-and-casualty industry's so-called cash-flow underwriting in the early 1980s. He can be expected to express these views in testimony today before the House subcommittee on commerce, consumer protection and competitiveness.

Minnesota's insurance commissioner, Michael A. Hatch, is even more heated on the subject of junk bonds. He told Congress earlier this month that life-insurance companies' investments in junk bonds are creating a crisis in the industry that will exceed that of the property-and-casualty industry. He calls for action by the federal government to avoid a situation in which "the barn has already burnt down by the time we get there."

Negative Evidence Isn't Strong

The evidence, however, suggests just the opposite. Rather than leading to a repeat of the record number of insolvencies that have stricken the insurance industry in recent years, the investment strategy that lies behind investments by Mr. Carr and other insurance executives in junk bonds is more likely exactly what the industry needs. Certainly something new is necessary if the industry is to avoid, without governmental price-fixing, the discrepancy between insurer investments and underwriting requirements that has brought about the erratic insurance price swings of recent years.

The evidence against junk bonds is not strong. According to Drexel Burnham Lambert, the leading seller of such securities, more than 95% of all U.S. corporations with assets of more than $25 million, if they applied for a bond rating, would not be rated at investment grade. Credit quality risk is only one of a number of analytical tools that should be used in an intelligent investment strategy. Many companies issuing junk bonds are among the fastest-growing and most productive in their fields, with high liquidities and aggressive managements.

These non-credit-related risk factors have been responsible for some outstanding results. A 1985 study by Morgan Stanley came up with a default rate of 1.6% a year for junk bonds, the same as the default rate for all corporate debt over long periods. According to William J. Carney, director of the law and economics program at Emory University Law School, even that overstates actual losses to investors because such bonds usually trade at about 40% of par even after default. The default rate rose to 3% in 1986, but, Mr. Carney points out, even a default as high as 6% produces a loss of only 3.6%, close to the risk premium on such bonds since they are currently paying 4% to 5% premiums over the yield of higher-grade bonds.

Mr. Corcoran's case against First Executive Corp. seems particularly weak. His broadsides ignore First Executive's favorable assets-to-capital ratio, diversified portfolio, conservative accounting practices and very low expense ratio. Such attributes have led Standard & Poor's to give the company a triple-A claims-paying-ability rating.

Mr. Corcoran's policies also fly in the face of a study conducted by the New York Graduate School of Business Administration, ordered by his own department and funded by the Life Insurance Council of New York. That study determined that "based on the relatively high default rate in 1986—the return-risk trade-off for investors in high-yield bonds has been highly favorable." The report concluded that "it is difficult to support an outright restriction on life-insurance company investment in low-quality corporate debt."

Similarly, a study done for the Federal Home Loan Bank Board found that "the best statistical evidence says that non-takeover junk bonds, when broadly diversified and actively managed, significantly outperform comparable portfolios of Treasury issues even after taking defaults into consideration."

It is this kind of research that leads former California Insurance Commissioner Bruce Bunner, now a partner in the accounting firm of Peat Marwick Main & Co., to say: "It is unfortunate that the regulatory response is arbitrary rather than directed toward an analysis of the nature of the risk we're actually funding." That comment underscores a second flaw in Mr. Corcoran's approach. Not only do flat limits on a single category of investment deprive insurance-company policyholders of potential economic gains, but they also run directly counter to the best new thinking on controlling insurance price swings and protecting against insurance-company insolvencies.

Support for this is found in the NYU Business School report ignored by Mr. Corcoran. In the report, the authors contend that insurance-portfolio managers must learn to apply basic lessons of modern portfolio theory. To avoid imprudent risk, they emphasize the need for insurance companies to have a "neutral" portfolio of assets diversified across many industries. They advise companies to develop scenarios of expected success or failure directly related to their particular obligations.

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Examined in this light, junk bonds are probably an important element in any balanced investment policy. A recent report by the Federal Home Loan Bank Board said "junk bonds remain inherently more liquid than unsecured commercial loans."

They are certainly more liquid than many insurance-company real-estate investments. Yet the Mandatory Securities Valuation Reserve requirements of the National Association of Insurance Commissioners compel insurers to put up additional reserves on junk bonds with no equivalent requirement for what may be less viable mortgage loans.

Rolf F. Hueppi, chief operating officer of the Zurich Insurance Group, recently called for "a completely new system of regulatory accounting." He says "the system should provide the regulator with enough information to determine whether the company can survive, rather than what its liquidated value would be." He sharply criticizes regulators' reliance on annual statements and calls for computerized reporting of quarterly figures instead.

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"We should mark bonds to market at all times," Mr. Byrne argues. "And the commissioners should make us do it. . . . If you mark bonds to market, it doesn't allow you to kid yourself about how much real capital you've got."

When he was insurance commissioner in California, Mr. Bunner overlaid a strong bias toward generally accepted accounting principles augmented by supplemental reporting requirements on top of the statutory accounting system he inherited. He insisted on taking a hard look at insurance-company reserves, growth rates, reinsurance, quality of investments and business classifications.

Many forward-thinking insurance-company executives recognize that they need to develop parallel tools. In light of these trends, Mr. Corcoran's actions are especially disappointing. Even more discouraging was the support he got from the Life Insurance Council of New York—despite its own study. And other states unfortunately may be following Mr. Corcoran's lead. Texas already restricts insurers' investments in junk bonds. Legislation has been beaten back in the California legislature to do the same, but it could be revived. The National Association of Insurance Commissioners is also thinking of getting into the act.

Protectionist Efforts

State insurance-company investment laws are already too restrictive. New blanket barriers to entrepreneurial investment strategies are nothing more than protectionist efforts to avoid competition that help deprive our domestic industry of much-needed new capacity. Officials in rival markets such as Britain generally give much more latitude to insurers. British regulators make up for it by being more sophisticated financial analysts than many of their U.S. peers.

Certainly the insured public deserves solvency protection as well as maximum investment returns. But junk bond investments, far from being a barrier to that goal, may now actually be a prerequisite to an intelligent investment strategy aimed at achieving it. Mr. Corcoran's wrong-headed regulation should not start a trend.

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Mr. FLORIO. Thank you very much.

Mr. Tweedie, could you talk into the microphone for the reporter?

STATEMENT OF JOHN TWEEDIE

Mr. TWEEDIE. Good morning. Thank you for allowing me to be here.

I am Chief Actuary at Metropolitan Life. My primary responsibility in that position is the projection of the solvency of our company on behalf of our policyholders.

In addition, you and the committee might be interested to know that I've been personally involved almost full-time since early 1984 in the development and implementation of the Baldwin-United rehabilitation enhancement plan for the six Baldwin companies that had difficulty in 1983, and so I know a fair bit about insolvencies, and I know a fair bit about guaranty funds, and I know a fair bit about risks that insurance companies face and try to deal with.

I agree with Mr. Kurz when he says—what I believe he is saying is that he believes that prudent management is the real key here; prevention is the key, and I certainly agree with that. I'm not here to trash junk bonds or suggest that they don't have a place in an insurance company's portfolio, that there is anything inherently wrong with a well-selected portfolio of junk bonds.

I might just add as an aside, you may be interested to know with respect to the mandatory securities valuation reserve, Metropolitan voluntarily holds a reserve for mortgage loans and real estate, although the NAIC blank does not require that. We believe it is prudent to nonetheless make some reserve on our balance sheet on the liability side for the possible defaults.

Mr. FLORIO. Let me just interrupt on this one point, a fundamental question.

Isn't the rationale for the nonreserve requirement for those types of things that there's obviously a security interest that can be held for real estate, or am I missing something?

Mr. TWEEDIE. Well,——

Mr. FLORIO. As contrasted with a security, and there's certainly no security interest on the security, but there could be a security interest on artworks or——

Mr. TWEEDIE. Recourse, yes.

Mr. FLORIO. Yes.

Mr. TWEEDIE. Well, that's certainly true. My understanding of the history of the mandatory security valuation reserve was that it was supposed to provide primarily for credit risk, but also absorbs, as Mr. Lennon and Mr. Corcoran suggested, it absorbs capital value changes and therefore smooths out the impacts on surplus. So it absorbs various types of investment risks. And I agree with Mr. Kurz that there are other types of investment risk beyond those associated just with fixed income securities, with bonds, and we think it's appropriate—if it's appropriate to have an MSVR backing those risks for bonds, then it may also logically be appropriate to have an investment reserve backing similar risks for other types of investments.

And I thought you might be interested to know that we and perhaps other companies, although I'm not familiar with that, do make some provision for that.

In any event, as I mentioned, my concern is not specifically junk bonds; my concern really is—the central issue is insolvency, and the concern is based on the fact that insolvency in the insurance industry is a shared experience. What happens to one company affects all of the other companies. This is really true for two reasons.

First, insurance is based on trust, faith that we'll be there to honor our obligations. When the time comes, we'll have the money to pay the claims. If one company breaches that trust, that public confidence, then that's going to impact the entire industry in a negative fashion, obviously.

Second, the existence of the guaranty fund mechanism and other types of mechanisms which have been devised from time to time to deal with problems in the industry, mostly of a voluntary nature like the Baldwin bailout and the similar, although not so complicated, situation with Charter in which Metropolitan also figured, those sorts of mechanisms mean that not only do we share the adverse publicity and the breach of public trust, but we also share the cost.

The guaranty fund mechanism visits the cost of insolvencies upon the other companies in the industry which have not been so unfortunate.

Mr. FLORIO. Is it the case that New York has a before-the-fact contribution system into the guaranty fund?

Mr. TWEEDIE. No, sir.

Mr. FLORIO. So that they, like everyone else, have an after-the-fact insolvency assessment mechanism?

Mr. TWEEDIE. All of the funds are post-assessment, yes.

Mr. FLORIO. I'm informed that the distinction is that on life insurance, you're observation is correct, but on property and casualty, New York has a unique before-the-fact pre-fund contribution mechanism.

Mr. TWEEDIE. I can't answer that factually.

Mr. FLORIO. The representative from New York is shaking his head yes, so I assume I'm correct.

Mr. TWEEDIE. There you go. That's probably better to have him do that.

To continue, I was going to observe that in our society and our economy, the risks that are associated with mismanagement or the risks that are associated with imprudence or just with high-risk business strategies are normally borne directly by those who are responsible for their implementation or for those acts, and those happen to be the same people who stand to gain in the case of the high-risk strategy if it pays off favorably, and this is appropriate.

The policyholders and the shareholders of an insurance company or an industrial company which embarks upon a high-risk strategy are, I think, entitled to share in the rewards if that is successful. But within the insurance industry, everybody pays.

I think the system is potentially abusive to the sound companies, to their shareholders, and to their policyholders. It's great to be innovative, and it's certainly appropriate to seek a competitive advantage, but when that's done through a higher-risk strategy, through any sort of—not just junk bonds, but all sorts of different things, like deliberately mismatching one's assets and liabilities to move further up the yield curve and pay a higher rate of interest than could be appropriate than if the assets were invested in such a fashion as to be able to meet the demands when the liabilities mature is another example—but when that sort of thing happens, the question has to be asked: These competitive advantages, at whose expense?

And I think again, I say it's at the expense of the other companies, getting at this fair competition question.

The normal rules of competition are bent in our industry. I think the right to go bankrupt and to let the market takes its course may have to have some modifying clauses. That's what the guaranty fund mechanism does. It basically shares the experience of the industry, so we're all in the same boat together.

So I'm concerned with insolvency and risk. I'd like to think that I need only be concerned with insolvency and risk as it affects Metropolitan Life and the protection of our own policyholders and the maintenance of our own financial strength. But the fact of the matter is that I also have to underwrite for and be concerned about the risks that my competitors are taking.

I think that brings me to the position that we would support and endorse things like Regulation 130 in New York, which I believe is a prudent limit of diversification, not that I think junk bond investment is inherently improper, but that there should be limitations. I think I feel—I would also like to say that I feel very strongly positive about Regulation 126, which was mentioned, which basically causes an insurance company to pay attention to the risks inherent in the asset/liability mismatch.

In fact, I am very much proregulation, and I am very much in favor of enlightened regulation, as I think we have in New York State, in heading off these problems before they occur.

If you have any questions, I'd be happy to answer them.

[The prepared statement of Mr. Tweedie follows:]

Statement of John Tweedie

My name is John Tweedie. I am senior vice president and chief actuary of Metropolitan Life Insurance Company and I am pleased to be here to present testimony today.

The life insurance industry sells promises, not goods and other intangibles. This naturally creates a focus on our financial soundness and our ability to keep these promises. Imprudent investments by life insurers, which might jeopardize their solvency, are therefore a matter of great concern to the industry and its policyholders.

The rapid growth of junk bonds in the last few years goes directly to the solvency issue. Investment in high yield securities can be a proper activity of life insurers, if prudently managed in a diversified portfolio. As we know, such investments often finance small and growing companies. On the other hand, we also must recognize that junk bonds are sometimes used in the abuse of the takeover process. In many instances the companies taken over through the issuance of junk bonds have been weakened. The bonds themselves were issued to finance the takeover and will have to be paid off with the target company's own cash and assets. The target company often emerges highly leveraged and very vulnerable to a downturn in its earnings and cash flow.

We are therefore very concerned about default risk. Because most of the junk bonds outstanding have been issued in the past 3 to 4 years, their default risk is really unknown. Therefore, the arguments being made by their promoters that the additional risk is adequately compensated for by additional yield are suspect. Whether these bonds have excessive default risk awaits future economic developments. Will an economic downturn produce a rash of defaults and a major flight to quality? If so, what will junk bond portfolios be worth, if they can be sold at all?

We believe there is a very real danger that some insurers who invest heavily in junk bonds could find themselves insolvent, should there be an unexpected change in economic conditions.

Because of our leadership role in coping with the failure of Baldwin-United, we believe we are in a unique position to comment on the dangers to policyholders of a life insurer's insolvency. Four years later, the Baldwin-United policyholders are finally going to get full access to their money. Over 165,000 consumers suffered through fear, uncertainty and delays. And, even after taking into account their claims against the guaranty funds and major cash contributions from the securities brokerage and insurance industries, they will still get yields significantly lower than they originally expected.

Clearly, as the Baldwin-United policyholders can attest, the guaranty funds where they even exist, are no substitute for prudent management.

Of course, the policyholders of the insolvent insurer aren't the only losers. The guaranty fund assesses the cost of the insolvency against the sound companies (possibly weakening them, in turn), and therefore, against their policy and shareholders. And so a high yield to a few policyholders, if it is actually realized, is achieved at additional risk to all other policyholders.

Let me take this one step further. Consider the nature of a failure in the junk bond market. Would this be an isolated instance or, because of the volatility and thinness of the market, the vulnerability of the bond issuers to an economic downturn and the risk that the market might be driven by emotional considerations, would we face a rapidly spreading crisis of default and illiquidity? If so, a number of investors could be affected simultaneously.

Since the guaranty fund mechanism can be characterized as spreading the cost of an insolvency among the other companies, we have a type of ripple effect from a given insolvency. Unfortunately, these two phenomena would tend to compound and could lead to a very disagreeable scenario indeed.

Our concern should not be interpreted as being opposed to innovation. Innovation in the life insurance industry has increased as companies compete for the Nation's savings. Innovation in investment markets also has been widespread during the last several years. These are positive developments. But when imprudence masquerades as innovation, the safety of policyholder funds and public confidence in our industry, may be threatened.

And so for the reasons outlined above, we have actively supported and endorsed the recent efforts of the New York State Insurance Department to limit junk bond investments via their Regulation 130. The New York Insurance Department's long standing and effective supervision of the life insurance industry has enabled the public to buy the industry's products in the knowledge that no policyholder in New York has ever suffered a loss as a result of insolvency. Further, New York has always been a leader in insurance regulation and its actions have a powerful influence throughout the Nation. We believe the department's regulation is an appropriate step and we will encourage similar regulation in other States.

Thank you for the opportunity to be here today. I welcome your questions.

Mr. FLORIO. Thank you very much.

Let me just make one observation. We discussed it a little bit earlier, and it's interesting, the different perspectives from the insurance industry representatives, when it was stated before that this whole initiative into reliance, to a lesser or greater degree, on junk bonds has forced big companies to increase their payout, I think was the way it was expressed.

That just sounds so similar to the types of discussions we had when we talked about cashflow underwriting in the property and casualty industry. The perception was that the premium reduction initiative at the top of the cycle was forcing some of the big companies, in the area of the smaller companies particularly, if I can break it down that way, reducing their premiums; it was forcing the bigger companies to reduce their premiums, and we had testimony here from Aetna and other people, that it was the market forces in those instances driving people to do things that they really didn't want to do, but competitive forces required them to do, that ultimately caused the apprehension that flows and the specific objective problems that flow from cashflow underwriting.

So it's an interesting analysis of the market dynamics that people are being forced to do things that they, other things being equal, would not choose to do, and in some instances, at least on the cashflow underwriting side, we saw the consequences of it. We have yet to see what the consequences would be in terms of payouts being obtained.

Mr. Kurz, why don't I do this? If you could just retain your response to that observation, let's hear from our other witnesses, and then we'll come back and have some interplay.

Mr. Ingersoll.

STATEMENT OF RALPH INGERSOLL II.

Mr. INGERSOLL. Good morning. I think for those here who are not familiar, I think you are chairman with our operations. I am a newspaper publisher. From our headquarters in Princeton, NJ, we publish more than 40 daily newspapers, and over 100 weekly newspapers in 17 States.

I appreciate the opportunity to address the committee this morning on these issues. My personal concern deals with my access to the capital markets. I am here on behalf of the Alliance for Capital Access, which is a group of more than 70 companies, which is united in its concern to preserve the access for all companies to the capital markets.

On the subject of insurance company investments in high yield bonds, I can recall, 30 years ago when I was a child, insurance companies—notably Jefferson Pilot in Greensborough, NC—making private placement investments in American newspaper companies.

When you consider that newspaper publishing is the largest manufacturing employer in the United States, its history goes back a long time. It also applies to other industries. That practice has continued without undue risk, without insolvencies, without all the problems being referred to for, now, decades.

When an insurance company makes a loan to a private company, whether it is a newspaper publisher or any other industrial concern, it does that in much the same fashion that a bank does. It does that on the basis of a credit committee review, and a judgment to make a loan.

On the other hand, when an insurance company purchases a high yield bond, the security it purchases has been reviewed, from a due-diligence viewpoint, by an underwriter. I can speak from first-hand experience, having sold hundreds of millions of dollars of high yield bonds, that that process is very thorough.

When the underwriter gets through with you, they turn you over to the SEC. Then you go through all of the rigors of the SEC review, and they work on your prospectus. When they are satisfied that you are giving a fair account of what you are doing, then that gets turned over to the credit committee at the insurance company for a third review of the credit.

Finally, if a decision to purchase is made, it is made on the basis of a credit review which really, in my view, cannot be compared with the insurance industry's historic private placement activity.

Once the purchase is made, in the event that there is something wrong with a particular company in which they have made the investment, or the industry in which they have invested loses favor for some reason, if you have made a private placement investment you are locked into that investment.

I was amazed to hear Mr. Corcoran talk about liquidity risk and credit risk. Private placements by insurance companies are, by their nature, more subject to credit risk because they are viewed once, not three times. They are more subject to liquidity risk because they cannot be sold.

From my viewpoint, this matter of the insurance companies in New York dividing large versus small over this issue has got fundamentally to do with competitive forces in the capital markets. In my personal view, the reason that the largest insurance companies have sided in favor of Regulation 130 is that the high yield bond market threatens their competitive position.

It does it in this way. For me to grow, and I am speaking from the viewpoint of a company—most of my companies are more than 100 years old, and on balance, my profit margins are higher than IBM's—but I can't build my business, nor can hundreds or indeed thousands of other American companies, without a source of fixed-rate long-term capital.

Fixed-rate long-term money is just as important to me as a home mortgage is to a veteran or any other home buyer. Before the high yield bond market developed, the only practical source since the New Deal—since the 1930's—of fixed-rate long-term money has been the insurance companies.

They had a lock on that market. They impose on entrepreneurs chattel mortgages, on my typesetters, presses, restrictive covenants that make it extremely difficult to run a business. The high yield bond market, for the first time, offers major competition with the large insurance companies.

I think it is a very healthy competition. Insurance companies still play a major role in providing fixed-rate long-term capital to American business. They do that now both through the private placement avenue, and through the high yield bond market.

High yield bond market, on balance, has reduced the risk of insurance company investments in private companies, and unrated companies; it has increased the liquidity of insurance company investments. It seems to me that that is all for the good.

On top of that, insurance company willingness now—assurance companies in their aggregate—willingness to acquire high yield bonds from issuers, such as myself, has broadened the capital market, the fixed-rate long-term money market for companies, such as my own.

That brings me to the second concern, the reason I appreciate having the opportunity to testify, which is to speak to an issue which, I think, is the most important economic issue facing the United States today.

In our market studies, our own markets, what we publish, it is incontestable that the middle class standard of living in this country has been in decline for more than a decade. It is continuing to decline as we lose our competitive edge to other countries in the world.

We need absolutely every asset we can marshal to be able to compete effectively. That includes, first and foremost, access to a competitive capital market. Any restrictions which the U.S. Congress, or any State regulatory agency, imposes on insurance companies—favoring the large ones over the small ones, and thereby restricting capital market access—is going to diminish American competitiveness.

It is not so critical for me because, relatively speaking, I am in a privileged position with our operating margins, and the nature of my business. But for a manufacturing business—and many of the Alliance for Capital Access members produce cans and paper products, and what have you, where the margins are narrower—it is critical to be able to obtain fixed-rate long-term capital.

As I have been down here a couple of times before, trying to underscore for the Congress, that is not a business that the banks are in. Commercial banks in this country do not loan long-term fixed-rate money to businesses to develop.

You can get that by selling equity, or you can get it in the debt market. The debt market, you can get it from insurance companies, or you can get it in the bond market.

I think they are both important. I would urge the Congress—and, in fact, every regulator in every State—to keep that in mind. It is very important that insurance companies and pension funds—which are the two main repositories of capital since the New Deal—be available to invest in every type of debt instrument.

I think that you have my formal remarks on record.

[Testimony resumes on p. 172.]

[The prepared statement of Mr. Ingersoll follows:]

TESTIMONY OF MR. RALPH INGERSOLL, II

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

INGERSOLL PUBLICATIONS COMPANY

ON BEHALF OF

THE ALLIANCE FOR CAPITAL ACCESS

Mr. Chairman, Members of the Subcommittee, I appreciate the opportunity to appear today on behalf of the Alliance for Capital Access.

The Alliance is a trade association made up of more than 70 companies that have issued high yield "junk" bonds. The companies of the Alliance are united by our common interest in preserving free access to the nation's capital markets for <u>all</u> businesses and by our certainty that we are far from "junk" companies. Alliance members are engaged in everything from making cans, boxes, bags, steel, and soybeans to sophisticated computer equipment, designer clothes, movies, homes, and day care. Together, we employ over 450,000 workers throughout the country. A list of our membership is attached to my statement.

<u>Introduction</u>

Our members depend on high yield bonds to finance their growth, to save and create jobs, to build state-of-the-art factories, nursing homes and child care facilities. We have a direct economic stake in any proposal at the federal or state level that could shrink the availability of high yield bond financing, either through limits on issuance of these securities or limits on the purchase of them.

And we are very concerned about efforts by individual states to sharply limit high yield bond investments by insurance companies.

Let me state at the outset that we understand and share the concerns of this Committee, the New York Insurance Department and others in seeking to protect against any insolvencies in the insurance industry.

But we have an equally important objective in making sure that such regulations do not, in the name of solvency, restrict access to capital for hundreds of companies and with it, the ability of many businesses to grow, create jobs and compete in the world economy.

And we are deeply concerned that regulations like the one recently promulgated by the New York State Insurance Department do not strike the appropriate balance between safety and soundness and capital formation.

Overview of the High Yield Bond Market

In order to understand our concern, it would be useful to discuss briefly the development of the high yield bond market.

Ten years ago, only about three percent of American corporations had access to the publicly traded bond markets: most of the Fortune 500 and a few others, which had been accorded investment grade ratings by the two principal private rating agencies, Moody's and Standard and Poor's. When an investment grade company like Penn Central or Chrysler fell on hard times, its bonds were downgraded and properly dubbed "junk" by the securities industry.

Then, investments in these "fallen angels" were indeed speculative: investors were purchasing the securities of troubled companies, often at deep discounts, to reap windfalls if the corporation recovered.

It is important to note that while these "fallen angel" bonds were the only publicly traded below-investment grade bonds, there has been a private market for high yield bonds for years. In this "private placement" market, insurance companies and other major institutions purchased the obligations of dozens of small and medium sized companies that, for a variety of reasons, could not receive an investment grade rating that entitled them to access to the publicly traded bond market.

That is why the claims by many that high yield bonds are new or experimental, is so strange. There is nothing new or experimental about high yield bonds. The only difference between a high yield bond purchased by an insurance company through a private placement ten years ago and most high yield bonds today is the development of an active, liquid public market for these securities. And that development makes these securities far safer than they have ever been before.

As I will discuss in greater detail later, every publicly traded high yield bond enjoys the benefits of public disclosure and due diligence required by federal securities laws, as well as the judgment of independent underwriters, independent analysts in securities firms other than the underwriter, and the judgment of other investors. Even more important, the presence of a public market which prices the security every day affords an investor the ultimate protection of a liquid market in which to sell if he or she so chooses. Given this history, the suggestion that high yield bonds are some strange new financial gimmick is simply wrong.

Who Issues High Yield Bonds

The development of a public market for high yield bonds has been a boon to small and medium sized growth companies like my own. Where I previously had to go either to a bank, which would not lend me the kind of long term, fixed rate money essential to building my business, or an insurance company, which, in exchange for the loan, wanted to attach a chattel mortgage to my linotype machines, I can now issue securities that provide me with fixed rate, long term money without the onerous covenants and intrusions I faced with banks or a private placement.

Today, approximately 800 companies rated below investment grade have turned to the public bond market to fulfill their need for fixed-rate, long-term growth capital.

Contrary to popular perception, the majority of new issuers of publicly traded high yield securities are not corporate raiders or undercapitalized corporations undertaking high risk corporate maneuvers. The average new issuer of a publicly traded, non-investment grade security in 1985 was a 36-year-old company with assets of approximately $1.1 billion. They have included major corporate successes like MCI Communications, Triangle Industries, Stone Container, Calvin Klein and TCI, which has grown to be the nation's largest cable television firm. The securities issued by such companies now comprise over 70 percent of the market for publicly traded, non-investment grade, straight corporate debt.

Credit Quality of High Yield Bond Issuers

Similarly, contrary to speculation by many, the credit quality of new issuers is improving. The most recent published study of new 1986 issues performed for Morgan Stanley & Co. found that the creditworthiness of new bonds in the investment grade category declined while the credit quality of new bond issues in the below-investment grade category improved.

This finding is confirmed by Fortune Magazine which, even as it proclaimed last March the "coming default in junk bonds," concluded that there is increasing quality in the high yield bond market which would allow prudent investors to significantly reduce whatever risks might lie ahead.

"As more investors join the chase for high yields, the market should grow more efficient. The interest rate advantage that quality junk bonds offer compared with high grade corporate bonds should narrow. Indeed, while more junk bonds than ever before are likely to live up to their name over the next five years, far more are apt to become known by a new, less pejorative label. Blue chip junk, anyone?"

In sum, a "junk bond" today is far more likely to be the security of a company on the way up, not one on the way down.

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Role of Insurers in the High Yield Bond Market

As noted, insurance companies have always played an important role in the high yield bond market, first through private placements and now through their purchase of publicly traded high yield bonds. Today, insurers own about 40 percent of all publicly traded high yield bonds. Sharp limits on their activity in this area would be devastating to those of us who depend on this market for growth capital.

It is important to emphasize this point: insurers do original placement high yield bonds; that is, they are in the front line of providing the seed money to develop and build business. If they simply helped provide market liquidity through their role in the secondary market, restrictions would be somewhat less of a problem. But there are few alternatives to insurers when it comes to original issue high yield bonds. There is no one to take their place. Limit their investment and you will cut the availability of growth capital in America today. At a time when we are struggling to become more competitive in the world economy, such a result would be counter-productive.

In order for insurers to continue playing that role, they need to be able to compete for investment dollars in today's financial marketplace. Otherwise, they risk losing investors' dollars to mutual funds, money market funds and others that can offer higher returns --but do not purchase original issue high yield bonds. If that happens, there will be a significant contraction of growth capital in this country and everyone will lose.

Until recently, insurance companies didn't have to worry as much about competing with other financial intermediaries. They had a very cheap source of investment money -- whole life policies. But the advent of volatile interest rates and money market funds, coupled with the deregulation of the banking and S&L industries, forced life insurers to compete with numerous players offering attractive investment options. At the same time, consumers have become increasingly sophisticated investors, and are far more sensitive to interest rates. These developments -- increased competition and increased consumer savvy -- are particularly relevant in today's financial markets. Investment-grade bonds and U.S. Government securities are paying relatively low returns. How can insurers earn a profit if the market forces them to pay out ten percent to investors to be competitive while regulators limit them to investments whose returns are six to nine percent?

The route to insolvency is not high yield bond investments, but creating an environment where companies are paying more for their money than they're earning from their investments. You need look no farther than the S&L industry to see the high price to taxpayers and consumers of limiting what financial institutions can invest in while simultaneously forcing them to pay out more to gain access to funds.

And high yield bonds are one of the investments that offer them the kind of return they need to compete and continue their historic role as nurturers of new and growing industries.

In evaluating the merits of high yield bond investments by insurers, it is worth comparing them to other types of permissible investments. If insurers are to be limited in this area due to concerns about safety and soundness, one would expect that other available investments would provide greater returns and greater protection against loss. Unfortunately, the data does not support this expectation.

<u>Returns on High Yield Bond Investments</u>

The wisdom of any investment is determined by evaluating its potential return and risk. The last six months offer an instructive lesson in this art. In that period, we have seen the first signs of recessionary behavior -- an interest rate spike. What happened in the bond market is quite revealing. A Barron's Magazine article on July 13, 1987 reported that, "From January through June, according to Drexel Burnham Lambert, its DBL Composite (of high yield, or 'junk' bonds) has given investors a 5.8 percent total return, compared to a negative 1.75 percent on the Salomon High Grade Corporate Index and a negative 3.6 percent on U.S. Treasuries."

<u>In other words, an investor in supposedly "safe" and "risk-free" government securities and investment grade corporate bonds would have lost money in the period while an investor in supposedly "high-risk" bonds would have made money.</u> I suggest to you that these numbers indicate we need to reevaluate our approach to this issue.

No one is for indiscriminate high yield bond investments. But why aren't people here talking about limits on investment in government securities and investment-grade bonds which cost investors far more money this year than any high yield bond investment?

These numbers make sense when you understand that rising market interest rates cause previously issued bonds with lower interest rates to lose value -- their market price drops, representing a loss to investors. Experience has shown over the past decade that U.S. Government securities and investment grade corporate bonds carry an interest rate risk which outweighs the interest rate <u>and</u> default rate risk of high yield securities.

For the nine year period from 1978 through 1986, the average yield on long term U.S. Government securities was 10.8 percent. For the same period, the average yield on high yield bonds was 14.5 percent, or 3.74 percent higher. During the period, average non-investment grade bond yields ranged from 3.1 percent to 5.07 percent above long term Treasuries.

For institutional investors managing major portfolios, such as life insurers, the attractions of such premium yields are significant, providing tremendous capital growth when compounded over time. For example, the 3.74 percent spread between U.S. Treasuries and high yield bonds in 1986 would have resulted in a 40 percent higher return over the period.

High yield bond investments have produced greater returns than any other taxable bond investment -- including U.S. Government securities and "investment grade" corporate bonds -- over the past decade, even after subtracting the small proportion of defaults and downgrading. For the ten year period from 1977 through 1986, a long term bond fund invested entirely in U.S. Government securities returned 156.8 percent on each dollar invested; a fund invested in a diversified portfolio of high yield securities, even when defaults were taken into account, returned 166.6 percent, according to Morgan Stanley & Co.

Default Risk

Clearly, then, the interest rate risks associated with many supposedly "safe" investments are significant. Unfortunately, many bond market observers tend to focus almost exclusively on the risk of default in evaluating bond investments.

But, as the preceeding discussion reveals, basing a policy on default risk alone is like diagnosing a patient by just feeling his pulse. It is an important indicator, but many other things must be examined.

Even so, high yield bonds stack up fairly well against many other investments when default rates are analysed. In the case of high yield bonds, the default rate in 1986 was 3.39 percent, including the default of LTV Corp. When LTV is discounted, the rate falls to 1.69 percent. And it is important to note, of course, that defaulted bonds retain a significant portion of their value in the event of a corporate bankruptcy. An October, 1986 study commissioned by the Life Insurance Council of New York found that lower rated bonds retain an average of 41 percent of their face value following a default. In addition, many bond issues continue to trade at much higher levels following default or bankruptcy, particularly if the potential for corporate reorganization or the corporation's asset values are high.

In contrast, the default rate of some other common life insurance investments are much higher. Statistics compiled by the Comptroller of the Currency reveal that the commercial loan default rate for banks in 1986 was 4.89 percent and the default rate for loans secured by real estate was 4.53 percent. To our knowledge, there is no comparable data for life insurers, a point I will come back to in a few minutes. And, unlike high yield bonds, there is no liquid public market for these types of loans. When they go sour, an investor is stuck.

Many will say that this historical performance, while encouraging, is not convincing. Wait until the next recession, they say, and the high yield bond default rate will soar.

Again, no data exists to support these fears. In fact, the previously cited Fortune Magazine piece predicting a wave of high yield bond defaults found that even if the default rate for high yield bonds reaches six percent, double the highest level recorded so far, a reasonably well diversified portfolio of high yield securities would provide an institutional investor with exactly the same return as a portfolio composed entirely of long term U.S. government securities.

In sum, high yield bonds offer greater returns than government securities or "investment-grade" corporate bonds. True, they carry a greater degree of default risk than these securities. However, this risk has proven to be very low -- significantly lower than conventional wisdom has repeatedly predicted. With their significantly higher interest rate yields, investors have found that high yield bond investments have consistently outperformed other bond investments over the past decade, even when default rates are taken into account. At the same time, government securities and investment grade bonds have been far more volatile investments, with far higher interest rate risk.

The New York Insurance Department Regulation

With this backdrop, let me discuss the New York regulation, which some suggest should be a national model.

The heart of the regulation is a 20 percent limit on high yield bond investments by state-domiciled insurers. The department asserts that this cap poses no threat to capital formation. To support his view that the regulation is exceptionally generous, Superintendent Corcoran has said that it would allow insurers in the state to purchase $125 billion of high yield bonds, "enough to make any investment banker happy."

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Of course, the issue isn't whether investment bankers are happy. The issue is whether the companies that are creating most of the jobs in this country will continue to grow.

While beguiling, the Superintendent's claim of a $125 billion market for high yield bonds in New York is misleading. It is based on the assumption that all 145 state-domiciled insurers will invest up to the 20 percent cap. But there is not a scintilla of evidence to support the assumption. Not only won't that occur, the regulation will also force the few who have made significant high yield bond investments to retrench, even though there is no data to support the assertion that these investments are dangerous.

Investments in publicly traded high yield securities have been very attractive for life insurers for some time and a number of life insurers have earned extremely attractive returns by investing in them. Yet, major insurance firms which support the New York State regulation have simply not made significant investments in these securities. In order to accept Mr. Corcoran's expansive view of the potential market, one must first wonder where many of the major insurance firms have been for the last decade. The plain fact is they haven't purchased high yield securities in the past and they are not likely to do so in any meaningful way in the future.

Superintendent Corcoran himself is the best witness to rebut his own statement. At the start of the department's public hearing on the draft regulation, he said that "even today, the vast majority of life insurers appear to feel that, as fiduciaries, prudence dictates either no position in junk bonds or a very modest position in junk bonds." That is an accurate summary of the attitude of most insurers toward high yield bonds, one not likely to change anytime soon.

All one needs to do for further confirmation is examine the statements of Metropolitan Life, one of the largest insurers in New York State. Presumably, if we are on the eve of a pell mell rush to high yield bonds by major insurers, the Met will lead the charge. But witnesses for the company were far more anxious to keep the stable doors shut than jump on the lead horse.

According to a March 7, 1987 article in the Insurance Advocate, Mr. John H. Tweedie, senior vice president and chief actuary of the Met, said that "investing in these instruments (high yield bonds) was really 'imprudence' masquerading as innovation." And a February 26 article in the American Banker quoted Mr. Tweedie as saying that the 10 percent cap on publicly traded high yield bonds contained in the original New York proposed regulation is too high! These hardly seem like the comments of a firm about to invest in high yield bonds. I don't mean to be critical of the Met. It's easy to understand its reluctance to invest in high yield bonds, given the numerous misperceptions that still exist about these securities. Nonetheless, if the Superintendent himself says that most insurers regard high yield bond investments as imprudent, and if one of the largest insurers in the state says they're imprudent, what on earth is the basis for claiming that the regulation won't hurt capital formation?

Not only won't there be a large jump in new investment, but those few insurance companies that have made large investments in high yield bonds so far will be forced to retrench. And, in some cases, they may be forced to divest themselves of millions of dollars worth of high yield bonds.

The combination of a cap and divestiture will be a blow to capital formation for companies like mine in New York and around the country. If other states follow the New York lead, the results would be even more ruinous.

There are other problems with the New York regulation. For example, the regulation exempts from the overall 20 percent cap private placement high yield bonds of less than $50 million. This is particularly strange in a rule aimed at promoting safe and sound investment. It seems to me that the department has run into itself coming around the corner.

The private placement exemption literally encourages life insurers to acquire the riskiest of high yield securities investments: investments which are the least liquid.

While investors in the publicly traded market are afforded investment protection through their ability to limit losses on investments by readily selling them for cash, the private placement securities exempted by the rule lack this protection of liquidity.

Further, an insurer investing in a private placement offering is solely dependent on the acumen of its few analysts in judging the issuer. In contrast, publicly traded high yield bonds offer far more safety. Every publicly traded high yield bond enjoys the benefits of public disclosure and due diligence required by federal securities laws, as well as the judgment of independent underwriters, independent analysts in securities firms other than the underwriter, and the judgment of other investors. Even more important, the presence of a public market which prices the security every day affords an investor an opportunity to measure his investment judgment against that of the market.

Ultimately, unlike a private placement high yield bond, an investor may sell a publicly traded bond well before it approaches a default stage.

Equally bizarre, the final regulation dropped one of its most sensible provisions-- the limits on the amount of high yield bonds of a single issuer that could be purchased. Instead, the final rule simply requires Boards of Directors to develop an investment plan which includes diversification guidelines. But it gives no guidance on diversification. While the regulation assumes that insurers aren't smart enough to diversify the types of investments they make (hence, the cap), it irrationally concludes that they are smart enough to diversify within each investment.

How is the goal of solvency protected by a rule which contains a 20 percent cap but which allows an insurer to concentrate its high yield bond investments in a handful of issues?

Indeed, by encouraging investments in private placements, the Department creates an incentive for life insurers to lessen the diversification of their portfolios. If, as a portfolio manager, I am faced with a choice of investing $49 million in the publicly traded issues of many different issuers or one private placement of $49 million, the Regulation strongly encourages me to make the riskier of the two investments -- the large investment in the private placement of a single issuer -- to maintain the option of making future investments in the publicly traded market which might be more attractive than the publicly traded issues currently available.

In these two respects, the regulation defies not only all current portfolio management theory, but simple logic. If the Department's concern is to limit life insurers' exposure to default risks in high yield securities, its policy should be to encourage high yield securities investments which provide the greatest protection from default.

By discriminating against publicly traded high yield securities, the Department encourages insurance investors to sacrifice both the protection of liquidity and diversification. In addition, it encourages life insurers to sacrifice the benefit of the market's pricing judgment with respect to the securities in which it invests.

Regulation Could Divert Money Into Riskier Investments

Finally, it's also worth asking whether the goal of the regulation -- to promote safe and sound investments -- is achieved merely through the existence of a regulatory cap. I would suggest that one must analyze where the investment funds that would have gone to high yield bonds will flow. If the answer is they will move to other, arguably riskier, investments, then nothing has been achieved. Indeed, if that is the result, the goal will be subverted.

Prior to adopting this type of regulation, I suggest that this type of analysis is critical. For example, I feel confident in stipulating that an insurer that invested in commercial real estate in the Southwest lost a lot more money than any investor in high yield bonds the last two years. Similarly, someone heavily invested in U.S. Treasuries and "investment grade" corporate bonds lost a lot more money than a high yield bond investor to date in 1987.

Regulatory Limits Are Unnecessary

Beyond diverting money into riskier areas and dangerously limiting the ability of insurers to compete in today's deregulated financial marketplace, discussion of regulatory limits on high yield bond investments overlooks an existing fact: there is already what amounts to a de facto check on high yield bond investments by insurers: it is called the Mandatory Security Valuation Reserve, or MSVR.

The MSVR is a loss reserve on high yield bond and common stock investments. Each year, the National Association of Insurance Commissioners publishes a list of "yes" and "no" bonds. Generally, high yield bonds are "no" bonds that require the establishment of loss reserves ranging from 10 to 20 percent. An insurer must "set aside" a portion of its high yield bond investments into that loss reserve every year in the first few years of the investment. Typically, for a new high yield bond investment, it would have a three to six percent set aside the first year, another two to four percent the second and third years, declining thereafter through the tenth year.

In other words, investing in high yield bonds is expensive and is not likely to be undertaken lightly. The MSVR requires every insurer investing in high yield bonds to put up a significant loss reserve in the first two years alone of at least four percent, a figure which is double the historical default rate of high yield bonds. Any defaults would be subtracted from the MSVR. A company's capital or equity would not begin to be threatened until the loss reserve is exhausted. In other words, in order for an insurer's high yield bond investment portfolio to pose a solvency threat, the high yield bond default level would have to explode beyond any level predicted by the most pessimistic observers.

Equally significant, the loss reserve operates as a direct check on imprudent investments since the money "set aside" for this purpose is locked up. That is, it can't be used for purposes such as paying out dividends. In addition, money in the loss reserve cannot be counted as part of a company's surplus. And it is the surplus which directly determines how much new underwriting a firm can do. The lower the surplus, the less new business can be written.

Given the restraints imposed by the MSVR, is it reasonable to believe that any insurer would wildly pour money into speculative investments? Indeed, I find it peculiar that numerous other insurance investments, such as mortgage-backed securities, "investment grade" bonds, and U.S. Government securities, all of which carry considerable risks as described earlier, are not subject to a loss reserve or are subject to far less onerous reserves than high yield bonds. Losses in these investments, which are far more prevalent than high yield bond investments would directly threaten a firm's solvency. Yet, we are not discussing any limits in these areas. Why should a high yield bond investments be penalized by establishment of a loss reserve in excess of any real or imagined threat while other investments that arguably pose equal or greater threats to solvency are untouched?

Comparative Study

Beyond a study of how the regulation will affect investment behavior, I suggest that an even more basic study is urgently needed. As I have outlined, there is simply no statistical data to support far reaching investment limits on high yield bonds. Indeed, the data which exists strongly rebuts the ease for such regulation. What we have here is a regulation in search of a rationale.

Thus, I would urge this Committee -- and any other states contemplating similar regulation -- to encourage some group or organization to undertake a comprehensive, national analysis of investments by life insurers prior to acting in this area. You don't know how well insurers have done with various types of investments; the regulators have no comprehensive empirical data. Shouldn't we develop comprehensive data comparing all the risks and returns of the full range of permissible life insurance investments before adopting regulations that could have such a damaging effect on capital formation in this country? We would be happy to work with you, Mr. Chairman, and other members of this Subcommittee, in developing such a study.

Conclusion

In conclusion, Mr. Chairman, I want to make it clear that the Alliance does not object to prudent steps to protect major institutions, including insurers, federally insured S&Ls and others from excessive, uninformed investing in high yield bonds. But most of what we've seen so far amount to sledgehammers whose ultimate victims are not the companies that issue high yield bonds, but those that work for them now and could work for them in the future.

Mr. FLORIO. We appreciate that. I have a couple of observations later on, particularly regarding your broad statement about any restrictions being inappropriate. We can come back and deal with that.

Mr. Taylor.

STATEMENT OF MICHAEL W. TAYLOR

Mr. TAYLOR. Good morning, Mr. Chairman. My name is Michael W. Taylor and I, too, appreciate the opportunity to be here today. I am an attorney in private practice in Albemarle, NC, and I represented Piedmont Area Mental Health, Mental Retardation and Substance Abuse Authority, which is a governmental agency, and a local political subdivision of the State of North Carolina, organized and governed by an area board appointed by the commissioners of three counties in North Carolina.

I am going to refer to the agency in my testimony as Piedmont. I am simply here, hopefully, to assist you in your information gathering process. I want to tell you the story of one consumer who was caught up in the Baldwin-United insolvency crisis.

July 13, 1983, will long be a memorable or, probably I should say an infamous, day in Piedmont's history. On that day, without any prior warning to Piedmont, National Investors Life Insurance Company—the company in which $650,000 of the agency's pension funds were invested—was placed in insolvency proceedings by the Circuit Court of Pulaski County, Arkansas.

The company's assets, including Piedmont's pension funds, were suddenly frozen into inaccessibility by an order of rehabilitation. The security of those funds was called into grave question. We are talking about the pension funds for 125 employees, about an average of $5,000 apiece.

This is very important money for these individuals. No one, at that point in July of 1983, stepped forward to guarantee that Piedmont would get anything back. To you folks up here in Washington, $650,000 may not sound like a lot of money; but to us in North Carolina, that is a lot of money, especially for a small governmental agency.

It was the bulk of the pension funds. The board was extremely worried. Upon receiving the news from my client, I examined the contracts under which Piedmont had placed these funds with National Investors. They were all called group annuity contracts. Next, I turned to the statute books and found that North Carolina law established the Life and Accident and Health Insurance Guaranty Association.

Membership, as has been referred to here today, is a condition of doing business in North Carolina. It is an association composed of the 650 companies that do business in North Carolina. The law requires that the Guaranty Associations assure payment of the contractual obligations of the impaired insurer to residents where an insurer has been placed under an insolvency order, an order of liquidation or rehabilitation, as in this case.

At first glance, just picking up the statute book and looking at it, I thought that the North Carolina legislature had made adequate provision, and that we really did not have anything to worry about. In fact, our problems were just beginning.

The Guaranty Association set up for Piedmont's protection became its adversary. We expected the Guaranty Association to be an impartial body which would take a balanced approach to protecting the rights of the policy holders on the one hand, and regulating the economic pressures on the insurers caused by this large insolvency.

We were rapidly disabused of that notion. The Guaranty Association, we quickly learned, was the insurance industry in North Carolina. It appeared to us that that industry was determined to escape from the Baldwin calamity at the lowest cost possible.

The way we felt was that, when the storm broke, the consumer was cast adrift. And it was the consumer whose business had been solvent, the consumer whose money was the lifeblood of the industry. We felt like we were just simply cast adrift at that point in time.

It was not until September 1985—more than 2 years after the July 13, 1983 order—that the Guaranty Association in North Carolina finally assumed some responsibility for the Baldwin insolvency mess. I believe that the North Carolina Guaranty Association was only the second guaranty fund to step forward and assume such responsibility, aside from whatever happened in New York.

From a consumer's point of view, the nonfederal State law based system worked with agonizing slowness, and in the end, it provide very substantial but incomplete coverage; leaving my client considerably short of the position where it would have been, had "all contractual obligations of the insurer been met."

For more than 2 years, the North Carolina Guaranty Association asserted in court proceedings that it had no liability for the National Investors annuity contracts, contending that they were securities. In the meantime my client, like all other National Investors policy holders, could only look for recourse to the distant court proceedings in Arkansas, by which all policy holders were bound.

This is due to a decision of the U.S. Supreme Court back in the 1930's. We looked into intervention in those proceedings, but the cost was prohibitive to employ counsel out in Arkansas, because we are a fairly small agency.

Finally, alone of all the policy holders in North Carolina, together with one other mental health agency, Piedmont intervened in the proceedings against the Guaranty Association, which the North Carolina Commissioner of Insurance instituted, to force the Guaranty Association to act.

In May of 1984, the Arkansas court placed into effect a rehabilitation plan, which gave policy holders a number of options. Option A provided for policy holders leaving their funds in National Investors for 3½ years—that is, up until the end of this year—with the hopes that interest in the range of 5.5 percent to 7.5 percent would be paid on funds held as of May 1, 1984. No guarantees of earnings were made by the rehabilitator. Option D, the so-called policy loan option, provided for immediate withdrawal by the policy holder of 75 percent of its May 1, 1984 accumulation value. The policy holder selecting Option D was required to pay interest on the 75 percent withdrawal, with the interest being paid out of the 25 percent that was left with the company.

Faced with this poor choice, with no guarantees being made by anyone, and with the continued denial of liability, at that point, by the Guaranty Association, my client felt as if it were standing at the teller's window of a failing bank and took Option D, laying its hands on the ready money that it could get.

In the summer of 1984, Piedmont did recover approximately $487,000 from National Investors, through exercise of Option D. To date, those are the only funds recovered. In September of 1985, the North Carolina Guaranty Association was successful in obtaining the concurrence of the North Carolina Commissioner of Insurance—Commissioner Long had taken over from Commissioner Ingram by this time—in a settlement which we contended did not make us whole.

Piedmont was placed in a position where, practically speaking, settlement became almost a necessity once the commissioner lined up with the Guaranty Association against Piedmont, in favor of the settlement.

I argued back and forth with the commissioners, submitted letters, and showed how we were coming out on the short end of the stick. But basically, when you have the Commissioner of Insurance on your side, you feel like you have a chance against the Guaranty Association; if you are the little consumer, and you have the commissioner of insurance and the Guaranty Association telling the judge that the settlement was fair, it was time to quit, we felt.

How does Piedmont contend it was not made whole by the settlement? First, the settlement provides no reimbursement for the substantial interest payments made over the 3½ years on the so-called 75 percent policy loan.

Second, the settlement provides only limited compensation for Piedmont's loss of use of the funds frozen in Arkansas. Naturally reasonable accountants and attorneys can disagree about these issues.

However, when you consider that a major annuity carrier such as The New England offered rates on comparable annuity products of 14 percent in 1984, 13.3 percent in 1985 and down to 11.7 percent this year, it is easy to see how substantial losses were incurred when frozen funds were unavailable to take advantage of that market.

The contractual obligation to let Piedmont withdraw its funds for a small "back-end" charge was not honored and that is the main contractual obligation that was not honored.

I do not want in any sense to mislead you. I want to be fair in this presentation. In a short summary of this nature, it is easy to gloss over important points. The North Carolina Guaranty Association did agree by the settlement to guarantee all the minimum guaranteed rates in the policy and we had three policies and one of them was a GIC or a Guaranteed Interest Contract.

It was a 5 year guaranty of 15.87 percent and the North Carolina Guaranty Association is underwriting that policy but even so, taking into consideration that fact, the losses we contend are substantial.

Mr. FLORIO. The losses are exclusively in the area of the use of the money?

Mr. TAYLOR. Yes, sir. It is the time value of money. I think it is interesting to know how we got into this mess. The products were sold to it by an agent who was a CLU, which is supposed to mean something, who has stated that National Investors offered the solution for all its pension needs—high guaranteed interest rates, guarantee of principal, low withdrawal charges and a good commission for the agent by the way.

The agent has stated to me about National Investor's annuity products and I quote, "We could eat it with a spoon, Mr. Taylor, it was so good. It was so good, Lord knows it was good. It was good and I repeat again, it was good."

That is the way National Investors looked. Such great claims by an annuity insurer would seem to have called for some in-depth investigation of the company before a client's funds in the amount of several hundred thousand dollars were placed there.

However, the agent has stated that his only investigation of National Investors was a review of the short-form A.M. Best's Report on the company which gave National Investors an "A" rating and that was good enough for him.

Proper analysis and scrutiny of Best's would have revealed that National Investors was a high risk investment with a faint praise of an "A" rating, that is a second rung rating, and that is really like a "B" or maybe even lower than a "B". Some of the experts are now suggesting that you don't put your money with any company unless it has had an A-plus rating for 10 years. Other people contend that is pretty extreme. But after this experience, I would go with that, to tell you the truth.

There was an absence of any A-plus ratings in its history, a negative unassigned surplus in 1980, a low net worth to assets ratio, a high percentage of net worth in affiliated securities which was a crucial problem, investment portfolio earnings of 8 percent to 9 percent with promises to pay in excess of 15 percent and reinsurance by a very weak affiliated reinsurer, National Investors Pension Insurance Company, which appeared right next to it in A.M. Best.

The connection to Baldwin-United was plainly stated in A.M. Best. No warnings of any possible risk were given to Piedmont. To the contrary, Piedmont was told over and over again that its principal was insured. I brought along one of the brochures that the agent prepared and I think he uses the word "guaranteed" 14 or 16 times all the way through it. It is just that everything was guaranteed.

Another problem is the problem of monitoring. The funds were placed in National Investors in February of 1982. In the intervening 17 months before the Arkansas Order of Rehabilitation was entered on July 13, 1983, Baldwin-United continued its slide to collapse in a process which was widely reported in the financial and insurance industry press such as the Wall Street Journal and National Underwriters.

For example, here is a December 20, 1982 Forbes article, "What happens when the music stops?" Here is a May 7, 1983 National

Underwriter article, "Baldwin suspends sale of annuities temporarily." This was all well in advance of this order of rehabilitation.

Piedmont provides mental health and not investment services. For these it relied on its agent and not one word about any impending trouble was provided to this consumer.

The agent has told us that his only act in monitoring the financial health of the company was a review of an April 1983, letter to an associate from the North Carolina Commissioner of Insurance stating that National Investors was duly licensed to do business in North Carolina. I have since learned that an NAIC committee was meeting regularly in the spring and summer of 1983 monitoring the declining financial health of National Investors. Why wasn't the consumer warned?

You will hear it said by the insurance industry that in Baldwin-United Insurance insolvencies the system worked. My client would respond that the system has many defects. I can tell you a series of sad stories about good employees, mostly women at retirement age, widows or women who were going to have to solely rely on their pension who had to delay retirement and suffered considerable anxiety on account of the freezing of funds.

These individuals have as yet to see 25 percent of their pension funds on hand as of May 1, 1984.

As you look at the system, remember one thing. The Guaranty Funds are not impartial bodies acting at arm's length from the insurance industry. Rather, the Guaranty Funds are the insurance industry. It is true they are mandated by State law and subject to supervision by State insurance commissioners.

Because of the insurance industry's political clout, supervision by the State insurance commissioner, just like insurer solvency monitoring by the State insurance commissioners, may, in certain cases, in some nonsubstantial States, be the next thing to an illusion. Now I am not going to say that about my own insurance Commissioner. I have great respect for Commissioner Long in North Carolina, but I would just say that you have a problem there with a State-based system and the system is a chain and it is only as strong as its weakest leak. National Investors was in Arkansas and, I guess, those in the know would say that Arkansas has, or had at that point, some very weak laws with respect to insurance company monitoring and regulation.

Let me just conclude by this: down in North Carolina, a favorite saying is, "If it ain't broke, don't fix it." My feeling is that that is something people say when they want to maintain a kind of a shaky status quo.

I am sure that this is the position of a lot of people in the insurance industry today. From the consumer's point of view, the system has many imperfections. Many times since July 1983, my clients have looked around and asked, "Who is in charge here and who is supposed to be looking out for our interests?"

The answer seemed to be a bewildering collection of courts, insurance commissioners, NAIC bodies, insurance industry groups and guaranty funds. Better coordination of agencies, better monitoring of potentially insolvent insurers, better warnings for the consumers and better security are what the consumers need. Thank you.

Mr. FLORIO. Thank you very much, Mr. Taylor, and to all of our witnesses. We appreciate the diversified views that we have gotten here today.

Mr. Ingersoll, listening to Mr. Taylor's tale of woe, are you still comfortable with the idea of opposition to any restrictions imposed on the capital formation capability of insurance companies?

Mr. INGERSOLL. Yes, sir, I personally am. Let me say to Mr. Taylor that I publish in North Carolina also and I do not consider it a minor State.

Mr. TAYLOR. Thank you.

Mr. INGERSOLL. It is a very progressive State. I don't think that lessons drawn from the Baldwin-United experience is dispositive of anything. If you are familiar with the facts in that case and I am sure you are, Mr. Chairman, it was a self-dealing fraud.

Mr. FLORIO. You are right. Obviously the specifics of any particular instance are going to be able to be distinguished from something else, but I think that the principle that we are talking about discussing here today is whether there is any public role to play in defining what practices will insure some degree of stability in this very important industry.

I suspect people would be somewhat uncomfortable if a company had 100 percent of its portfolio into common stock. That might be an extreme example of where there is some sense of objective affirmative feeling that that is wrong and I suppose that what we are trying to do is to define back from that extreme case where it is that we have some public responsibility to spell out restrictions—I know that some people do not like the word, but restrictions to insure some degree of stability.

We have, in a different context, been beating up on these insurance commissioners in the area of property and casualty insurance for not doing things in the area of cash flow underwriting until after the fact. I think almost everyone, including the insurance industry, acknowledges that that phenomena, particularly the last go-around, was clearly inappropriate and someone should have done something to avoid that sequence of events that got us to the point that we are at now.

So I guess maybe I would ask all of the witnesses——

Mr. INGERSOLL. Let me comment on that.

Mr. FLORIO. I would ask all of the witnesses and certainly feel free, whether we take the position that Mr. Ingersoll appears to be taking, that no restrictions are necessary as opposed to arguing that this particular restriction that we are talking about in New York is inappropriate because of the nature of what we are dealing with. Are we saying the 20-percent number is a wrong number or are we just saying that generically there is no role for the public agency, in this context the insurance commissioners, to play in defining what the portfolio of an insurance company would be. Maybe we will ask Mr. Ingersoll first.

Mr. INGERSOLL. Let me respond. I was really speaking to Mr. Taylor there. First of all, the insurance industry, State-by-State, operates in a heavily regulated environment and has for generations.

I understood the question to be additional new restrictions, new regulations, not any. My response was that I could not personally see a case for new regulations since if New York State, which was supposed to be the most restrictive of all States in this respect, can exempt private placements over $50 million, if insurance companies are required to maintain MSVR reserves as they are, as Mr. Kurz discussed, and if no insurance company has become insolvent as the result of an investment in high yield bonds, then I personally don't see a case for additional restrictions on that type of investment, particularly when you bear in mind that one of the characteristics of professionally managed high yield bond portfolios is they are heavily diversified. They tend to hold very small pieces of lots of issues.

Mr. FLORIO. Would your views change at all if the exemption for private placements were struck out of the New York system? If the security interest requirements for real estate, art works, were included, would that change your views?

Mr. INGERSOLL. I think—to put it positively because, I think in my oral testimony this morning I have given you my own personal thesis on why I think 130 was created—it is a capital market competitive issue and naturally the large insurance companies preferred not to have the competition which the high yield bond market offers.

However, if you choose to persist, and I can well understand certainly from an intellectual viewpoint that you would, I would propose that the Congress undertake a study, a really comprehensive study, of the risks and the returns of all types of insurance company investments on a national scale. I would specifically urge that you include in that study not only high yield bonds, but art work, real estate, as was focused in the southwest recently, oil rigs, and private placement experience—every type of insurance company investment and return.

From everything I know about the facts underlying that, it would be very interesting to do that and I think then you choose to legislate based on those facts that would be appropriate.

Mr. FLORIO. I am not sure. First of all, I think it should be made clear that no one, at least I don't and I suspect other members of the committee don't have anything in our back pocket that someone is preparing to spring on you.

Mr. INGERSOLL. No. I know you don't have anything in your back pocket.

Mr. FLORIO. One presumes that with the State regulatory systems that we have now, different States respond different ways. One has to presume that when a State makes the determination as New York State has made in this particular context or any other State makes a determination as to restrictions that they would impose almost in any area, that they have done so from a rational basis of their perception that the restriction is required presumably because they are apprehensive about the functioning of the system without the restriction.

So if, in fact, the Congress was contemplating national restrictions, your observation would be a very appropriate one, that we ought to do a study and make sure that it is a real problem.

Inasmuch as that is not the system that we have now, but rather we are dealing with State-by-State operations and a State such as New York and there are other States that have seen fit to do that, I have to believe that they have based the restriction on some understanding, whether it be a formal study or not, that there is a problem.

Mr. INGERSOLL. Yes, but your hearings here are going to influence.

Mr. FLORIO. Hopefully.

Mr. INGERSOLL. I believe they will because of your position. Your hearings here will influence State policy on these issues. I understand, as you do, that there have been effective State regulations on insurance company operations for years, but when the high yield bond market developed, and I am coming at it from this perspective, there were two oxen to be gored by the development of this capital market.

One was the commercial bank universe and the other was the large insurance companies because they had a lock on this before this market opened up. Now the commercial banks have done everything in their power to upend this and they nibble away at any corner they can.

They go after S&L's. They go after pension funds. They go after insurance companies. The real intent in my personal opinion of the opponents of high yield bonds in these areas is to restrict competition and access to capital markets.

The State insurance commissioners have their jobs to do and I am all for their doing it. I am pro consumer. I am also pro free access to capital markets.

Mr. FLORIO. Let me ask the two banking representatives, and I suspect I know what the different perspectives will be, but is there any legitimacy to concerns that some may have about competition? Mr. Ingersoll talked about his view that competitive forces are driving where bigger institutions come out on these issues as contrasted with perhaps smaller institutions.

Is there any legitimacy to the observation that we have seen in the cash flow underwriting controversy, that sometimes the competitive forces will drive people to almost self destruction policies and that we should be concerned about just talking about the unfettered marketplace forces in the competitive analysis resulting in policies that don't insure the long-term health of the industry?

Mr. KURZ. Mr. Chairman, I would like to respond to that, if I may. The key item in establishing rates is whether or not there are adequate profit margins. In cash flow underwriting, the companies assume underwriting loss and hope that the accelerated interest rate returns would more than overcome it.

Mr. Corcoran referred to a 12 percent return on high yield bonds. Obviously, a 12 percent return and we are setting an 8.35 percent rate, we have adequate spreads even though we don't average 12 percent because we do keep money in government bonds or we keep money in short-term situations to provide for liquidity.

I want to return again to the fact that we do have a mechanism in place which is unique. If you feel the reserve is too low, increase the reserve. But there is a mechanism; since there has not been a default, not been an occurrence in life insurance companies related to high yield bonds, we do have a successful mechanism. Let's enlarge on it. Metropolitan does put up money for real estate and mortgages. Let's do the same thing for oil and gas rigs. Let's make the mandatory security valuation reserve the safety valve for the consumer.

It would, one, protect the consumer against insolvencies, and by allowing investments in a diversified portfolio, including high yield bonds, a more competitive return. Inherent in the investment world of most life insurance companies in most States is a requirement that investments be prudent. In my judgment, this is the function of the board of directors and management of the companies, to determine what is prudent. I don't think a regulatory body, no matter how wonderful it is, can determine for a company what is a prudent investment policy.

Mr. FLORIO. Mr. Kurz, we are not unrealistic in the sense we know that not everybody over the course of our history has been prudent, and in some instances—for example, Mr. Taylor can give you, I suspect, some evidence that he would offer that in his context someone was not prudent. So it is not sufficient, I don't think, to say that we are going to rely on the inherent wisdom or lack of wisdom in the management policy of management to provide us with the assurance that the right thing is going to be done.

Mr. KURZ. Mr. Florio, let me be specific about what Regulation 130 can do. It limits the investment in high yield bonds; however, we can invest an unlimited amount of money, virtually unlimited, in the preferred stocks of these very same companies. You know that a preferred stock is less secure. We can go out and we can invest large amounts of money in partnerships, including partnerships that may have part of their purpose——

Mr. FLORIO. Mr. Kurz, I understand the thrust you have made, saying that this may not be good but this is something else that should be dealt with as well. Let's assume for a moment that tomorrow New York State provides the regulations or a statute that does everything you advocate with regard to works of art and gas partnerships and things of that sort with lost reserves.

Does that in any way detract from the advisability or the desirability of requiring, at least in the area of junk bonds, some degree of diversification that is represented by this 20 percent restriction?

Mr. KURZ. I would say that would be true if a study would conclude that junk bonds furnished a greater possibility of loss than investment in high grade bonds. I do not believe that to be true. I believe that a diversified high yield bond portfolio over time has a better performance record than an investment in a diversified portfolio of investment grade bonds.

Mr. FLORIO. How about an insurance company with 100 percent of its portfolio in junk bonds?

Mr. KURZ. I don't believe any insurance company would have that. I think prudent management—it might be possible, but I don't believe that prudent management—no.

Mr. FLORIO. My point, obviously, is that at some point you have made the decision that that would be imprudent.

Mr. KURZ. The counterpart would be 100 percent——

Mr. FLORIO. Common stock.

Mr. KURZ. In investment grade bonds. No, common stock, you are precluded. Only 20 percent in common stocks. But you could have 100 percent in investment grade bonds, which would include things like LTV, Bethlehem Steel, industries which are more fraught with risk because of the very nature of the industries.

Mr. FLORIO. Let me get Mr. Tweedie's thoughts on some of the things we have just been talking about.

Mr. TWEEDIE. Thank you. I would like to add a point with respect, if I may, to what Mr. Taylor was talking about with the experience he had with the Baldwin situation. I would just like to point out that when all was said and done, his client and other policy holders, if they took a 75 percent loan, had access to 75 percent of their money and were able to reinvest that.

I would like to point out that the individuals who had single premium deferred annuities had, at almost all times through the 3½ year rehabilitation period, the opportunity to annuitize and retire, if they so wished, 100 percent of their funds.

I would like to point out that although there were 80 cents on the dollar of assets available in the Baldwin companies in May of 1984, the policy holders will get all of their money back with interest retroactive to May 1, 1984, and where necessary, will be brought up to snuff in terms of the minimum guarantees in the contract by the guarantee funds, where they have them, and by the assistance of the insurance industry and the stockbrokerage industry, to the tune of something approaching a quarter of a billion dollars.

By point of perspective and contrast, Mr. Taylor's clients had a choice to make. They bought a $650,000, if I remember the number correctly, GIC, Guaranteed Investment Contract, from National Investors Life. That wasn't the only investment choice they had available. That paid 15.87 percent, if I recall, or some rather attractive number for 5 years. They could have bought a bond from Baldwin-United, a senior security, at 15.87 percent, perhaps, with a coupon rate for 5 years. I don't know if Baldwin actually had such an issue, but had they done so, they would have had that choice.

The instruments from the point of view of funding a pension plan are very similar. Had they done that, how much money would his clients have gotten back? Where would they be today? The secured bondholders of Baldwin-United got 50 cents on the dollar. The unsecured bondholders got nothing. The stockholders got nothing. The policy holders got all the money back plus interest retroactive to the date of insolvency.

Mr. FLORIO. What is your conclusion, Mr. Tweedie?

Mr. TWEEDIE. The system works.

Mr. FLORIO. The system works?

Mr. TWEEDIE. There is a very, very strong motivation in the insurance industry to self regulate and to support enlightened regulation because we are all in the same tank together, as I mentioned before. One company's problems are my problems, and my problems are the other companies' problems.

Mr. FLORIO. How about all the insurance company contributors to the State guarantee plan? When you say it worked, presumably you are talking about it worked in an equitable way. Was this equitable to the insurance company stockholders, policy holders of those other insurance companies that have had to effectively bail out his clients?

Mr. TWEEDIE. That's a good question. I think not. I think that the Baldwin-United company whomped us in the marketplace, and then they whomped us again. I think that is abusive of our policy holders and shareholders of stock companies who are also competitors with Baldwin, and I regret that in the end, the solution wasn't quicker and that full money wasn't returned to all of the policy holders immediately, but I do suggest that it was on balance a fairly good solution for the policy holders. They came out of this thing whole.

Now, the insurance companies who contributed $50 million, and there are 61 of them who are partners in this, did so because they believed it was in their interest to do so. They believed that the public trust and public confidence was worth the $50 million. A lot of people worked very hard on this thing to try to recover the policy holders' money. But we could have said let it go, too bad. But, of course, there is also the implication of what would have happened if we had done that—we would have funded it through the guarantee funds.

Mr. FLORIO. I think all of the panelists have to appreciate at least the perspective or the sensitivity to the concerns that some of us have. If we wanted to say, well, this is an isolated example, it has worked out, not the best, but whatever. The concern, of course, is that this may not be an isolated example. The concern is that there are some generic deficiencies in our system of State guarantee plans, and if, in fact, we do have something occurring out there that this GAO report that I made reference to earlier indicates is something that is happening, I mean if these things are happening, if insurance companies are sort of falling off the edge now when the marketplace is apparently in prosperity, the concern is that we haven't repealed the business cycle yet here in Washington, and that at some point there is going to be a slowdown, and how do you anticipate being able to respond to something more than an isolated example? That is the concern.

Mr. TWEEDIE. Absolutely. I am worried about that. I am concerned also. I am very pleased to see things like the regulations which force an examination of the matching of assets and liabilities and the holding company regulation legislation in New York. The Baldwin situation is very instructive in that respect.

I would say there were three things that put Baldwin in the tank, and not one of the three happened to have been junk bonds in this particular instance. It was the tax issues. Unfortunately, tax liabilities were not recognized and should have been. Eighty-five percent of the problem had to do with investment in Affiliate Securities, which proved to be worthless, which I think the New York regulation addressed, and another 5 to 10 percent was the asset-liability mismatch, which again Regulation 126 in New York would address. I believe that that sort of regulation is correct minded. It is going in the right direction and it is to the benefit of the industry and all of its constituents.

What you are saying, I think, is almost an illustration of how the system is not working. There are obviously model codes, and the model codes are not being adopted so you don't have uniformity in a lot of these areas, and we hope that—I am sure not everybody would subscribe to the idea that New York has a model system, but to the degree that it is a stronger system, and let's assume we all subscribe to the fact that they are moving in the right direction, we are not getting that degree of uniformity, and that the absence of the uniformity in and of itself is going to require that we are talking about an interstate, a national and perhaps even international dimension to this problem, and we don't seem to be moving.

Mr. Taylor, I suspect, can tell us all the reasons why the system doesn't appear to be working.

Mr. TAYLOR. Mr. Florio, could I comment on that about New York?

Mr. FLORIO. Sure.

Mr. TAYLOR. What you were just saying. I think that is a very important point to realize, that when you are looking at this from a national perspective, in a sense you are wrong to focus on New York because as far as I can tell, New York seems to be one of the best regulated States from an insurance point of view, and it is important to know that National Investors Life Insurance Company was not licensed to do business in the State of New York, and that is one of the reasons why they were able to get out of the situation so quickly. National Investors did not meet New York standards, so they could not sell their annuities, their SPDA's, in New York.

There are agents in my neighborhood who say they did not get their clients involved in it because they checked and found out that it was not licensed in New York, and that to them was a great litmus test. But the point is there are plenty of States that do not have New York's level of regulation.

Mr. TWEEDIE. That is true, but New York has always been the leader in insurance regulation and in many instances has influenced the regulation in other States and influenced the design of model bills. I would admit that if you have a situation where you have 50 or more jurisdictions, you are not going to have absolute uniformity and absolute universality, but the whole purpose of the National Association of Insurance Commissioners is to attempt to extend enlightened regulation to all jurisdictions. It is a process that is happening. It does take time.

Mr. FLORIO. Let me stop at this time. The gentleman from Utah has been very patient. Let me yield to him at this point.

Mr. NIELSON. Thank you.

I just made a note that I was going to have to leave because of the Price-Anderson debate on the floor.

I'm interested in the testimony of Mr. Kurz and Mr. Tweedie, and I recognize that one of you is from a very long established company, Metropolitan Life, a rather conservative company, and the other is from a relatively smaller company, but I am struck by the difference in your testimony. I didn't hear the testimony, but the statement that Mr. Kurz makes is: "I find the subject of this hearing ironic, since high-yield bonds have not been a factor in the financial problems of those life insurance companies which have had troubles."

Would you concur with that, Mr. Tweedie?

Mr. TWEEDIE. Yes.

Mr. NIELSON. OK. He says, "The loss in foreign loans, real estate, and agriculture dwarf any losses that might come from high-yield corporate bonds."

Do you agree with that also?

Mr. TWEEDIE. Is that statement specifically with respect to insurance companies? I had read it to be broader.

Mr. NIELSON. "The performance of our industry is far better than that of other financial institutions, banks and savings and loans."

Mr. TWEEDIE. I certainly agree with that.

Mr. NIELSON. OK. Then you also have the statement here: "The performance record of well-managed, diversified portfolios of high-yield securities have been stronger than portfolios of investment grade securities over many decades."

Mr. TWEEDIE. In the last 3 years, I believe Dr. Altman points out, and I believe others too, that a Treasury portfolio will have outperformed a high-yield portfolio in terms of total yield.

Mr. NIELSON. So you basically disagree with this, in the last 3 years?

Mr. TWEEDIE. That's too strong a statement.

Mr. NIELSON. I beg your pardon?

Mr. WEINBERGER. From 1981 to 1986, the best performing portfolios have been high-yield portfolios with government——

Mr. NIELSON. Now we have a difference here.

Mr. TWEEDIE. Well, maybe I could conclude the answer to the question, and it might just moot the issue anyway. I think the point is really not so much what has happened, but what might happen when we have an economic downturn.

I don't know what's going to happen to default rates in the high-yield security market if there is a major economic downturn. I don't think anybody knows. My problem is, I don't want to find out.

Mr. NIELSON. What percentage of your assets are in high-yield bonds, of Metropolitan?

Mr. TWEEDIE. Metropolitan Life doesn't invest in high-yield bonds.

Mr. NIELSON. None at all?

Mr. TWEEDIE. We have fallen angels unfortunately, but we have no original issues.

Mr. NIELSON. What about Presidential Life Insurance? What percentage of yours would be high-risk?

Mr. KURZ. At the end of 1986, it was slightly under 20 percent.

Mr. NIELSON. Twenty percent?

Mr. KURZ. At this moment, because of the advent of Regulation 130, we increased that before the effective date.

Mr. NIELSON. I see.

Mr. FLORIO. If the gentleman would yield, increased it to what?

Mr. WEINBERGER. It is approximately 35 percent.

Mr. KURZ. Thirty-five to 40 percent. What we did, we calculated those items which would be redeemed or, because they were short-term in nature, mature between now and the end of 1988, and we developed a portfolio which would have about 20 percent, assuming no additions and assuming an increase in our assets, that we would have a value of about 20 percent at the end of 1988.

Mr. NIELSON. So State regulation has increased your investment there. You moved it up in order to avoid the regulation or grandfather in; is that the idea?

Mr. KURZ. That's correct. And we also found it necessary to invest a greater portion of our money in preferred stocks.

Mr. NIELSON. Why?

Mr. KURZ. Because we could not invest anymore, and we didn't want high-yield bonds.

Mr. NIELSON. Mr. Kurz, I'm going to talk to Mr. Taylor for just a moment.

Mr. Kurz has suggested that the problem that they had with the Baldwin-United program had nothing to do with high-yield bonds; it had to do with imprudence in the investment and a lot of other problems.

Would you concur with his statement? Do you think he was fair in his assessment?

Mr. TAYLOR. Well, I think we've heard that high-yield bonds, junk bonds, were simply not in existence in 1983, so, I mean the problems involving United were related to poor reinsurance and promising to pay a lot more than they were earning on their investments. That's basically what they were doing.

Mr. NIELSON. When you make investments, don't you exercise some caution, especially in those investments which promise a rather high yield?

Mr. TAYLOR. Yes, sir. But if you think back to early 1982 and the rates that were being paid on the market, the 15.87 percent, and that was only for one of three contracts and less than a third of our money, that seems tremendously high right now, but it was about half a point, maybe three-quarters of a point above what the market was at that point in time.

Mr. NIELSON. On page 3 of your testimony, you suggest an in-depth investigation of an annuity company would be a reasonable thing to do before one places $650,000 in one company.

Do you stand by that statement?

Mr. TAYLOR. Yes.

Mr. NIELSON. What would that investigation have shown, had you applied that to Baldwin-United?

Mr. TAYLOR. Well, I believe I've indicated that simply an indepth reading of the A.M. Best report, we felt we were paying our agent—he was earning his commission for some reason, and we felt that he should have at least gone into an in-depth analysis of the A.M. Best report. And I mention there the things which an analysis of the 1980 A.M. Best report to National Investors would have shown.

Mr. NIELSON. Why didn't the pension plan conduct that investigation?

Mr. TAYLOR. Well, as I said, we are a mental health agency and one that employs professionals for all sorts of things. I'm employed as an attorney by them, and we assumed that we could rely on an insurance agent, who was holding himself out as a certified life underwriter, for certain investment advice.

Mr. NIELSON. Well, as Mr. Tweedie hinted, you can't get guarantees for insurance agents. You have to conduct your own investigation and make your own decision. You can't really blame the insurance agent, if you willingly invest, can you?

Mr. TAYLOR. Well, I guess that's a question to be asked. That's certainly a question to be asked. I would say that, yes, you can. But, you know, that's an issue before us.

Mr. NIELSON. Mr. Ingersoll, would you like to comment on that?

Mr. INGERSOLL. Would you put the question to me again?

Mr. NIELSON. The question was, don't you have to—when something appears to have a higher than average yield or something too good to be true, shouldn't you take—doesn't the one who buys have the obligation to investigate for himself before he does that? Wouldn't you think that would be prudent?

Mr. INGERSOLL. Yes, sir. I'm a Connecticut Yankee. It comes naturally. Yes, sir.

Mr. NIELSON. OK. And do you think that they did it in this case? Do you think that the problems they had were of their own making primarily?

Mr. INGERSOLL. I wouldn't assess it that way. I'm a member of—I'm a director of Phoenix House in New York, for example. I deal with substance abuse, and I know the culture within which Mr. Taylor is working. I think trying to provide $5,000 pensions for 125 people is not an undertaking of a magnitude that would attract the best, you know, resources they might have if it were a different dimension.

I think he did the best he could under the circumstances.

Mr. NIELSON. There are many people who object to high-yield bonds, given even the name, the pejorative term of junk bonds is not very attractive. They say the risks associated with these bonds are relatively high, and they may be a direct threat to solvency in the industry.

Do you—I'm sure you don't subscribe to that. What comments would you make? What rebuttal would you make to that kind of a charge?

Mr. INGERSOLL. Well, sir, I believe that the regulation in New York State in rule 130, for example, and attempts to regulate elsewhere, are based on misperceptions of high-yield bonds.

I was interested in the chairman's comment to Mr. Kurz—well, now, if you don't invest 100 percent of your portfolio in high-yield bonds, you're really telling us by that that you've got some worry about it, that it's risky.

Now if in the last 3 or 4 months you'd had 100 percent of your portfolio in Treasury securities, you'd have taken a good licking. You'd have lost, you know, at least 17 percent of your assets in less than 6 months.

Obviously, I think that the credit review, which is attendant to the issuance of high-yield bonds, which goes through three stages—through the underwriter; you're going through the SEC; and then you're going through the insurance company credit review—is much more thorough than a private placement directly from an insurance company.

And yet for decades insurance companies, including Metropolitan—Metropolitan is where I have all my pension assets, by the way—they have been soundly managed, and they have made private placements and exercised excellent credit judgment, and the experience has been satisfactory.

Now high-yield bonds are lower risk than private placement. I think it's a very benign development.

Mr. FLORIO. Would the gentleman yield?

Mr. NIELSON. Yes. Let me just explain why I wasn't here. We were talking about tender offers in the other subcommittee two floors down, and it's hard to balance the two.

Mr. INGERSOLL. I wasn't being critical, sir.

Mr. NIELSON. No. I'm just saying, the two are both very interesting, and they're somewhat related in this case, because tender offers usually come with some high-yield bonds and so on, high-yield stocks as well.

Mr. FLORIO. And just to make the observation, my point with regard to Mr. Kurz, your earlier using the example of 100 percent junk bonds, was designed to illustrate the point that there is some sense of a need—and I suspect everyone would subscribe to the idea that an insurance company portfolio should be diversified, and that entails some degree of judgment by someone, and I suppose the point that's in dispute here is to whether it is appropriate for governmental regulation to draw some minimum lines to guide the diversification process.

Some would say no, we're going to trust the business judgment of the people in the company to make the appropriate judgment as to how one diversifies. But I think we're beyond that point, and the question is, the new, in some instances, over-reliance upon, in this case that we're talking about today, junk bonds is something that has prompted the State, New York State, to feel the need for guidance.

But I don't think anybody—and I'd be pleased to elicit if anyone does have any difficulty with the idea that there should be diversification in an insurance company's portfolio and that 100 percent of anything, whether it be government securities or junk bonds, would not be appropriate, or inappropriate levels would be not desirable.

The question then is how do you spell out what's appropriate.

Mr. INGERSOLL. Well, I'd like to comment on that. I think it speaks, gentlemen, to both your issues.

On the subject of—let's talk about level playing fields, because in the tender offer world, my personal counsel is a man named Martin Lipton. Marty Lipton is probably—well, he certainly is one of the leading, if not the foremost, authorities on this subject.

He talks a lot, as does George Katz and his partners, about a level playing field. I certainly would support in principle, Mr. Chairman, the proposition that insurance company investments should be diversified. I believe they are diversified. I believe they've always been diversified.

But if the States' agenda is to increase that regulation on the subject of diversification, then I am urging that the States, and influenced by your hearings, do that on the basis of a level playing field, that they do a national study to assess capital loss risk in Treasury securities, private placements, oil rigs, artworks, everything that we've discussed here today, and notably including high-yield bonds.

From everything I know about the subject, I believe that a study of this would reveal, as Mr. Kurz has indicated, that high-yield bond risks are lower than risks in investment grade securities. There is no harm in bringing the facts out, and then regulate on the basis of the facts.

Mr. NIELSON. Lower in what respect? You say the risks are lower. Are you saying the return on the investment is greater, or are you saying the risk is lower? Which are you saying?

Mr. INGERSOLL. The sum of the capital recovered, your principal recovered plus your interest. You recover more capital.

Mr. NIELSON. So your return on investment is greater.

Mr. INGERSOLL. Yes.

Mr. NIELSON. Not that the risk is lower necessarily.

Mr. INGERSOLL. Well, risk is defined in terms of the probability of loss of capital and return, a combination of the two. And I just think the facts would support that.

Mr. FLORIO. Let me respond a little bit, and maybe it's unfair to ask Mr. Tweedie to justify the New York State policy, but you did say——

Mr. TWEEDIE. Very difficult.

Mr. FLORIO. Some nice things about it. You're generally—your testimony is supportive of what it is that's being done in New York State.

Mr. TWEEDIE. I'm supportive, yes.

Mr. FLORIO. Are you working from the assumption that the State agency went through some sort of a formal review or even an informal review to make a determination that in its goal to diversify, so as to ensure the integrity of the insurance community—that is, the insurance companies—that they made some decision that above a certain percentage—in this discussion, 20 percent—was something that was inappropriate?

I'm almost starting from that premise. Mr. Ingersoll appears to be putting it into question as to whether anyone has done the intellectual drill of evaluating whether something is more risky or less risky.

Mr. TWEEDIE. Well, someone has done it. There's one entity that has certainly done it, and that's the marketplace.

Do you really believe that there should be a 400- or 500-point spread between high-yield issues and Treasury issues if there's no risk, if it's not as risky or that additional risk isn't there?

I'm not an investment expert, but there's an awful lot of people in this country who make the market, and they're prepared to say that there ought to be that kind of a spread. Now I don't believe in a free lunch. Sooner or later, that's going to come home to roost. You get that premium because you have additional risk.

Mr. FLORIO. Mr. Kurz.

Mr. KURZ. Mr. Chairman, as long as there are companies like Metropolitan which will not invest in high-yield bonds and will concentrate its investment on investment grade bonds, there becomes a distortion in the marketplace where the price of investment grade bonds are bid up vis-a-vis high-yield bonds, and the 400 to 500 base points premium, in our judgment, more than adequately compensates the companies investing in them, in the investment risk that they take, the risk of defaults less recoveries.

If I may, I have given, I hope, not the impression that I disagree with the New York State regulations and the operation of the New York State Insurance Department. I do not.

On 130, I have very substantive disagreement with them. Regulation 126 on the matching of assets and liabilities, we have participated in a task force and worked out an excellent regulation. We were the first company to support the Holding Company Act.

You raised the question before about whether New York State, in promulgating Regulation 130, had undertaken a review. I believe a moment of history of that is in order.

LICONY, the trade association of New York State life insurance companies, financed a study by Professor Altman and other people at the NYU Graduate School of Business, and the New York State Insurance Department participated in that study. That study, although in my judgment it was not a totally thorough one, should have had more time and more depth, but that study, which was the only study done prior to the promulgation of Regulation 130, concluded that there was no need for such a regulation.

Mr. TAYLOR. Mr. Chairman, for the record I would like to note that I was not Piedmont's adviser at the time they placed the money. I would like to comment on the issue of caveat emptor which has been raised by Mr. Nielson. I think that when you have something as complicated as analyzing the financial stability of insurance companies, the consumer needs some kind of professional help. A small board of people who are not investment experts has got trouble on its hands.

I will say this. When Piedmont went out and placed this money which it got back from Arkansas, that it did engage in an in-depth study. We decided to find out where the Board of the Federal Reserve placed their pension funds, and then we put our money with that company.

Mr. NIELSON. Would the chairman yield on that point?

Mr. FLORIO. Certainly.

Mr. NIELSON. Mr. Tweedie indicated that you fared better, that is, getting the 85 percent back and eventually you get it all back, that you fared much better than his company did because he has to bail you out. De you agree with him?

Mr. TAYLOR. Yes, I think he has a legitimate point. As I understand it, we are talking about the system here today.

Mr. NIELSON. Now just a personal question, which you don't have to answer. Do you plan to sue this insurance agent who gave you this great advice?

Mr. TAYLOR. I would rather not comment on that.

Mr. NIELSON. That's why I said you don't have to.

Mr. TAYLOR. Thank you.

Mr. NIELSON. Just curious, though.

Thank you, Mr. Chairman.

Mr. FLORIO. Let me just ask particularly our two insurance representatives on a matter that is not related to the hearing directly but is related to the viability of your industry, and this is the whole question of AIDS and AIDS testing, if you have any thoughts on this.

The CEO of Prudential was recently quoted in a magazine, National Underwriter, as saying that the mortality aspect does not look particularly forbidding economically, but on the health insurance side, AIDS is very expensive to treat. Health insurers concede that they are not worried about group health so much as the 10 percent of applicants who seek insurance individually. Even with respect to individual coverage, the data is not particularly compelling, as I understand it.

New York Blue Cross offers individual health insurance without testing, and this year it expects to pay $80 million for AIDS, less than 1 percent of its total payout for $10 billion.

Do either of you have health insurance presence? You have health insurance. Can you give us your thoughts on the health insurance aspect, and perhaps, Mr. Kurz, your thoughts on the life insurance ramifications of the current AIDS situation?

Mr. TWEEDIE. I will certainly try. The situation with respect to health insurance is certainly very cloudy as yet. Our experience suggests that a disproportionately small amount of our health claims are from AIDS cases. If you were to figure out how much of our claims we ought to have associated with AIDS cases, if we had the same proportion of AIDS victims in our policyholder group as exists in the general population, then we would have expected to have seen more AIDS claims.

Mr. FLORIO. What is your mix of group policy versus individual health policies?

Mr. TWEEDIE. I'm glad you asked that because we are not a significant writer of individual health, in New York or anywhere else. We are just not in that market and never have been, but in the group health market we are a major writer, very, very significantly, about a $5 billion-a-year business for us.

Mr. FLORIO. The testing policy question in the group health insurance area is one that I have heard responded to by saying, well, we don't test anybody in group so therefore there is no need to provide for testing for AIDS among group insurers. Is that your policy?

Mr. TWEEDIE. That is the way the business is done basically, without medical evidence, except for late entrants to a group or in the case of some small groups there may be requirements. Incidentally, I think the Blues, although they don't test coming in, have a preexisting conditions clause. They wouldn't honor an AIDS claim for, I believe, 11 months after the initial date of the policy. There are different ways to deal with the issue, but by and large, on large group insurance cases there is no medical evidence required, life or health, so that would not be an issue. For individual health insurance, it is very, very much an issue.

Mr. FLORIO. How about life insurance, your response and then Mr. Kurz' response on life insurance.

Mr. TWEEDIE. In life insurance it is a little easier to track what is an AIDS claim versus not an AIDS claim. I should point out that the under-reporting issue is a major problem in trying to determine what a claim is associated with, particularly in the health area. If you have a lot of little claims, maybe it isn't a clear diagnosis and you don't know quite what you have got. In life it is a little clearer.

Again, our experience so far suggests that either we are very fortunate or our mix of policy holders happens not to have the same demographic characteristics as the general population, so our claims have been running at a relatively small proportion of the total claims so far.

Mr. FLORIO. Mr. Kurz.

Mr. KURZ. We are not a major player in the risk-taking portion of the life insurance market, for two reasons. One, our volume is not as tremendous as some of the other companies such as Metropolitan, and second, we reinsure a great portion of our risk. However, in principle, I think more risk evaluation, which has always been the basis for life insurance underwriting, is necessary, and that has to be weighed against the civil rights, the potential loss of jobs and every other situation for the policy applicant who turns up positive.

I think there is a relative balance needed, and I would not just leap ahead and say that the underwriting needs are so absolute that it would preclude an evaluation and some very, very thorough safeguards for those rights of the applicant.

Mr. FLORIO. May I ask if you have a single reinsurer?

Mr. KURZ. No, we do not. We have many, many reinsurers.

Mr. FLORIO. We obviously didn't go into the whole question of reinsurance, but we have in property and casualty hearings in the past focused on that part of the problem the insurance industry currently has. Could I ask Mr. Tweedie, on the life side is there much reinsurance that takes place?

Mr. TWEEDIE. I am not an expert in that area at all. In our company there is very little because we have very high limits of retention since we have such an enormous volume and we can absorb a greater amount of risk than most companies might. We do have some reinsurance specialty products, substandard life products, where we prefer not to keep the risk and we have made a blanket arrangement with other carriers.

Mr. FLORIO. What would be an example of those types of policies you are talking about?

Mr. TWEEDIE. Just substandard life.

Mr. FLORIO. I'm not sure I understand what that word means.

Mr. TWEEDIE. We go through the process of——

Mr. FLORIO. I mean I wouldn't want to have my policy categorized as this is a policy on Florio, who has a substandard life.

Mr. TWEEDIE. Indeed not. No, not at all. The medical rating process divides potential risks into a series of categories, if you like. I think ours works something like preferred risk, standard risk, and then rated risks. The industry jargon for the rated risks is a substandard risk.

Mr. FLORIO. Substandard risk would be someone with an impediment?

Mr. TWEEDIE. For example, someone with a recent history of recent heart attack, or a lot of different things, high blood pressure. So there are companies who specialize in the underwriting of those particular types of situations. They are very good at it. They understand it very well and they offer a service to the people who need the product and a service to the industry, who perhaps are not as comfortable writing it as they are.

Mr. FLORIO. Have there been any problems with that part of the reinsurance industry? In the property and casualty side, we have found a lot of the reinsurers just sort of leaving the field, and there has been some serious question about the adequacy of any kind of public supervision over many in the reinsurance field.

Mr. TWEEDIE. I can't really give you a very definitive answer other than to say that I don't know of any capacity problems in the life reinsurance area. I do know that the life reinsurers are monitoring the AIDS experience very, very carefully because they will probably get, particularly with the large cases, the tip of the iceberg cases. They may have a fairly substantial exposure relative to the number of lives they actually insure. These kinds of things generally show up here. So they are carefully watching.

Mr. FLORIO. Let me express my appreciation to this panel for its participation and ask that they continue to keep in contact with us, and we will feel no inhibitions about keeping in contact with you as we deal with these things.

Before we adjourn, I would just like to ask the gentleman, Mr. Lennon, to come forward for 1 minute, if he wouldn't mind, just to ask two questions. I thank this panel for your participation today.

Mr. Lennon, I just wanted to ask two things. One is on this last item. My understanding is you have had some problems with reinsurers, life reinsurers in New York, and you have a new regulation dealing with reinsurers. Can you just briefly tell us what that is about?

Mr. LENNON. The regulation deals more with the form of reinsurance than reinsurers themselves, particularly in association with the products recently like SPDA's. We found a type of reinsurance in which a chunk of liabilities are taken off the ceding company's books and put on the assuming company's books, but the assuming company does not assume a comparable amount of risk, so that if any stress came upon the ceding company and the Department found they were insolvent, they would immediately be insolvent by whatever it was on their books to be insolvent, plus the reinsurance because the reinsurance was not there to give any protection. It was, in effect, a loan disguised as reinsurance.

We passed a regulation that rather quickly became an NAIC model right after we passed it.

Mr. FLORIO. My last point is just to get from you authoritatively a response to a question a number of witnesses asked, Mr. Ingersoll particularly. What survey, what study, what research did you do that prompted you to make a determination that 20 percent is an appropriate number and that there was some degree of risk that you felt the need to balance between the other risks associated with other types of securities and investments in your portfolio?

Mr. LENNON. As the superintendent pointed out in his remarks, we included warnings on the buildup of high risk or junk bonds in the portfolios of some of our insurers as early as 1985, which was our observation during 1984. During that time—and I know somebody on the panel suggested that this was a big company regulation or somehow managed by the big companies. The idea for the regulation started in the head of the person who is talking now, and the only insurance company that I consulted with during that period was the company that had the highest concentration in junk bonds. In fact, I talked to no other insurer but that insurer.

During those years, 1984, 1985, 1986, the concentration of that company went from 17 percent to 25 percent to 43 percent. For 17 percent and 25 percent, I had conversations with them. When they got to 43 percent—the conversations, by the way, were very general. I was assured that they could manage the risk. They were nonspecific about how they would manage the additional risks or what would happen in a downturn. When it got to 43 percent, I suggested to the superintendent that we either have legislation or a regulation putting a limit on it.

The normal course of events after that would be for the parties in interest to join with us in a task force in forming an adequate regulation to address the problem. In this case, the junk bond people decided not to partake in the process. They chose, rather, an adversarial——

Mr. FLORIO. When you say the junk bond people, you are talking about the investment companies that——

Mr. LENNON. The companies that had concentrations in junk bonds chose not to join the process. They chose to stay removed from the process and not engage us and talk about what would be appropriate levels to maintain. We, nevertheless, did go ahead. The report that was referred to, the LICONY report by Professor Altman, who is one of the foremost experts on junk bonds, was done and submitted to us.

I will say this. Professor Altman, who is one of the experts, talked to the Insurance Department for a total of 20 minutes. He talked to me, and his first remarks were that there really wasn't enough funding for these kinds of interviews. When the report came in, it had pages and pages upon which numbers had been left blank, obviously not even filled in. The report was canned from other sources.

At our hearing which Dr. Altman appeared at as a paid representative of the securities dealers, he admitted that the report was done somewhat in haste, and he further went on to demonstrate a lack of familiarity with the way insurance companies operate and the way the insurance law monitors the size of other gains. So that is the reason that we did not put too much credibility on that report.

We wound up with 20 percent, which is, interestingly, quite close to—when you do a diversification within a portfolio, I am told what people try and do is model the portfolio, to come as close to the universe in terms of your diversification so that anything that happens to the universe happens to your portfolio in a similar fashion.

It happens now that about 22 percent of the straight corporate debt outstanding is junk bonds, and our 20 percent is a model of that universe.

Mr. FLORIO. I think the point, though, that was being raised earlier in suggesting that Congress, if we were going to contemplate action, that it would be in our interest and the public interest, presumably, to evaluate the respective risks of all of the types of instruments and items in the portfolio. My counter-response is that what I would hope would be done, and at the State level one would hope that that would be done, if you evaluated the risk associated with junk bonds and inappropriate levels of reliance on junk bonds, that you would do that with other types of mechanisms. Was that done?

Mr. LENNON. You do, but you must understand that, for instance, real estate, if it is perceived to be that additional risk, is still no more by law than 10 percent of anybody's portfolio, and the last time I looked, it was no more than 6 or 7 percent of anyone's portfolio. So the concentration, the exposure to it is not as great, and companies generally do put up their own reserve.

However, if it got to be 40—well, it can't get to be 40 by law, but if it were in any kind of a concentration of that kind, we would certainly look into it. Nevertheless, in the insurance industry a lot is going on at one time. There was reference to the MSVR. I must also point out that an industry advisory group to a technical actuarial group at the NAIC has recently effectively recommended doing away with the MSVR. I don't think that will happen, but I do think it will be healthy, we will look at it anew, and don't forget it was formed in 1951 at a time when it could not have been designed for the environment that we are in now, and when we do that, I believe we will look at all kinds of investments and the need to reserve for those kinds of things.

Mr. FLORIO. What is the rationale for the nonloss reserve requirement for property, art works, things of that sort?

Mr. LENNON. Well, that is a little bit blown out of proportion. There is only one company I know that got some press for buying a few very large paintings. They are not carried as admitted assets, so you can say they have 100 percent reserve. They do not count them as an asset.

Mr. FLORIO. Let's say art works, but there is no question about a gas partnership or a piece of real estate being counted as——

Mr. LENNON. Right. So there are limits.

Mr. FLORIO. How do you deal with the observation that Mr. Kurz made that those are not required to have loss reserves and that doesn't seem to be, in his mind, equitable?

Mr. LENNON. They are not, and if they got into the kinds of concentrations where they were 40 percent of an insurer's assets, I would be extremely uneasy that there weren't special reserves for them. The fact is that all of them are much lower concentrations, below 10 percent, and therefore, that even if something goes wrong—many of the companies have reserves for them anyway, voluntarily, but even if something goes wrong, they still have only 5 or 6 percent of their assets, and presumably the wrong might be in only 1 or 2 percent.

Mr. FLORIO. You are working off the premise that the loss reserves should have some correlation with the degree of intensity of reliance upon——

Mr. LENNON. To a degree, yes, to the risk. Don't forget the surplus of the company also stands for the additional risks that haven't been covered in the reserves. You try to put up a reserve when you feel that there is a risk that may be greater than what that surplus could tolerate.

Mr. FLORIO. Let me thank you very much for your participation as well. Thank you.

There is no further business to come before the committee. The committee stands adjourned.

[Whereupon, at 12:25 p.m. the hearing was adjourned subject to the call of the Chair.]

FINANCIAL GUARANTEE INSURANCE

WEDNESDAY, OCTOBER 14, 1987

HOUSE OF REPRESENTATIVES, COMMITTEE ON ENERGY AND COMMERCE, SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION, AND COMPETITIVENESS,

Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. James J. Florio (chairman) presiding.

Mr. FLORIO. The subcommittee will kindly come to order. It is time for the committee to commence. We assume that our colleagues will be here before too very long.

I want to welcome all in attendance to our hearing today dealing with the subject of financial guarantee insurance.

For decades, this kind of insurance has been available to lenders, to ensure payment in the event of defaults on mortgages. In the 1970's, insurance became common to assure payment to municipal bond holders.

In recent years, financial guarantee insurance has been used in many new ways, from insurance for payment of corporate debt, to guaranteeing interest rates and even guaranteeing so-called golden parachutes after corporate takeover, that they would be paid.

Financial guarantee insurance appears in many cases to play an important role in capital formation. At the same time, the rapid growth of the industry and the proliferation of novel kinds of guarantees have raised important public policy questions that we will hopefully address today.

State insurance regulators have concluded that financial guarantee insurance has outgrown the existing regulatory framework. Data regarding financial guarantee insurance was virtually nonexistent until recently, and many observers still believe that it is inadequate.

The National Association of Insurance Commissioners has adopted a model code to tighten regulation of financial guarantee insurance, but to this point no State has enacted the model.

In the meantime, we hear troubling reports of significant losses and some insolvencies among financial guarantee insurers.

All of this returns us to the issue which this subcommittee has addressed on a number of occasions. In a number of different contexts, we have studied the relationship between insurance industry financial practices and insurance company solvency.

We have examined the influence of the treatment of investment income on the property and casualty availability crisis. We have examined the impact of investments in junk bonds on life insurance company solvency. And today, we examine financial guarantee insurance.

Financial guarantee insurance may make an important contribution to the operation of our capital markets and to economic growth. At the same time, insurance companies have fiduciary responsibilities.

The task of public policy is to strike the proper balance between private initiative and public accountability. I know this is what our State insurance officials and our industry leaders hopefully are attempting to do, strike that balance.

We look forward to the discussion today as to how best to strike that balance.

We have a distinguished and a long group of witnesses today that we are going to hear from.

I would, at the outset, inform everyone that today is going to be a somewhat difficult day scheduling-wise because the full committee is meeting at the same time as we are meeting, and there will be matters on the House floor that members of this committee are interested in today. So, there may be some need for periodic disruptions.

We will be having other members perhaps chair the committee for a period of time in the interest of trying to accommodate everyone's schedule.

I am pleased to have as our first witness, once again, the Honorable William Anderson, Assistant Comptroller General of the General Accounting Office, and he will have staff people with him that we would ask him to introduce and to recognize.

All of our witnesses today will have their formal prepared statements included in the record in their entirety, and we would ask our witnesses to try to summarize their testimony, keeping it roughly in the area of 5 minutes or so, so we can have maximum opportunity for interchange between members of the committee and the witnesses.

Mr. Anderson, welcome to our committee. We would appreciate your recognizing your colleagues.

STATEMENT OF WILLIAM J. ANDERSON, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT PROGRAMS; ACCOMPANIED BY CRAIG A. SIMMONS, ASSOCIATE DIRECTOR FOR FINANCIAL INSTITUTIONS AND MARKETS, AND GILLIAN G. GARCIA, GROUP DIRECTOR, GENERAL ACCOUNTING OFFICE

Mr. ANDERSON. Thank you very much, Mr. Chairman. Good morning.

To my far right here is Craig Simmons. Craig is an Associate Director, in GAO's lingo, in charge of the work that we call financial institutions and markets.

To my immediate right is Jill Garcia. Jill was on the faculty at Berkeley, and we hired her from the Federal Reserve a couple of years ago. She is a Group Director in charge of the report that causes us to be here today.

To my left is Al Vieira, from our Washington Regional Office. Al was the person that actually was in charge preparing the report that we have presented to you.

Mr. FLORIO. We welcome you all to the committee.

Mr. ANDERSON. Thank you. I might run a little over 5 minutes. I timed it, sir. It is not much over.

Our testimony is based on a report we issued on June 25 entitled Developments in the Financial Guarantee Industry.

We performed the study in order to gain an understanding of the mechanics of the financial guarantee industry in light of public reports of problems affecting it.

I know you are well aware of the Glacier General, Pacific American, Industrial Indemnity and Ticor Mortgage situations.

Let me begin by identifying the types of guarantees we are concerned about.

First, municipal bond insurance, guarantees on general and special purpose obligations in municipalities. Corporate debt insurance, guarantees of money market funds, Eurodollar notes, et cetera. Mortgage insurance, and then a catchall that we call unusual forms of financial guarantees in our full statement, that get into future interest rates, bank deposits in excess of FDIC coverage, the golden parachutes you spoke of, and other products, as well.

A wide variety of participants provide financial guarantees. Participants include both mono-line and multi-line companies.

The multi-lines include traditional insurance companies, such as Aetna, United States Fidelity and Guaranty, Travelers and Firemen's Fund.

The mono-lines were created solely by individual and groups of companies to write financial guarantees. Some parent firms are multi-line insurance companies, while others, such as Xerox and General Electric, are in different lines of business.

The industry has been marked by significant growth in recent years. The Federal Reserve Bank of New York has estimated that financial guarantee premiums increased about 47 percent annually between 1980 and 1985. It is not precisely correct when you look at the way they did it, but I guess, order of magnitude, it will do, from $187 million to about $1.3 billion by their estimate.

The premiums from buying guarantees are estimated to exceed $600 billion, and there is considerable room for growth considering the type of products that are currently being covered.

Now let me discuss our observations regarding the regulation of these activities. A good starting point would be to consider why strong regulation would appear important.

Simply put, many of the participants in this business seem particularly vulnerable. Assessing financial guarantee risk is, in some cases, quite difficult.

With traditional insurance products, insurers are generally able to refer to historical data on similar or related events, develop estimates of future losses, and use actuarial techniques to define risks. Some experts note that it is very difficult to adequately price certain guarantee products, such as merger and acquisition, or resource availability coverage on the basis of historical loss experience.

Also, many financial guarantees are composed of risks, such as the possibility of an adverse political decision or fraud, which are beyond the traditional insurance company's area of underwriting expertise.

Finally, many financial guarantee products, such as mortgage default and industrial development bond insurance cover economic risks. Unlike more traditional accident insurance, which relates to isolated incidents, these types of coverage may have to cover claims that occur during business cycle recessions.

Attempting to price such risks over the full business cycle may be difficult, particularly for new business products that have short histories.

The consequences of inadequate risk assessments and pricing are believed to be significant.

First, even a small number of poorly written financial guarantees could result in significant losses and adversely affect an insurer's ability to honor all its guarantees.

Second, significant financial guarantee losses, if not properly insulated from other parts of an insurer's business, could reduce the insurer's ability to honor its other insurance commitments.

Third, the failure of one insurer could be contagious and spread to other firms.

Having established the need for regulatory oversight, let's consider what is happening in this regard.

The States have traditionally been responsible for regulating the insurance industry. A primary concern of State regulation has been the development and oversight of operating rules, restrictions and accounting practices designed to preserve company solvency.

These activities require adequate information on companies' operations and the ability to accurately assess the risk exposures associated with the varying lines of business in which companies engage.

Without adequate information or an understanding of risks, the efficacy of regulation and oversight of any insurance business line becomes questionable.

During our field work, we found it difficult to acquire statistics on the actual number or value of guarantees underwritten by insurance companies. Likewise, we were unable to determine the amount of premiums charged by the insurance companies for the services provided.

At that time, about a year ago, neither the State insurance regulators nor the industry were able to provide this type of data.

Insurance regulators in the nine States we included in our study were concerned about the lack of information on financial guarantees. In some cases, regulators only found that companies were writing financial guarantees when they did a field examination. These examinations vary in frequency. In some cases, every 5 years.

Let me hasten to add that progress is being made to address the lack of information on the size of the business, its participants and their growth exposure.

Nevertheless, the current requirements for reporting of information will not reveal much about the nature of business being written or its risks.

Of more fundamental importance, it seems to us that a much better understanding of the nature of risks associated with financial guarantee transactions is needed by both regulators as well as certain industry participants themselves.

One of the principal causes of failure or major losses that have occurred in the industry seems to stem from faulty credit analysis. An example that was used in our report highlights this problem.

A firm had written a large amount of guarantee business, relying on the expertise of a managing general agent for evaluating the risk of the transaction and pricing the policy. The borrower defaults. Both the insurer and the bank that had purchased the insured note of the defaulting borrower stood to lose so much money that either one could have failed. In this case, the insurer relied on a third party to assess the creditworthiness of the borrower.

A similar short-circuiting of the credit analysis process appears to have occurred in the three highly publicized cases involving the insurers I mentioned at the beginning.

We have two general concerns with these sorts of events.

First, it appears that the parties involved assumed that everyone else was doing the credit analysis, when in fact no one was, or at least not in a competent manner.

Second, these transactions intertwine the business interests of a number of parties. When the borrower defaults, the ensuing financial losses may be spread among a number of different parties and not be confined strictly to the lender, as would occur in the absence of a financial guarantee.

The spreading of the consequences of defaults is a reason for regulators to be particularly concerned about the nature of financial guarantee business and for the insurers and insured to be certain they understand the risks involved before engaging in these transactions.

Let me now conclude.

In June of 1986, the National Association of Insurance Commissioners unanimously adopted model legislation to regulate financial guarantees. It remains up to the individual State legislatures or the regulators to accept the model legislation.

Some States have adopted financial guarantee regulations, while a number of others have introduced legislation or are considering doing so.

At the time we completed our work, it was our understanding that progress was being impeded to some extent because of disagreements over such matters as the form of organization under which the financial guarantee business line should be conducted and the amount and nature of initial capitalization necessary to cushion the business against claims.

We are in no position to evaluate the merits of the opposing points of view over how to best regulate this industry. However, we do observe that in considering the various options, two fairly fundamental requirements should be met.

First, the quality and quantity of data on the industry must be sufficient to better understand the exposures of the firms writing the business.

Second, even with agreement on how best to regulate the structure of the business, its capitalization and the information requirements, it strikes us as essential that State insurance departments develop more knowledge about these complex transactions and assure that training is provided to develop the skills necessary to assess the risks and pricing of financial guarantees.

Thank you for bearing with me, Mr. Chairman. That concludes my summary.

[Testimony resumes on p. 216.]

[The prepared statement of Mr. Anderson follows:]

STATEMENT OF WILLIAM J. ANDERSON

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in your hearings on financial guarantee insurance and the adequacy of its regulation. My testimony is based on a survey of the industry that we conducted in 1986 and reported on in our staff study entitled: Developments in the Financial Guarantee Industry (GAO/GGD-87-84), June 25, 1987. Much of the information contained in our staff study represents a compilation of the views of industry participants and state regulators on the industry's development and regulation. My remarks today are intended to summarize the study's contents with an emphasis on the adequacy of information and regulatory oversight.

There is no widely agreed upon definition of a financial guarantee. However, in a generic sense it involves an independent party guaranteeing, for a fee, that another party's obligations will be met in a financial transaction. The primary purpose of such guarantees is to reduce risks to investors and the borrowers' cost of obtaining financing.

The US and international economies are undergoing substantial changes. To facilitate those changes, many new, sophisticated financial products have been created. And, the economic changes and increasingly complex nature of financial products have resulted in an increased demand by investors and creditors for protection against loss. The increased demand for

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The US and international economies are undergoing substantial changes. To facilitate those changes, many new, sophisticated financial products have been created. And, the economic changes and increasingly complex nature of financial products have resulted in an increased demand by investors and creditors for protection against loss. The increased demand for security has led to (1) an increase in the number of financial guarantees written, (2) the development of new types of financial guarantees, and (3) the emergence of a number of new financial guarantee underwriters.

The growth in the financial guarantee business has not occurred without problems. Our study was initiated because of public reports about the failure of individual firms to honor their guarantees as well as the bankruptcy or near bankruptcy of firms underwriting guarantees or relying on the security presumed to be provided by them. To illustrate the nature of these problems:

-- In 1985, the Glacier General Assurance Company and the Pacific American Insurance Company failed to honor guarantees they had written supporting worthless mortgage-backed securities. As a result, the Bank of America, trustee and escrow agent in the transaction, agreed to pay $133 million to several banks and savings institutions that had purchased the securities. It appears that neither the bank nor the thrifts had carefully examined the quality of the mortgages backing the securities or guarantees given by the insurance companies.

-- The Industrial Indemnity Financial Corporation, a subsidiary of Xerox's Crum and Forster insurance unit, paid a $10 million claim resulting from the default of the Buttes Gas and Oil Company, a California energy firm. In late 1984, Buttes obtained a revolving line-of credit using Industrial Indemnity's guarantee. State insurance regulators and members of the insurance industry have questioned whether Industrial Indemnity had either evaluated the assets Buttes used to secure the guaranteed loans or adequately monitored Buttes' loan performance.

-- Several leading mortgage guarantee firms, including Ticor Mortgage Insurance Company, were faced with the possibility that they would have to honor part or all of the guarantees they had written on some financial obligations of the Equity Programs Investment Corporation. Equity Programs was a real estate subsidiary of a Maryland thrift and could not make principal and interest payments on $1.4 billion in mortgages and mortgage backed securities it had sold. Ticor's total risk exposure was $161 million --two-thirds of its corporate capital. Ticor took a significant risk by guaranteeing such a large, single transaction. Reportedly, Ticor did not scrutinize Equity Programs creditworthiness.

Two of these three cases have not yet been fully resolved and litigation continues. It may be several years before legal issues are settled and the extent and identity of those incurring losses are revealed.

Those we talked to during our evaluation have two general concerns about the adequacy of regulation of the industry:

-- There is very little information on its size and scope. It seems to us that in order to assure better oversight of the financial guarantee industry regulators need information of sufficient quality to enable them to identify the number and types of guarantees being written and the risks associated with them.

-- The nature of financial guarantees does not seem to be well understood by many of the state regulatory agencies. It appears that in order to better regulate financial guarantees, more qualified examiners will be needed to evaluate the risks of these products and their impact on the stability of individual companies as well as the industry.

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-- In 1985, the Glacier General Assurance Company and the Pacific American Insurance Company failed to honor guarantees they had written supporting worthless mortgage-backed securities. As a result, the Bank of America, trustee and escrow agent in the transaction, agreed to pay $133 million to several banks and savings institutions that had purchased the securities. It appears that neither the bank nor the thrifts had carefully examined the quality of the mortgages backing the securities or guarantees given by the insurance companies.

-- The Industrial Indemnity Financial Corporation, a subsidiary of Xerox's Crum and Forster insurance unit, paid a $10 million claim resulting from the default of the Buttes Gas and Oil Company, a California energy firm. In late 1984, Buttes obtained a revolving line-of credit using Industrial Indemnity's guarantee. State insurance regulators and members of the insurance industry have questioned whether Industrial Indemnity had either evaluated the assets Buttes used to secure the guaranteed loans or adequately monitored Buttes' loan performance.

-- Several leading mortgage guarantee firms, including Ticor Mortgage Insurance Company, were faced with the possibility that they would have to honor part or all of the guarantees they had written on some financial obligations of the Equity Programs Investment Corporation. Equity Programs was a real estate subsidiary of a Maryland thrift and could not make principal and interest payments on $1.4 billion in mortgages and mortgage backed securities it had sold. Ticor's total risk exposure was $161 million --two-thirds of its corporate capital. Ticor took a significant risk by guaranteeing such a large, single transaction. Reportedly, Ticor did not scrutinize Equity Programs creditworthiness.

Two of these three cases have not yet been fully resolved and litigation continues. It may be several years before legal issues are settled and the extent and identity of those incurring losses are revealed.

Those we talked to during our evaluation have two general concerns about the adequacy of regulation of the industry:

-- There is very little information on its size and scope. It seems to us that in order to assure better oversight of the financial guarantee industry regulators need information of sufficient quality to enable them to identify the number and types of guarantees being written and the risks associated with them.

-- The nature of financial guarantees does not seem to be well understood by many of the state regulatory agencies. It appears that in order to better regulate financial guarantees, more qualified examiners will be needed to evaluate the risks of these products and their impact on the stability of individual companies as well as the industry.

The remainder of my testimony is divided into two parts. In the first part, I will provide some background information on the types of guarantees being written, the participants in the industry, and the nature of these products' risks. In the second part, I will discuss in more detail the concerns that exist about the adequacy of regulation.

USERS AND PROVIDERS OF GUARANTEES AND ASSOCIATED RISKS

Financial guarantees may be divided into four major groups:

-- Municipal Bond Insurance: Guarantees on general and special purpose (such as industrial development bonds) obligations of municipalities.

-- Corporate Debt Insurance: Guarantees of money market funds, eurodollar notes, leases, investment contracts, receivables, commercial paper, and securitized loans, including groups of car loans, mortgages, and other types of consumer debts.

-- Mortgage Insurance: Guarantees of mortgage payments (principal and interest) for residential and commercial properties.

-- Unusual Forms of Financial Guarantees: Guarantees of items such as future interest rates, bank deposits in amounts in excess of government insurance coverage, compensation packages of executives in case of company takeovers, and numerous others. Appendix I of our staff study contains a more extensive list and description.

A wide variety of participants provide financial guarantees. Participants include both monoline (insurers providing only one line of insurance) and multiline (insurers providing multiple lines of insurance) companies. The multilines include traditional insurance companies, such as Aetna Life and Casualty, Travelers, United States Fidelity and Guaranty, and Firemen's Fund. The monolines were created solely by individual and groups of companies to write financial guarantees. Some parent firms are multiline insurance companies, while others such as Xerox and General Electric Credit Corporation are in different lines of business.

Risks associated with guarantee products generally vary with the circumstances of individual transactions. Industry sources divide financial guarantees into two basic types:

-- Credit Enhancement: In these transactions, the insurer's guarantee improves the financial product's rating by reducing the risk to the investor. The guarantor or insurer requires extensive amounts of collateral or other forms of protection against default. Because of this, the insurer expects no losses even if a client fails.

-- Risk Insurance: This type of transaction is much closer to traditional insurance in that it anticipates and accepts the eventuality of some losses. The insurer uses historical data as a basis for setting premium levels to compensate for risk. Over the long run, it is expected that losses will be more than offset by the premiums collected and the related investment earnings.

The ability to analyze financial guarantee risks is particularly important because financial guarantee insurers may be exposed to high levels of loss. In many financial guarantees, such as mortgages, bonds, and consumer and business credit, the guarantor commits to making both principal and interest payments for as long as the insured is unable to do so.

Assessing financial guarantee risk is, in some cases quite difficult. With traditional insurance products, insurers are generally able to refer to historical data on similar or related events, develop estimates of future losses, and use actuarial techniques to define risks. Some experts note that it is very difficult to adequately price certain guarantee products such as Merger and Acquisition or Resource Availability Coverage on the basis of historical loss experience since the repetition of similar events is unlikely.[1] Also, many financial guarantees are composed of risks, such as the possibility of an adverse political decision or fraud, which are beyond the traditional insurance companies' area of underwriting expertise. Finally, many financial guarantee products such as Mortgage Default and Industrial Development Bond insurance cover economic risk.[2] Unlike more traditional accident insurance which relates to

[1]Merger and Acquisition Insurance covers the expenses of the insured attorneys, investment bankers, etc., during the successful resistance of a hostile or unfriendly takeover attempt. Resource Availability coverage provides for payment of debt service in the event that an unanticipated reduction of a natural resource occurs.

[2]Mortgage Default Insurance guarantees the timely payment by the mortgagor for loans secured by first or second mortgages. Industrial Development Bond Insurance guarantees principal and interest on tax-exempt industrial development bonds.

isolated incidents, these types of coverage may have to cover claims that occur during business cycle recessions. Attempting to price such risks over the full business cycle may be difficult, particularly for new business products that have short histories.

The consequences of inadequate risk assessments and pricing are believed to be significant. First, even a small number of poorly written financial guarantees could result in significant losses and adversely affect an insurer's ability to honor all its guarantees. Second, significant financial guarantee losses, if not properly insulated from other parts of an insurer's business could reduce the insurer's ability to honor its other insurance commitments. Third, the failure of one insurer could be contagious and spread to other firms. The third concern could occur directly, as in cases where the inability of the insurer to honor guarantees threatens the solvency of banks and others who originate the covered credit. Or, it can occur indirectly, by diminishing public confidence in the insurance industry and limiting the industry's ability to attract capital and assume risk.

ADEQUACY OF REGULATION OF THE FINANCIAL GUARANTEE INDUSTRY

The states have traditionally been responsible for regulating the insurance industry. A primary concern of state regulation has been the development and oversight of operating rules, restrictions and accounting practices designed to preserve company solvency. These activities require adequate information on companies' operations and the ability to accurately assess the risk exposures associated with the varying lines of business in which companies engage. Without adequate information or an understanding of risks, the efficacy of regulation and oversight of any insurance business line becomes questionable.

Adequacy of Information

Little concrete information exists on the exact size and growth of the financial guarantee industry. Estimates of its size vary widely. Outstanding guarantees originated by both banks and insurance companies probably exceed $600 billion at the present time. And, the industry has the potential to expand well beyond its current size. There are literally hundreds of billions of dollars of financial transactions occurring annually which could make use of either credit enhancement or risk insurance. The Federal Reserve estimated in 1985, that there were over $303 billion of commercial paper, $119 billion of new corporate bond issues, and $718 billion in outstanding bank loans available for coverage by financial guarantees.

Although it is clear that the use of financial guarantees is growing rapidly in size and scope, there are no comprehensive, accurate data available on:

-- the actual volume of activity,

-- the participants,

-- the types of guarantees being offered, and

-- the risks being assumed by the insurers writing the guarantees.

Part of the problem has been the lack of a standard definition for a financial guarantee. Additionally, a majority of what is most often perceived by regulators and those in the insurance industry as financial guarantees has been indistinguishably reported, in insurance companies annual operating reports to insurance regulators, as part of their surety line of business.[3]

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[3]The Surety line of business generally involves a guarantee of monetary payment or completion of a project should a party fail to perform specified acts within a stated period.

During our field work we found it difficult to acquire statistics on the actual number or value of guarantees underwritten by insurance companies. Likewise, we were unable to determine the amount of premiums charged by the insurance companies for the services provided. At that time, neither the state insurance regulators nor the industry were able to provide this type of data.

Insurance regulators in the nine states we included in our study of the industry were concerned about the lack of information on financial guarantees. In some cases regulators only found out that companies were writing financial guarantees at the time of field examinations. These examinations vary in their frequency, but in some cases occur only once every five years.

For these reasons California instituted disclosure requirements in 1985. California insurers now provide data to the regulators on any guarantee for which the amount due for unpaid principal and interest exceeds a specified percentage of the insurer's capital and surplus. These reporting requirements were supported by the National Association of Insurance Commissioners (NAIC) and similar requiremants have now been adopted by all state insurance departments. We also understand that the 1987 company statements will include a separate line item on financial guarantees which will conform with a standard definition adopted by NAIC.

Clearly, progress is being made to address the lack of information on the size of the business, its participants and their gross exposure. Adoption of a standard definition of financial guarantees should improve the accuracy and consistency of information, and reports of financial guarantee activity should help state regulators target examinations in cases where there is concern about this activity. Nevertheless, the current requirements for reporting of information will not reveal much about the nature of business being written or its risks.

Adequacy of Oversight

Based on the discussions that we had with industry regulators, it seems to us that a much better understanding of the nature of risks associated with financial guarantee transactions is needed by both industry participants and the regulators themselves.

One of the principal causes of failure or major losses that have occurred in the industry seems to be a short-circuiting of the credit analysis component of the underlying lending decision. An example that was used in our report highlights this problem. A firm had written a large amount of guarantee business relying on the expertise of a managing general agent for evaluating the risks of the transaction and pricing the policy. The borrower defaulted on the loan, and both the insurer and a bank that had purchased the insured notes of the defaulting borrower stood to lose so much money that either one could have failed. In this case the insurer relied on a third party to assess the creditworthiness of the borrower; arguably, the bank had no incentive to perform an independent credit evaluation of the borrower and, it is at least questionable whether the bank assessed the capability of the insurer to honor its commitment. Regulators have expressed concern about cases such as this one in which too much reliance is placed on unqualified individuals to evaluate risk and price products. A similar short circuiting of the credit analysis process appears also to have occurred in the three highly publicized cases I mentioned at the beginning of my testimony.

We have two general concerns with these sorts of events. First it appears that the parties involved assumed that everyone else was doing the credit analysis, when in fact, no one was (or at least no one was in a competent manner). Second, these transactions intertwine the business interests of a number of parties. When the borrower defaults, the ensuing financial losses may be spread among a number of different parties and not be confined strictly to the lender as would occur in the absence of a financial guarantee. This spreading of the consequences of defaults is a reason for regulators to be particularly concerned about the nature of the financial guarantee business and for the insurers and insured to be certain they understand the risks involved before engaging in these transactions.

I indicated earlier in my testimony that risk assessment is very difficult for certain types of financial guarantee products. It is therefore not surprising that another major concern of regulators involves the pricing of financial guarantee products. The California and New York Commissioners of Insurance indicated that prices may either be too low because of competition or bear little or no relationship to risk. The Pennsylvania deputy commissioner said his department lacks the expertise to evaluate the adequacy of rates when risks are considered and Illinois insurance officials indicated that they have no specific knowledge of how rates are established.

CONCERNS FOR THE FUTURE

While our survey indicates that there are a number of concerns about the adequacy of regulation of this industry, it also points out that a number of steps are being taken to overcome those concerns. In June of 1986, the NAIC unanimously adopted model legislation to regulate financial guarantees. It remains up to the individual state legislatures or the regulators to accept the model legislation. Some states have passed financial guarantee legislation while a number of others have introduced legislation or are considering doing so. At the time we completed our work it was our understanding that progress was being impeded to some extent because of disagreements over such matters as the form of organization under which the financial guarantee business line should be conducted and the amount and nature of initial capitalization necessary to cushion the business against claims.

We are in no position to evaluate the merits of the opposing points of view over how to best regulate this industry. However, we do obeerve that in considering the various options two fairly fundamental requirements should be met.

First, the quality and quantity of data on the industry must be sufficient to better understand the exposures of the firms writing the business. As I indicated, some regulators have expressed concerns over the value of information currently reported. These hearings may help shed more light on the additional information requirements that will be necessary to assure better regulation and supervision of the industry.

Second, even with agreement on how best to regulate the structure of the business, its capitalization and the information requirements, it strikes us as essential that state insurance departments develop more knowledge about these complex transactions and assure that training is provided to develop the skills necessary to assess the risks and pricing of financial guarantees. Not only will it be necessary to understand the complexities of the guarantees themselves, it will be equally important to understand the nature of the financial transactions they stand behind.

Until these two requirements are met, we believe there will continue to be doubts about the adequacy of regulation and oversight of the financial guarantee industry.

Mr. Chairman, that concludes my prepared statement. My colleagues and I will be happy to answer any questions that the subcommittee may have.

Mr. FLORIO. Thank you very much.

It is interesting, so let me perhaps get some thoughts on today's newspaper stories, which are obviously very relevant. I saw in one instance where a nuclear facility in New Hampshire, I believe, just announced today that it is going into default. I assume that is the type of thing that someone might have had some guarantee insurance on.

And then I also noted that another investment brokerage house today announced that it was starting to lay off its municipal bond people. It is the second one in the last couple of days that I have seen.

I am not sure what that portends, but I suspect there is a pattern of something happening with regard to municipal bonds, and the municipal bond guarantees are a very important aspect.

Let me ask with regard to those types of problems, those types of areas, municipal bond guarantees as well as guarantees for things like public work projects, nuclear facilities.

I don't know how anybody draws some sort of a risk assessment on those types of things. Are we really talking about something too terribly much more sophisticated than a rough gamble?

Mr. ANDERSON. When you consider a Washington public power supply system, and the demise of that—fortunately, apparently AMBAC—my recollection is ultimate possible vulnerability of about $75 million, out of that $2.5 billion—appears to be the only one that was impacted, the only insurer that was impacted by that default. But that looked so solid up front.

I just don't know how an insurer can anticipate. It demonstrates very forcefully the uncertainties and the vulnerability, the risks that are being taken by these type of insurers.

With respect to the municipal bond market, I can only speculate that, as we know, there was a tremendous increase in the number of municipal bonds that were being floated in anticipation of the Tax Reform Act. I wonder whether some of the firms geared up to deal with that, and now that we are returning to a more normal level of business, have laid some people off.

I can't explain otherwise why the drop-off in that regard.

Craig, do you have anything?

Mr. FLORIO. Well, let me just throw out a hypothetical, and you and other witnesses can respond to it.

In my State there has been an awful lot of bonding, in many respects out of desperation because traditional sources of funding sewerage plants—for sewerage plants, the Federal moneys have been cut dramatically. Sewerage upgrading has to take place, ironically, by virtue of Federal law. So, people are going to have to resort to the bond market to deal with the infrastructure needs.

All of those things, of course, are secured by revenues that may come out, ultimately, I assume, municipal tax benefits.

If one anticipated a downturn in the economy that would jeopardize the economic wellbeing of the tax base in the area, you might be in a position to say that you are not too enthusiastic about existing municipal bonds, much less the ability to float any more. Because in many instances, I know municipalities that are reaching their responsible capacity in floating bonds.

But I guess my concern is that even the model code—and I am going to ask our next witness particularly to give us his thoughts on the advisability of the model code—let's assume the model code was law in every State in the Union. I am not sure how that is going to take into account and how you are going to give the insurance regulators the ability to foresee whether the financial insurance guarantee is a good instrument if you have got to anticipate that in the case of a couple of the utility facilities, they couldn't get evacuation plans approved, therefore they are not going on line, therefore they are not generating the revenues.

I don't know in any kind of a risk assessment analysis that you can take into account those types of things that are not traditional risk assessment factors, that actuaries have difficulties in the normal course of events trying to calculate out risks.

When they have to calculate those types of essentially political factors, I don't know how you approach this as being any kind of an objective actuarial risk assessment exercise.

Mr. SIMMONS. Well, let me just comment briefly on that. I agree with everything you have said.

One of the things that the regulators expressed concern to us about was the fact that many financial guarantees underwrite economic risks, as opposed to things like automobile insurance policies and other business lines within the property/casualty industry that tend to rely on the law of large numbers. A large number of policy holders within a risk class provide enough premium income to underwrite the few losses that occur.

I think that particularly in the corporate bond market and in the guarantees in the corporate bond market, the industry may be vulnerable to the economic risks that occur.

If you have an economic downturn, sales fall off, corporate borrowers are unable to repay their borrowings, it is entirely possible that many of the guarantees that would get written in the corporate bond market may all come due at one time.

That kind of event generally can't be analyzed through actuarial techniques, as I understand them.

Jill, you may want to add something to that.

Ms. GARCIA. There are, I think, three ways in which you can assess risks.

One, you can do it actuarially, based on historical data.

Two, you can use modern finance theory, options theory and things of that sort, based on probabilities that you have to determine subjectively because you have no historical experience as to what those probabilities are. But you can make an assessment.

The third sort of risk is the political risk. That is different from both the accident type risk and the economic risk that Craig talked about. And you were mentioning the political risk. It is much harder to deal with the political risk.

Mr. FLORIO. Aren't we really engaging in a little bit of fantasyland exercise here? Because we have had insurance commissioners from fairly progressive States come and tell us that they haven't got the resources and the capability of analyzing traditional risk questions in the normal activities of property and casualty insurance.

To be talking about this relatively new phenomenon that in many instances, by definition, has no past history, that even if you had actuarial techniques and actuarial skill and actuaries, which some divisions and departments don't even have, you would have a hard time trying to make any kind of a pattern clear, because there is no history. There is no history in many of these instances and many of these things are new.

One of our witnesses today, reading through his testimony, is going to talk about collateral, that if in fact we can extract more collateral, that will provide for a higher degree of stability.

Have you any thoughts on that proposal?

Mr. ANDERSON. Obviously, there are tremendous variations in the quality of collateral, and to the extent it is good collateral, fine. That is one thing. To the extent that it is founding wanting in some fashion, or even nonexistent, then your purposes really haven't been served. But I would say that is, as far as I know, the exception rather than the rule.

Craig.

Mr. SIMMONS. That is correct. Certainly, in the Bank of America Case and in the Ticor Case, there was presumed to be collateral. As it turned out, there wasn't collateral, or at least there wasn't sufficient collateral at least when the losses occurred to have an expectation that those losses would be covered by sales of the property.

Mr. FLORIO. Was that a factor of a State either not having the interest or the resources to go check through the stability of the collateral?

Mr. SIMMONS. Well, I don't know whether I would tend to view it as the State regulator's responsibility to do that in every case. But I certainly worry a great deal about the fact that nobody seemed to go out and touch the collateral and evaluate it.

Mr. FLORIO. Who would be the alternative of the State regulators, in terms of making a determination that a transaction and a company's operation is sufficiently firm and secure? Who would be the alternative?

Mr. SIMMONS. I suppose that I would think that the rating agency for the insurer's financial condition would be one party that would be interested in it. Certainly, the State regulators should be interested in that sort of thing, but I think it impractical to expect the State regulators to thoroughly analyze every deal that is made in this market and question it.

Mr. ANDERSON. Let me break in, Craig. The analogy that I would draw, let's go back to Continental Illinois and the role of the regulator.

I think that the regulators ought to first ensure that there are a set of processes in place at the insurers that will assure, to the extent possible, that good business practices are being pursued in deciding what to insure, what to stick your neck out on, and there ought to be some testing of transactions to see whether, in fact, they are doing those good things, are they verifying the creditworthiness of the ultimate maker of whatever paper you are talking about.

In Continental Illinois, we found after the fact that the regulator wasn't getting into that loan portfolio and really getting a fix on a test basis. But I would never expect a regulator to go through and look behind individual transactions, except in the course of establishing how good processes generally are. But that is my set of views.

Mr. FLORIO. I suspect we are going to hear from some private sector people later on, saying that is an interesting analysis but totally unrealistic, they wouldn't know what to look for if they were out looking for it, and that you are going to have to leave us alone, we, the private people, and we will determine in our own self interest, which we think parallels the public interest, and the marketplace forces will allow these things to work out.

How do you respond to that sort of an analysis?

Mr. SIMMONS. I would like to respond to that.

We have heard some horror stories, including Bank of America, Ticor as well as a recent case involving an insurance firm in Virginia. If those situations were limited, if the losses were limited and isolated with the insurer, then I suppose that I would be willing to say, fine, let's let market forces work whatever miracles they can and whoever takes the losses takes the losses.

But the problem with this industry, as I see it, is this instrument creates an increased vulnerability for a seemingly isolated loss, a seemingly isolated event, to spread to a number of financial institutions.

In the Bank of America case, 140 financial institutions, as I understand it, have been affected by the fiasco that occurred.

In the EPIC case, 160 financial institutions have been affected. In the case in Virginia, 31 financial institutions have been affected.

The thing that I worry about is, the lenders in this case, who are insured, don't seem to have the incentive to do the credit analysis that they would typically do on an uninsured basis.

The insurance industry, at least as we understand it from the regulators, doesn't have the ability to assess the risks that they are insuring. The rating agencies, it seems to me, in some cases have given very questionable ratings on the strength of the insurer's ability to honor its commitments.

So, the question that occurs to me is, who is doing the credit analysis in these cases, and what are the spillover effects that can occur? They spill beyond the insurance industry. They can spill into banking. They can spill into securities markets.

So, I tend to view this problem as a bit broader than, first of all, just whether people pursuing their own self interest in the insurance industry are going to make this thing work, and second, whether just viewing this as an insurance regulation problem is the right perspective.

Mr. FLORIO. Mr. Anderson, on your suggestion about the rating agencies being the key factor, with the multi-line company, do we have any information that the rating agencies are looking at the financial guarantee line component of a multi-line company, as opposed to looking at the overall company and giving it a rating on the basis of the anticipated cross-subsidization of resources in the event that the financial component or the guarantee component goes down?

Mr. ANDERSON. Let me make two points, Mr. Chairman.

First, I see the regulator being the one that really should be looking at the practices, the business practices of the insurer.

To be talking about this relatively new phenomenon that in many instances, by definition, has no past history, that even if you had actuarial techniques and actuarial skill and actuaries, which some divisions and departments don't even have, you would have a hard time trying to make any kind of a pattern clear, because there is no history. There is no history in many of these instances and many of these things are new.

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How do you respond to that sort of an analysis?

Mr. Simmons. I would like to respond to that.

We have heard some horror stories, including Bank of America, Ticor as well as a recent case involving an insurance firm in Virginia. If those situations were limited, if the losses were limited and isolated with the insurer, then I suppose that I would be willing to say, fine, let's let market forces work whatever miracles they can and whoever takes the losses takes the losses.

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Mr. Anderson. Let me make two points, Mr. Chairman.

First, I see the regulator being the one that really should be looking at the practices, the business practices of the insurer.

But with respect to your point, my understanding is that they are looking at the multi-lines as an entity, without regard to specifically looking at the vulnerabilities that may exist in the financial guarantee segment.

Mr. FLORIO. Isn't that virtually worthless, then, in terms of you are talking about a situation where the bad part pulls down the good part?

Mr. ANDERSON. Or vice versa. It is operating in the other direction, as well. And your point is correct, sir.

Mr. FLORIO. Let me ask just sort of a general question with regard to why we are even dealing with this problem at this point. I sense in the financial community growing apprehension, and I guess in some respects I also sense the concern that the reason why people are creating new vehicles and new mechanisms for financial capital development is that you are talking about a worldwide liquidity surplus that is almost out there looking to create new vehicles to get the capital into productive uses, which is, of course, a commendable goal and we want to be encouraging capital formation.

But the sense that some have—and I would like your thoughts on this—is that it is now beyond responsible capital formation, it is almost frantic, creating new markets or new mechanisms for getting the capital into play.

Do you have any sense of one or the other of these two?

Mr. ANDERSON. I have two economists to my immediate right here. I will let them speak to that.

Mr. SIMMONS. I think I am going to let Jill speak to that first. I don't think I have anything to offer on that. Do you, Jill?

Ms. GARCIA. I don't.

Mr. FLORIO. We will let that be the definitive word, then, on this. One of the other things that I was struck by in the briefing memos that I looked through last night was one of the rationales for this type of insurance was because of international trade and in the area of currency stability, there was a sense that international traders wanted to be cushioned against fluctuations in currency. And, of course, this type of insurance can be formed to deal with that.

I had occasion not too long ago to have a tour of the Philadelphia Stock Exchange, and I was struck by the parallelism of new vehicles that are being created in the stock market industry, currency futures, currency index futures, and those were being advocated as means of providing a hedge for currency fluctuations.

So, again, you see almost everywhere people are doing the same thing, and I have no difficulties with that if it is designed to deal with legitimate concerns, which they are.

The question is, is anybody looking to see that these things are being done in a responsible way? And I guess we will hear from some of our other witnesses today as to whether there is even the possibility of responsibly having some degree of public accountability, or do we just throw up our hands and say, no, we will just rise and fall with the marketplace conditions and we will experience the business cycle and the problems that are associated with that.

Mr. ANDERSON. I see that the demand is driving all of this. I mean, first there was a concern on the losses that were incurred as part of the WPPS situations, the volatility, the risks that you see, the dollar going from three to the mark to seven to the mark, it seems, within a 6 month period.

People are trying to hedge. They are risk averse. And then, in response to that demand, we have organizations, entities, businesses, arising when you are dealing with municipal bonds and the desire for more people to avoid risk, fine. It is just a question of writing more of the old kind of business.

But as we get into some of these new types of risks and new types of hedges that they are trying to find, then that is where we have the uncertainty on some of the products.

Mr. FLORIO. I will ask other witnesses as well. You maintain that this is demand induced. I would be interested to know if anyone thinks that there is any component of supply inducement? That is, overseas capital, overseas liquidity looking for a place and therefore someone wanting to welcome that capital into the market, conjuring up new mechanisms to take advantage of that. Is there any validity? You nodded your head, yes. I was wondering if you had any observations.

First of all, do we see foreign capital, a foreign presence in this relatively new industry, particularly the new innovative parts of it?

Mr. SIMMONS. Well, I certainly know that foreign owned agencies and branches of banks are fairly heavily involved in the standby letter of credit business. And, in fact, they account for most of the growth in the standby letter of credit business.

It seems to me that the supply response—the way I tend to think about the supply response is that there is an enormous amount of competition in the financial services industry right now, and the various segments of the industry are trying to develop new products that can, in some way, add to their profitability. And all of the institutions, in one way or another, are involved in either transferring risks or absorbing risks, and this is all just part of that phenomenon.

Mr. FLORIO. Let me interrupt you there, because the parallels with the cash-flow underwriting question, I think, are interesting and worth developing.

If that is the case—and I have no reason to believe it is not the case, that the financial services institutions are all scurrying around for market share—then the question is: Are we getting pricing in this instance done in an accountable, responsible way? Or are we having the lowest common denominator competition in order to obtain that competing market share from different institutions and from different entities even within one's segment?

That is a concern that I think a lot of people are starting to develop, that it is the supply side aspect, the control or the desire for market share, that is conjuring up new applications for these types of things, without anyone looking through. And again, the parallel with the cash flow underwriting in property and casualty, I think, is worth developing at some point, as well.

Mr. SIMMONS. I certainly have heard that concern. It seems reasonable to me. It seems quite reasonable to argue that that may be what is going on.

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The industry, you know, the number of financial guarantee insurers in the business rose fairly significantly in the 1980's, and they are in business now. And the question becomes, if they want to stay in that business, they are going to have to continue to write it and that implies more competition in an interest rate environment that isn't as conducive to demand for financial guarantees as a higher interest rate environment is.

So, if they want to continue to write financial guarantees, they are going to have to compete on the basis of price.

Now, we have already heard from the regulators and already expressed our own concerns about whether people are able to adequately assess the risks in this industry. And if you can't adequately assess the risks, you can't price the product appropriately.

So, it seems reasonable to be concerned about the effect of increasing competition on whether pricing is being done appropriately in this industry or not, or whether prices are, in fact, too low to cover the risks and the contingencies that are being underwritten.

Mr. ANDERSON. I can't speak to what the true answer to this problem is. But I am looking at a copy of the spring 1987 Quarterly Review of the New York Fed, an excellent article that I am sure you have seen. But in any event, talking about the relationship of what is happening here to what is happening in the property/casualty industry generally. And let me read here:

"High interest rate environments tend to be profitable for financial guarantee insurers. However, since strong demand during these periods assures that competitive pressures to reduce premium rates and weaken underwriting standards do not become too severe, property/casualty insurers therefore have an incentive to divert capital resources away from the overly competitive property/casualty market and into financial guarantees when interest rates are high."

So, it would almost seem that as we have more available capital, we are increasing the supply of our service.

Mr. FLORIO. I assume, though, because in both instances, property and casualty and financial guarantees, the overall dynamics work in parallel ways, what you are trying to do is maybe underprice your product to gain market share of the premium to be able to take advantage of the investment side with the high interest rates.

So, on that alone there would be no particular advantage, one or the other, except that if one has a more speculative risk and you don't know whether the payout is going to occur at some longer period of time, that might very well induce one way or the other. That is, that analysis is to transfer out of property and casualty into financial guarantee.

The only reason I can think of that that would be a fact would be that if someone said, well, the potential for a payout is more remote on a financial guarantee investment than in a property and casualty investment. And I am not sure there is anybody that has any legitimate analysis that says that is or is not the case. And I am not even sure you could say it is or is not the case industrywide, because in the instance of, at least on the financial guarantee components, there is just no history and there is no particular objective analysis that you could undertake to arrive at that type of conclusion.

Ms. GARCIA. Could I make one comment? There is an explosion of world growth, greater volatility of interest rates and other aspects of the economy. That has led for investors to want hedging and security.

At the same time, there is an explosion in the academic life. Business schools all over the country are busy producing models and techniques to apply to this situation. Many of my colleagues from Berkeley are making themselves millionaires in this way.

What I think we need to do is to have some of those people from some of the best business schools hired by regulators to look at the public interests, not just the private ones, because they don't always coincide.

Mr. FLORIO. Let me state my appreciation to the panel for its help today.

Now we will turn to a regulator to see what he has to say about this.

Mr. ANDERSON. Thank you, Mr. Chairman.

Mr. FLORIO. We are pleased to have with us the Honorable James Corcoran, Superintendent of Insurance of the State of New York.

Superintendent, we welcome you back to our committee, and we would ask that you introduce your colleague. Your statement will be put into the record in its entirety.

STATEMENT OF JAMES P. CORCORAN, SUPERINTENDENT OF INSURANCE, STATE OF NEW YORK, ON BEHALF OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, ACCOMPANIED BY SANDRA SIEGEL, DIRECTOR OF DEPARTMENT PROGRAMS, DEPARTMENT OF INSURANCE

Mr. CORCORAN. Thank you, Mr. Chairman.

This is Sandra Siegel, of my staff, not from Berkeley, but very bright and very competent. I don't know if I can afford someone from Berkeley, but we will see what we can do.

I would like before I get into my formal statement, Mr. Chairman, to thank you very much for continuing these hearings on this very important and evolving subject and agree with most of the testimony which I just heard, especially regarding the question of assessing of the risks and the comment, removal of discipline from the economy. I think that is a very important point.

When I first became aware of the growth of this product and after having been visitod upon in this country by the same people who are doing this business in the form of a property/casualty insurance crisis, the idea of removing of discipline from the economy was of great concern to us.

Based on that, the National Association of Insurance Commissioners appointed a committee to look at this very important question, and the result, of course, of that committee work and a unanimous vote by the Association of Insurance Commissioners within 1 year, a very short period of time, on a model bill, underlines very much the importance which we, as commissioners and regulators, see the need to regulate this business.

Now, as Superintendent of Insurance of the State of New York, we, of course, chaired that group. I think we have discussed that before, Mr. Chairman—the rapid growth of the business being written and the number of traditional property/casualty insurers getting into it, and the lack of information on the types of obligations to which innovative insurance guarantees are being attached.

Now, financial guarantee insurance is written, for the most part, as surety insurance. I think it is important to note that. It is not a defined type of insurance. It is being written under a surety license.

When that license was issued by the various insurance commissions throughout the country, financial guarantee insurance was never even thought of.

Mr. FLORIO. Can you give us just a 2 minute brief analysis of the difference between what surety insurance purports to do as contrasted with this product that we are talking about?

Mr. CORCORAN. Well, it is my view, and I think the view of most of the commissioners, that financial guarantee insurance is not in any way in form insurance per se. Surety, of course, is assuring someone performs under a contract. Financial guarantee is credit enhancement.

A concept that I have often stressed in my statements is that what you are basically saying here is that the same people who got us into the continuing insurance crisis in the property/casualty failure to properly price, their failure to properly assess risks, are now in the business of not only assuring the creditworthiness of corporate America, but assessing the ability of corporate America to pay its long-term debts.

And I am one who believes they do not have that ability without a properly structured regulatory environment to assure that we in the traditional insurance business, who regulate the traditional insurance business, wall that business off from the traditional insurance business.

The statements previously just made that what would occur here in the multi-line situation, of course, is that if one of these major defaults occurred in a multi-line situation, you would be impacting all the lines in that company.

In a sense, it is not really traditional insurance. It is logical to require them to break that off into a mono-line company, in a subsidiary, to wall off the corpus of the insurance company, say, from any harm or damage it could do and simultaneously giving the multi-line company the benefits, of course, of dividend passing up from profits that are eventually earned, at the same time protecting it from these catastrophic losses.

But more importantly, also, I think we all agree here that this type of insurance should be removed from the State Guarantee Fund, because, of course, basically what you are doing is underwriting someone who really is kind of speculating in the marketplace in buying this financial guarantee to limit the risk.

Mr. FLORIO. What is the experience in States now? For the most part, are State guarantee funds sufficiently broad not to encompass financial guarantees?

Mr. CORCORAN. Absolutely not. They could not possibly withstand those types of hits.

Mr. FLORIO. Not whether they could, but is someone able to make a claim? Let's assume financial guarantee insurance is defaulted upon. Someone who is a beneficiary, can they go to a State guarantee plan and make a claim?

Mr. CORCORAN. In seven of the major States, they could. And the assessments as a result thereof would be placed upon all licensed property/casualty insurance companies, which of course would have the trickle down effect of increasing premiums in other lines of insurance that are totally unrelated.

Mr. FLORIO. So, even if the model code were to shift over to a mono-line system, unless you make sure that the mono-line company is not into the State guarantee plan, you could still have this domino effect.

Mr. CORCORAN. Right. That is why the model bill requires you remove it from the State guarantee funds, as well.

One of the arguments you will hear is, I think—the industry, even the people who we have had long dialogues with who are in opposition to the model bill—is that it is consistent and logical to remove it from State guarantee coverages. But there is no logical way you can do that without making it a mono-line sub, because if that is the particular line, the financial guarantee line, in a multi-line company, that causes the insolvency, it is academic. Then the entire company falls in and you have total assessments all over again.

So, that is why, from a structural standpoint, it is very inconsistent to say a mono-line company is not the way to go.

Also, you will be hearing a lot of testimony about capacity and you will see from our own testimony, we do feel strongly that there is no capacity shortage in this business.

From many of the statements that were just previously made by the prior witnesses and your own questions, it was clearly indicated that it is a tremendous growth business, and it is growing mono-line. It is not growing multi-line.

The situation here is, there are companies that have been in that business in boutique operations, and those are multi-line companies who were doing it more or less as a sideline and investing very little and designating very little capital per se writing this business with tremendous exposures, which we feel very uncomfortable with.

Mr. FLORIO. Almost as a matter of survival, one would have to ask the question, if the analysis is correct that the risk capability, even in the mono-line form, is not everything that it should be in terms of acting in a prudent businesslike way, to what do you attribute this tremendous growth, as you say, even in the mono-line segment in the industry?

Mr. CORCORAN. Well, we will have to go back through 2 or 3 years when we started this dialogue. I have got to stress with the Chair that when we first got into this issue in New York, and of course the NAIC got into it, I met with a number of the people doing the business, some of the chief executive officers, and I have also stressed that in my testimony.

And they made the incredible statement that this is a riskless business, don't worry about it, it is riskless. And they kept talking about not imposing depression mentalities on this business, after all. They were using an analogy of what occurred during the great depression.

Of course, we have the one instance that you just noted today of the default of the Seabrook utility, where, from today's New York Times, the Public Service Company of New Hampshire moved a step closer to bankruptcy yesterday when its board voted to skip a $37.5 million interest payment due tomorrow.

The article goes on to state:

"A bankruptcy, if it occurs, would be the first of an investor-owned electric utility"—and these are the type of guarantees that are being sold—"since the Great Depression, according to industry experts."

So, we do have a real thing out there and real gigantic exposures, and it is not riskless.

Mr. FLORIO. You wouldn't happen to know, by the way—and we can get some information—as to whether there is actually financial guarantee insurance for that particular facility?

Mr. CORCORAN. We will be looking into it. As soon as we find out, Mr. Chairman, we will determine that. But that is the type of thing, as you can see from my testimony, that financial guarantees are being issued to. And that was one of the analogies we used about 1½ years ago.

We used the analogy, if in fact, say, for instance, a nuclear power plant—and that is in one of my prior testimonies—caused a default of a utility, what kind of domino effect would it have.

I heard from a radio news presentation last night that it was a potential $6 billion loss by the utility, if it has the domino effect of a bankruptcy.

So, these are real substantial losses, losses that don't belong imposed upon the people who buy insurance. You and I and the small businesses that have such difficulty securing commercial insurance should not have the burden of this particular line, which is not really insurance per se. It is credit enhancement.

What you are doing, the insurance company has a triple-A rating and it is taking that rating, the entire rating, a multi-line company, where, as noted by the prior testimony, the rating bureau is not looking at the particular risk. It is looking at the entire claims paying ability of the multi-line company and giving it a triple-A and selling that triple-A rating to someone who perhaps has a triple-B rating so that they can save a small amount or a substantial amount, depending on the market, on their issue, whatever their issue is.

Now, their issue might well be—and we have seen it and I have said this—most people think it is a jovial comment, but it is not. We really don't feel that the insurance companies doing the business knew or still don't have the expertise with which to price this.

That is why the NAIC model bill, which to me is crucial, is a comprehensive approach requiring ratios, aggregate ratios, collateralization, and a whole comprehensive approach to the entire issue, to make sure they are solvent, but at the same time walling off the public, in general, the public who buys insurance, from the possible exposure of insolvency of the situation.

And the triple-A ratings now—we also said in our prior testimony and we reiterate it here—there have been multi-line insurance companies that lost their triple-A rating after having sold these products.

We really don't know the consequences of that. After all, the buyer did not get what it purchased. The buyer did not get a triple-A rating.

Mr. FLORIO. If the statute was passed in your State and it was exclusively a mono-line operation that was permitted in this area, do you have the capability of assessing risks in some of these areas sufficient to a knowledgeable start, I assume, saying when a rate is inappropriately low or that reserves are inappropriate?

Mr. CORCORAN. Let's step back for one second on that. One thing we are doing, though, is we are protecting the insurance buying public from the consequences of our abilities to or to not evaluate that risk.

We are saying by making a multi-line company simply form a downstream subsidiary, if we do fail in that job, the consequences to the public are very limited, and then only to those people who bought speculatively or otherwise on the marketplace.

Mr. FLORIO. Hopefully, you can be a little more firm. I understand what you are saying.

Mr. CORCORAN. That is the first premise.

Mr. FLORIO. The first part is that if worst comes to worst, if we don't know what we are doing and they don't know what they are doing, at least it is going to be cushioning the impact across the entire industry.

Mr. CORCORAN. Right, it is mitigated.

Mr. FLORIO. But let's go beyond that.

Mr. CORCORAN. Beyond that, more importantly, and as a regulator, I don't issue licenses and not care. The entity, the privilege to do the insurance business in the State of New York, goes with it the public's reliance upon that license, and that has to be a much more comprehensive approach.

Now, to be quite candid with you, Mr. Chairman, the intensity of the dialogue of the NAIC model bill in the State of New York was probably, in my 4½ years as superintendent, the most interesting and comprehensive and overwhelming, I think, in the legislature. The legislature couldn't believe the volume and numbers of lobbyists and industry people that visited upon this particular bill.

And it is amazing to me that the industry had a very provincial short term view of that topic, since no one was saying to them you can't do the business. We were simply saying to them, you have to do it in a subsidiary, and by doing it in a subsidiary there are many good things for the public-at-large.

In that NAIC model bill there are ratios, collateralizations, discussions, very comprehensive discussions with the industry trying to come up with fair figures to assure adequate pricing. And that is an important issue here, adequate pricing of the product, because we have all been visited with cash flow underwriting.

Mr. FLORIO. I guess my question is, assuming all the things you have just said, you have got everyone to sign on to the fact that it should be mono-line, it should be a sub, do you have the capability as an agency to make a determination as to what is viable and what is not in terms of costing out your best determination as to risks, the surpluses that would be required, the premium setting that would be sufficient, so that you can comfortably say, fine, you can stay in business or you can go into business?

I am at a loss—and obviously I don't have the expertise that you do—I am at a loss as to how to make those types of actuarial determinations, when by definition you are talking about so many subjective things that are not experiencing how many automobiles crashed over the last 10 years or any of the other traditional actuarial factors that you roll into your evaluations in property and casualty.

Ms. SIEGEL. Well, you hit the nail on the head. There is no actuarial way of pricing this business.

But what we did do in the bill was to attempt to prevent cash flow underwriting by setting up the contingency reserve so that companies would have to place a certain percentage of the par value that they are guaranteeing in the contingency reserve.

Mr. FLORIO. Based on what? What is the percentage based on?

Ms. SIEGEL. The percentage was based on a study that we did of 1985 pricing of this business, where before the cash flow problems had begun the prices had remained pretty steady up until then. And so, we did an analysis of what the average price was for the different classes of risks that we developed within the model bill.

Mr. FLORIO. How do you roll in the factor as to whether New York State—if we are going to do it on a State basis, and there is a question as to whether we should do it on a State basis—is going to have a 3 percent growth rate next year or we are going to go into a minus growth rate as a result of changes in the business?

Ms. SIEGEL. We don't. The bill also has a plan of operation that has to be filed and approved by the departments, and we would review that. And what we would be looking for is to see that they are hiring experts in the business and, you know, doing proper underwriting.

But we are limited in what we can do, and that is one of the reasons we want to wall it off.

Mr. FLORIO. I understand you ban certain types of lines, certain types of insurance that you regard, I assume, as speculative.

Ms. SIEGEL. Yes. The bill only permits the traditional types of guarantees. It precludes the guaranteeing of interest rates or something you mentioned earlier, currency.

Mr. FLORIO. How about currency?

Ms. SIEGEL. Yes, it would preclude that.

Mr. FLORIO. Ironic. I mean, you have got mechanisms out there under, presumably, SEC control, that are allowing things, currency options on indexes.

Ms. SIEGEL. Yes. But we don't think you should have to guarantee those. We want the investor to look at that.

Mr. FLORIO. OK.

Mr. CORCORAN. Let me point out that there is a little history on the currency conversions, and of course no one will ever know the final chapter on the Citibank's CIGNA, where there was an announcement that CIGNA was guaranteeing the currency conversions of Citibank's foreign debt up to $900 million. And when this department asked some questions about it, the deal was canceled.

So, you are talking about a possible exposure of $900 million to CIGNA, and we are not sure exactly—we could never find out, because they canceled the deal—what exactly occurred.

So, we felt very uncomfortable with currency conversions. But once again, we must stress, lack of expertise, potential lack of expertise, and whether or not they can do this.

Let's look at the figures. A preliminary view indicates that in 1986 46 insurers wrote financial guarantee insurance, as compared to only 3 as recently as 1981. That is an awful lot of expertise developed in a pretty short period of time in a very sophisticated line that changes and evolves every day.

So, as 1986 premiums written aggregate approximately 693 million exposures, total about $152 billion of municipal debt, $6.5 billion of nonmunicipal debt, and $13.5 billion of noncredit enhancement guarantees.

That is a lot of exposure, especially with the great dialogue we have had in the last number of years and the ability of the United States to compete was the inability of small companies and companies in general in the United States to get commercial liability coverages.

Mr. FLORIO. References were made by the previous witness about the academicians are out there doing their computer models. It would be an interesting thing for someone to do a computer model as to what the impact with regard to that type of exposure would be if we talked about a negative growth rate nationally of 1 percent or 2 percent as a result of a recession situation.

I think that could be something that is a manageable project that somebody ought to be able to formulate what the impact would be of that type of thing, which of course is not that unforeseeable at some point within the next reasonable period of time.

Mr. CORCORAN. Perhaps we can look at the recent occurrences in Texas because of the oil prices and some municipalities' defaults, and the issues that were going on in Texas in the last 2 years, and see if we can come up with something along those grounds.

But there have been defaults, there have been losses, and they are evolving, I think, quicker than we were told initially about 2 years ago.

First of all, you noted the one thing, which I also cannot give anything definitive on, talking about the municipal debt situation. And today's Times again notes that Salomon Brothers, which I guess was their biggest operation at one time, the leading underwriter of tax exempt securities, has announced a withdrawal of the business totally, abandonment of the municipal bond debt business.

So, what is going on out there?

Mr. FLORIO. Today you have Kidder Peabody talking about that.

Mr. CORCORAN. So, you are talking about a situation here where, at best—and I must also note something that came across yesterday, and I think the Chair might be interested, that this department at the invitation of the Government of Taiwan, is going to visit them and try to open up their markets for United States insurance companies.

And it was noted to me by the officials of Taiwan that they were very interested in our position on junk bonds and financial guarantees and the things going on in mergers and acquisitions in the

United States, and they don't want those things in their economy, a very conservative economy, and they want to know how to protect themselves from it, because they want the businesses in, they want the insurance companies in, but they don't want this type of risk. And they want to know how to regulate against it.

So, I think the future phenomena we are seeing now, and I think it is kind of reaction to deregulation, is the need for good regulation in the economy, and this is really a very prudent, modest step.

All the hysteria you will hear from some of the witnesses, maybe not today but eventually, we have heard over and over in the State of New York.

And you will hear a number of people who perhaps are purchasers of this insurance, and what they will be saying is, basically, they want cheap insurance, we have been getting it cheap and this regulation will kill capacity, which is totally untrue, because the capacity, as you see, has grown tremendously, or raise the prices.

And I think we have gone through our commercial liability insurance crisis and know what cheap insurance results in. It results inevitably in no insurance or insolvency.

So, what we are saying here is this bill will create an environment where you will have stabilized prices, collateralization. You will have various aggregate ratios to make sure that eventually people will be paid.

And more and more people will be coming into the business. We have had some companies approaching us, trying to assist in enactment of the model bill in New York, they are saying, because they can't draw much new capital to the business unless there is good regulatory structure where there can be fair pricing.

And that is what we are talking about here. We are talking about fair pricing, structuring it so if there is a crisis, there is a catastrophic loss, that you and I can assure the public that they are not going to be hit by this in the commercial liability lines or the personal liability lines.

To me, it is just common sense, and you will hear a lot of hysterical dialogue, but if you sit down and analyze it and you weigh it against the public good, short term and long term, they are without any merit.

Mr. FLORIO. The testimony of one of our witnesses that I read talks about student loans, and makes the argument that the collateral that is available for student loans is sufficient so as to deal with some of your concerns. And inferentially, the suggestion is that, therefore, you ought to carve out certain lines that have good collateral because that is not a problem in the way that some other areas might be a problem, where you can't get good collateral with any degree of certainty.

Is there any merit to that approach?

Mr. CORCORAN. I don't think there is any merit. Father Whalen and I have discussed this many, many hours, and he has been in New York quite often, and I think that when you really question it, I think he is talking about cheaper insurance. He is not talking about lack of capacity. And that line shouldn't be treated like any other line if it should be properly collateralized.

There are many programs in many States to help students get loans, and the question really is—and I have pointed it out and you might want to ask Father Whalen—that they really could get it even cheaper if they simply took some of the property they hold and put it up as collateral, that the risks are so small.

There are many things that he could even do to reduce it even less in a prudent manner.

So, I don't really think there is any merit to that. It is just, who is going to oppose—like apple pie and motherhood—student loans? Because Lord knows, I have got two children ready to go to college, and I will be applying, too. But we can assure you that there will be plenty of capacity in an adequately and fair priced market for student loans.

Mr. FLORIO. I have been disrupting your flow of thought here.

Mr. CORCORAN. I have no flow. The flow went a long time ago.

Mr. FLORIO. I have been asking my questions. Please, feel free to proceed and conclude, if there is anything else that you want to add.

Mr. CORCORAN. Well, I can just glean through my testimony, which I think we are familiar with. It is basically the dialogue that has been going on in the States.

I think it is very important to note, though, that it is crucial that we act quickly on this issue. One commissioner in the State of Iowa has already proposed a regulation—I think it is already in force. That might be the way that most States will be compelled to go, if we don't get enactment of some legislation in most of the States, especially the model bill.

The model bill is a structure, as I have noted before, that they can easily, easily live with, and I think from an industry, especially, that specializes in creating subsidiaries for just about any particular reason, for tax purposes, including restauranting and all sorts of issues, creating a downstream subsidiary for this issue is really not a burden on them in any sense or form.

I think you are familiar with my testimony, and I don't think there is any point of me reiterating it.

Mr. FLORIO. Let me again express our appreciation to you for your participation today.

Mr. CORCORAN. Thank you very much.

[Testimony resumes on p. 292.]

[Mr. Corcoran's prepared statement follows:]

STATEMENT

OF

JAMES P. CORCORAN

GOOD MORNING. MY NAME IS JAMES P. CORCORAN. I AM SUPERINTENDENT OF INSURANCE FOR THE STATE OF NEW YORK. I APPRECIATE YOUR INVITATION TO APPEAR TODAY ON THE SUBJECT OF FINANCIAL GUARANTY INSURANCE AND WISH TO THANK CHAIRMAN FLORIO AND THE MEMBERS OF THE SUBCOMMITTEE FOR THIS OPPORTUNITY.

I CHAIRED OF THE NAIC FINANCIAL GUARANTY INSURANCE STUDY GROUP WHICH WAS ESTABLISHED TWO YEARS AGO TO MAKE RECOMMENDATIONS TO THE VARIOUS STATES ON THE MOST APPROPRIATE REGULATORY RESPONSE TO THIS INCREASINGLY POPULAR INSURANCE PRODUCT. THE STUDY GROUP WAS FORMED BECAUSE STATE INSURANCE REGULATORS WERE CONCERNED OVER BOTH THE RAPID GROWTH IN THE VOLUME OF BUSINESS BEING WRITTEN AND THE NUMBER OF TRADITIONAL PROPERTY/CASUALTY INSURERS GETTING INTO IT, AND WITH THE LACK OF INFORMATION ON THE MYRIAD TYPES OF OBLIGATIONS TO WHICH INNOVATIVE INSURANCE GUARANTIES WERE BEING ATTACHED. FINANCIAL GUARANTY INSURANCE IS WRITTEN FOR THE MOST PART AS SURETY INSURANCE AND NO SEPARATE REPORTING WAS AVAILABLE UNTIL 1987.

AT THE SUGGESTION OF THE STUDY GROUP, THE 1986 ANNUAL STATEMENT FILED IN MARCH OF THIS YEAR DID REQUIRE SOME LIMITED REPORTING OF WRITINGS AND AGGREGATE EXPOSURES. WHAT WE FOUND ONLY HEIGHTENED OUR CONCERN OVER THE GROWTH IN SIZE AND TYPES OF GUARANTIES BEING ISSUED. A PRELIMINARY REVIEW INDICATES THAT IN 1986 46 INSURERS WROTE FINANCIAL GUARANTY INSURANCE AS COMPARED TO ONLY THREE* AS RECENTLY AS 1981. 1986 PREMIUMS WRITTEN AGGREGATED APPROXIMATELY $693 MILLION AND EXPOSURES TOTALLED $152 BILLION OF MUNICIPAL DEBT, $6.5 BILLION OF NON-MUNICIPAL DEBT AND $13.5 BILLION OF NON-CREDIT ENHANCEMENT GUARANTIES (WHICH THE GAO CHARACTERIZED AS "RISK INSURANCE")

* Source: Insurance Information Institute.

INCLUDING GUARANTIES OF SUCH VARIABLES AS INTEREST RATES AND RATES OF EXCHANGE. MY STAFF IS ATTEMPTING TO GET MORE DETAILS, ESPECIALLY CONCERNING THE LAST CATEGORY, ALL OF WHICH WAS WRITTEN BY MULTILINE INSURERS AND ALL OF WHICH WOULD BE PROHIBITED IF THE NAIC MODEL WERE INACTED.

IN DECEMBER, 1986 THE STUDY GROUP COMPLETED WORK ON A MODEL FINANCIAL GUARANTY INSURANCE ACT (COPY AND ACCOMPANYING MODEL BILL MEMORANDUM ATTACHED) WHICH WAS UNANIMOUSLY ADOPTED BY THE NAIC. THE STUDY GROUP FOUND THAT SINGLE EXPOSURES CAN BE ENORMOUS AND THAT PREMIUMS WERE GENERALLY QUITE LOW IN RELATION THE EXPOSURE. IT BECAME APPARENT THAT INSURERS HAD NO TRADITIONAL HISTORICAL OR ACTUARIAL BASIS FOR THE RATES CHARGED. SOUND INSURANCE PRINCIPLES MANDATE THAT RATES BE BASED UPON A PROJECTION OF ANTICIPATED FUTURE LOSSES. IN FACT, A NUMBER OF INDUSTRY SPOKESMEN INITIALLY TOOK THE POSITION THAT THIS BUSINESS WAS "RISKLESS" AND THAT LOSSES WERE NOT EXPECTED.

SINCE DEBTORS PURCHASE FINANCIAL GUARANTY INSURANCE ORDER TO BENEFIT FROM THE LOWER INTEREST COSTS ASSOCIATED WITH THE INSURER'S AAA RATING, THIS INSURANCE IS ONLY MARKETABLE IF THE PREMIUM CHARGED IS LESS THAN THE SAVINGS REALIZED THROUGH THE CREDIT ENHANCEMENT. WITH THIS FACTOR IN MIND, PREMIUMS ARE SET AT WHATEVER LEVEL THE TRAFFIC WILL BEAR. OBVIOUSLY, WHEN INTEREST RATES GO DOWN, SO MUST THE PREMIUM, ALTHOUGH THE RISK OF DEFAULT WILL REMAIN ESSENTIALLY THE SAME.

SINCE THERE WAS NO HISTORICAL BASIS UPON WHICH TO PREDICT FUTURE LOSSES, INSURERS HAVE RELIED UPON SCENARIOS INVOLVING MUNICIPAL BOND EXPERIENCE DURING THE GREAT DEPRESSION. THESE SCENARIOS ARE INAPPROPRIATE WHEN APPLIED TO THE TYPES OF INVESTMENTS NOW BEING GUARANTIED, MANY OF WHICH WERE NOT EVEN CONTEMPLATED IN THE 1930s. THE GREAT DEPRESSION EXPERIENCE IS ALSO INAPPROPRIATE TODAY BECAUSE THERE HAS BEEN A SIGNIFICANT CHANGE IN THE

JUDICIAL CLIMATE. AN EXAMPLE OF THIS CHANGE OCCURRED IN THE STATE OF WASHINGTON WHEN ITS HIGHEST COURT PERMITTED THE DEFAULT OF SEVERAL WASHINGTON PUBLIC POWER (WPPSS) NUCLEAR PROJECTS, OBLIGATING AMBAC INDEMNITY CORPORATION TO PAY $76.2 MILLION OVER THE LIFE OF THE BONDS. THUS, WHEN THE NAIC UNDERTOOK TO DRAFT MODEL LEGISLATION IT HAD TO PROVIDE FOR REGULATION OF GUARANTIES OF RISKIER TYPES OF MUNICIPAL BONDS (SPECIAL REVENUE AND INDUSTRIAL DEVELOPMENT), GUARANTIES OF CORPORATE OBLIGATIONS (SOME OF WHICH ARE BELOW INVESTMENT GRADE), AS WELL AS GUARANTIES OF OBLIGATIONS OF LIMITED PARTNERSHIPS, STUDENT LOANS, MORTGAGE BACKED SECURITIES AND OTHER CATEGORIES OF DEBT FOR WHICH GUARANTIES WERE NOT CONTEMPLATED AS RECENTLY AS FIVE OR TEN YEARS AGO.

ADDING TO THE REGULATORS' ANXIETY WAS THE FACT THAT MULTILINE INSURERS HAD BEGUN TO WRITE FINANCIAL GUARANTIES, WITHOUT THE INDEPTH SCRUTINY OF EACH RISK BY THE RATING AGENCIES, TO WHICH GUARANTIES ISSUED BY MONOLINE INSURERS WERE SUBJECTED TO. THE AAA RATING "RENTED" BY A MULTILINE INSURER TO THE GUARANTIED OBLIGATIONS IS BASED UPON THE OVERALL CLAIMS PAYING ABILITY OF THAT MULTILINE RATHER THAN A REVIEW OF THE OBLIGATIONS GUARANTIED AND THE STRUCTURE OF THE GUARANTY. IT IS THE RATING AGENCYS' COMFORT IN THE MULTILINE'S DIVERSIFIED BOOK OF BUSINESS WHICH MAKES INSURANCE COMMISSIONERS UNEASY. IN FACT, THE RATING AGENCIES HAVE TOLD US THAT THEY DO NOT PRESENTLY HAVE THE EXPERTISE TO EVALUATE SOME OF THE "DEALS" MULTILINE INSURERS ARE GUARANTYING.

IN ATTEMPTING TO OBTAIN AN EXEMPTION FROM THE SEC REGISTRATION REQUIREMENT FOR INSURED CORPORATE BOND ISSUES, SOME FINANCIAL GUARANTY INSURERS PROPOSED THAT SUCH ISSUES SHOULD NOT BE SUBJECT TO RIGOROUS DISCLOSURE REQUIREMENTS AS AN EXEMPTION CURRENTLY EXISTS FOR CORPORATE ISSUES BACKED BY BANK LETTERS OF CREDIT AND THE INSURERS WANTED A "LEVEL PLAYING FIELD". AS I TESTIFIED LAST MARCH BEFORE THE SEC, THE CURRENT STATE OF FINANCIAL GUARANTY INSURANCE

REGULATION IS, TO SAY THE LEAST, INADEQUATE. UNTIL REGULATION BECOMES MEANINGFUL, ANY ATTEMPT TO WEAKEN SEC REGISTRATION REQUIREMENTS IS UNWARRANTED AND UNWISE.

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UNLIKE SEC REGULATION, WHICH EMPHASIZES FULL DISCLOSURE AND THEREAFTER "LET THE BUYER BEWARE", INSURANCE REGULATORS ARE MOST CONCERNED WITH REGULATION FOR SOLVENCY. SOME RECENT DEFAULTS EXPERIENCED BY BOTH MONOLINE AND MULTILINE INSURERS WILL ILLUSTRATE THE BASES FOR OUR CONCERN. FIREMAN'S FUND INSURANCE COMPANY, INDUSTRIAL INDEMNITY INSURANCE COMPANY, CAL-FARM INSURANCE COMPANY AND GLACIER GENERAL ASSURANCE COMPANY EACH SUSTAINED CATASTROPHIC LOSSES ON FINANCIAL GUARANTIES, RESULTING IN THE INSOLVENCIES OF THE LATTER TWO INSURERS. IN ADDITION, FOUR INDUSTRIAL DEVELOPMENT BOND ISSUES INSURED BY AMBAC, INVOLVING THE SAME TENNESSEE DEVELOPER, RECENTLY WENT INTO DEFAULT WITH AN AGGREGATE PAR VALUE OF $79 MILLION.

MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY, A PENNSYLVANIA DOMESTIC, FROM 1983 THROUGH AUGUST, 1984, GUARANTIED LIMITED PARTNERSHIPS INVOLVING TAX SHELTERED OIL AND GAS AND REAL ESTATE VENTURES. AGGREGATE GROSS PREMIUM WAS $13.4 MILLION AND POTENTIAL LOSS EXPOSURE BEFORE REINSURANCE IS $435 MILLION.

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INCURRED LOSSES TO DATE EXCEED PREMIUM INCOME. THE COMPANY HAS DEFAULTED ON THESE CLAIMS, ASSERTING THAT IS WAS DEFRAUDED BY ITS MANAGING GENERAL AGENT, AND IS NOW UNDER THE PROTECTION OF THE PENNSYLVANIA INSURANCE DEPARTMENT.

THE CURRENT LEVEL OF REGULATION OF FINANCIAL GUARANTY INSURANCE IS CLEARLY INADEQUATE. FINANCIAL GUARANTY INSURANCE IS NOT TREATED AS A SEPARATE AND DISCRETE KIND OF INSURANCE. IT IS WRITTEN UNDER SEVERAL HISTORICAL KINDS OF INSURANCE, INCLUDING SURETY, INLAND MARINE AND CREDIT. IT IS ABSOLUTELY ESSENTIAL THAT FINANCIAL GUARANTY INSURERS OPERATE UNDER A REGULATORY STRUCTURE THAT MINIMIZES THE POTENTIAL FOR INSOLVENCY AND THAT, EQUALLY IMPORTANT, CAN SUCCESSFULLY MANAGE MATERIAL CLAIMS WHEN AND WHERE THEY ARISE. FINANCIAL GUARANTIES THAT FAIL WOULD BE FAR WORSE THAN WORTHLESS. FAILED FINANCIAL GUARANTIES WOULD BE DAMAGING TO ECONOMIC SECURITY, CORROSIVE OF INVESTOR CONFIDENCE, AND DESTRUCTIVE OF THE FINANCIAL GUARANTY BUSINESS ITSELF. WE CANNOT ALLOW THE PUBLIC OR PUBLIC POLICYMAKERS TO BE LULLED INTO A FALSE SENSE OF SECURITY WHEN SUPPOSEDLY GUARANTIED SECURITIES ARE MARKETED. NOR CAN WE TOLERATE LETHARGY ON THE PART OF FINANCIAL INSTITUTIONS, WHEN THEY REQUIRE OR DEVISE GUARANTIES ON LIMITED PARTNERSHIPS AND OTHER COMMERCIAL DEALS, IN LIEU OF ADEQUATELY INVESTIGATING THE RISK THEMSELVES.

ALTHOUGH IT HAS BECOME A PROFITABLE AND, UNTIL NOW, EVEN A LUCRATIVE BUSINESS FOR A NUMBER OF THE WRITERS, FINANCIAL GUARANTY INSURANCE IS RISKY BUSINESS, AND THERE MUST BE AN EFFECTIVE REGULATORY SYSTEM IN PLACE TO HELP MANAGE THIS INHERENT RISK. NOTWITHSTANDING EFFORTS BY FINANCIAL GUARANTY INSURERS TO UNDERWRITE TO ZERO LOSS, IT IS NAIVE TO ASSUME THERE WILL, IN FACT, BE ZERO LOSSES.

IN THE REAL WORLD, THE ZERO LOSS ASSUMPTION HAS BEEN DEFINITELY DISPROVED. AS A RESULT OF FINANCIAL GUARANTY REPORTING REQUIREMENTS

INSTITUTED FOR THE FIRST TIME LAST YEAR AT THE RECOMMENDATION OF THE NAIC STUDY GROUP, DATA REPORTED IN THE 1986 ANNUAL STATEMENTS REVEALED A 90 PERCENT PURE LOSS RATIO FOR THIS ALLEGEDLY "NO LOSS", "RISKLESS" BUSINESS. (MY STATE WILL REQUIRE ADDITIONAL EXTENSIVE DETAILED REPORTING IN THE 1987 ANNUAL STATEMENT AND WILL RECOMMEND ADOPTION OF SUCH REPORTING BY THE NAIC FOR THE 1988 STATEMENT.) THE SURETY ASSOCIATION OF AMERICA PROVIDED MY DEPARTMENT WITH THE STATISTICS DOCUMENTING THE 90% LOSS RATIO. THE LOSS RATIOS POR SIX OF THE 22 INSURERS INCLUDED IN THE SAA CALCULATION COMPUTED AT OVER 200%. IN COMMENTING ON BOND GUARANTIES, ROBERT HEPBURN, VICE PRESIDENT OF THE SURETY ASSOCIATION WAS QUOTED IN THE JOURNAL OF COMMERCE AS FOLLOWS - "THE BONDS ARE VERY-LONG TERM OBLIGATIONS THAT ARE SO NEW, THE ULTIMATE HAZARDS ARE UNKNOWN."

BY NO MEANS APPROACHING WORST-CASE ANALYSIS AND DURING A PERIOD OF RELATIVE PROSPERITY, THIS POOR EXPERIENCE MAY BE STARTLING ONLY TO THOSE WHO PREDICTED, MISTAKENLY, THAT FOREIGN GOVERNMENTS WOULD NEVER THINK OF DEFAULTING ON THEIR SOVEREIGN OBLIGATIONS, OR THAT STRIPPING MORTGAGE SECURITIES INTO NAKED INTEREST ONLY AND PRINCIPAL ONLY COMPONENTS WAS PRUDENT. THE $3 BILLION WRITE-OFF BY CITIBANK OF ITS FOREIGN LOAN PORTFOLIO AND THE $275 MILLION LOSS SUFFERED BY MERRILL LYNCH IN TRADING "INTEREST ONLY" AND "PRINCIPAL ONLY" PAPER, IN MAY OF THIS YEAR, DEMONSTRATE THAT WE CANNOT BE ACCUSED OF IMAGINING PROBLEMS WHERE NONE EXIST, OF ENGAGING IN GROUNDLESS SPECULATION, OR OF RESORTING TO UNREALISTIC HYPOTHETICALS.

THE NAIC MODEL BILL REPRESENTS A COMPREHENSIVE APPROACH THAT IS NEITHER EXTREME NOR PURIST. RATHER, IT CONSISTS OF CAREFULLY COORDINATED COMPONENTS, TESTED BY AN INTENSIVE ANALYTICAL AND EXTENSIVE CONSULTATIVE PROCESS BY A STUDY GROUP INFORMED BY AN EXPERT AND DIVERSE INDUSTRY ADVISORY COMMITTEE. THE NAIC MODEL, IF ENACTED, WOULD, FOR THE FIRST TIME, DEFINE AND REGULATE FINANCIAL GUARANTY INSURANCE AS THE SEPARATE KIND OF INSURANCE IT IS, TO BE

WRITTEN BY SPECIAL PURPOSE CORPORATIONS, SUBJECT TO SPECIALIZED RULES APPROPRIATE TO THE RANGE OF GUARANTIES THAT A FINANCIAL GUARANTY INSURER SHOULD BE AUTHORIZED TO WRITE. IN DISCUSSING THE COMPLEX SUBJECT OF FINANCIAL GUARANTY INSURANCE BEFORE MANY CONCERNED GROUPS, INCLUDING THE NEW YORK STATE SENATE AND ASSEMBLY INSURANCE COMMITTEES DURING THE LAST LEGISLATIVE SESSION, I HAVE EMPHASIZED HOW CRUCIAL IT IS THAT A FINANCIAL GUARANTY BILL BE ENACTED INTO LAW IN NEW YORK, WHERE APPROXIMATELY 25% OF ALL FINANCIAL GUARANTIES ARE WRITTEN. THE BILL HAS NOT YET BEEN ENACTED IN ANY STATE. AS NOTED BY THE SEC IN ITS AUGUST 28TH REPORT, THE OTHER STATES ARE WAITING ON NEW YORK WHERE THE BATTLE IS BEING FOUGHT. THE VIGOROUS OPPOSITION OF THE MULTILINE INSURERS HAS SO FAR PREVAILED.

SPECIAL MONOLINE STRUCTURE & EXCLUSION FROM SECURITY FUND PROTECTION

IT WAS THE JUDGMENT OF ALL THE INSURANCE REGULATORS OF THE UNITED STATES THAT THE MONOLINE STRUCTURE SHOULD BE THE ONLY PERMISSIBLE FORM OF ORGANIZATION. TO PERMIT MULTILINE OPERATIONS NEGATES ALL OF THE OTHER SAFEGUARDS CONTAINED IN THE NAIC MODEL ACT, AS THE PROPERTY/CASUALTY LINES WILL BE EXPOSED TO THE POTENTIAL OF CATASTROPHIC LOSSES SO LONG AS FINANCIAL GUARANTY INSURANCE IS WRITTEN BY MULTILINES. ONE MUST SERIOUSLY QUESTION WHETHER GUARANTORS CAN PREDICT THE LIKELIHOOD THAT THE OBLIGORS WILL BE AROUND AND FINANCIALLY SOLID WHEN THEIR DEBTS MATURE MANY YEARS INTO THE FUTURE. UNLIKE BANKS' LETTERS OF CREDIT, INSURERS' GUARANTIES EXPIRE ONLY UPON MATURITY OF THE DEBT, WHICH CAN BE TEN, TWENTY OR MORE YEARS INTO THE FUTURE.

CATASTROPHIC FINANCIAL GUARANTY LOSSES SUSTAINED BY A MULTILINE INSURER COULD BANKRUPT THE ENTIRE COMPANY OR SEVERELY RESTRICT ITS WRITING CAPACITY SINCE THE SURPLUS SUPPORTING FINANCIAL GUARANTY WRITINGS IS THE SAME SURPLUS SUPPORTING ALL OF THE LINES WRITTEN. AS AN EXAMPLE, CRUM & FORSTER REPORTS FOR 1986 SHOW A REDUCTION IN SURPLUS DUE TO FINANCIAL GUARANTY LOSSES OF $26

MILLION. THIS DRAIN ON SURPLUS TRANSLATES TO A LOSS OF WRITINGS CAPACITY OF APPROXIMATELY $80 MILLION IN ESSENTIAL PROPERTY/CASUALTY LINES OF INSURANCE. CATASTROPHIC LOSSES SO SEVERE AS TO BANKRUPT A MULTILINE INSURER WOULD ADVERSELY AFFECT ALL OTHER PROPERTY/CASUALTY INSURERS AND CAUSE DEPLETION OF STATE GUARANTY FUNDS COVERING THEIR OBLIGATIONS. INSURERS ASSESSED BY THE GUARANTY FUNDS WOULD TEMPORARILY EXPERIENCE CAPACITY SHRINKAGE AND WOULD, IN TURN, RECOUP THEIR ASSESSMENTS THROUGH HIGHER INSURANCE PREMIUMS. THE GENERAL PUBLIC WOULD THUS BEAR A BURDEN WHICH SHOULD BE BORNE EXCLUSIVELY BY INVESTORS AS PART OF THEIR INVESTMENT RISK. IN FACT, AS NOTED EARLIER, DURING THE TWO YEAR PERIOD THAT THE MODEL BILL WAS DEVELOPED, A NUMBER OF MULTILINE INSURERS HAVE EXPERIENCED FINANCIAL GUARANTY LOSSES SEVERE ENOUGH TO THROW AT LEAST THREE INSURERS (MUTUAL FIRE, MARINE; GLACIER GENERAL; CAL-FARM) INTO INSOLVENCY.

DEDICATION OF CAPITAL, COMBINED WITH EXCLUSION OF FINANCIAL GUARANTY INSURANCE FROM GUARANTY FUND PROTECTION, IS THE ONLY WAY TO INSULATE THE PROPERTY/CASUALTY INSURANCE INDUSTRY FROM THE ADVERSE EFFECTS OF FINANCIAL GUARANTY LOSSES. DEDICATION OF CAPITAL CAN ONLY BE ACCOMPLISHED THROUGH A MONOLINE STRUCTURE. WALLING OFF OF PROPERTY/CASUALTY BUSINESS FROM FINANCIAL GUARANTY LOSSES CAN ONLY BE ACCOMPLISHED THROUGH THE SETTING UP OF MONOLINE SUBSIDIARIES. PROTECTION OF THE GUARANTY FUNDS CAN ONLY BE ACCOMPLISHED BY BOTH MANDATING THE MONOLINE STRUCTURE AND EXCLUDING FINANCIAL GUARANTY INSURANCE FROM GUARANTY FUND PROTECTION. REMOVAL OF FINANCIAL GUARANTY INSURANCE FROM THE PROTECTION OF THE GUARANTY FUNDS, WITHOUT THE IMPOSITION OF A MONOLINE REQUIREMENT, WILL NOT PROTECT THE GUARANTY FUNDS BECAUSE THE PROPERTY/CASUALTY CLAIMS OF ANY MULTILINE INSURER BANKRUPTED BY FINANCIAL GUARANTY LOSSES WILL STILL HAVE TO BE PAID OUT OF THESE FUNDS.

THE FACT OF THE MATTER IS THAT THE COMPANIES WHICH HAVE ENTERED THE FIELD

IN RECENT YEARS WITH THE INTENT TO BECOME SIGNIFICANT PLAYERS HAVE ORGANIZED AS MONOLINES AND HAVE HAD NO DIFFICULTY IN ATTRACTING CAPITAL. THIS IS LARGELY BECAUSE THEY RECOGNIZE THE UNIQUENESS OF THIS BUSINESS, WHICH REQUIRES SPECIALIZED EXPERTISE UNRELATED TO PROPERTY AND CASUALTY UNDERWRITING. EACH ENTRANT HAS FURTHER SPECIALIZED IN ONE AREA OF DEBT IN RECOGNITION THAT THE EXPERTISE REQUIRED TO UNDERWRITE EACH AREA IS UNIQUE. FOR EXAMPLE, FINANCIAL SECURITY ASSURANCE INC.(FSA) SPECIALIZES IN GUARANTYING CORPORATE DEBT WHILE BOND INVESTORS GUARANTY INC.(BIG) CONCENTRATES ON MUNICIPAL DEBT. THIS PAST DECEMBER, MUNICIPAL BOND INSURANCE ASSOCIATION (MBIA), AN UNDERWRITING ASSOCIATION COMPOSED OF FIVE MULTILINE INSURERS AND THE LARGEST FINANCIAL GUARANTY INSURER OF MUNICIPAL OBLIGATIONS, CONVERTED TO A MONOLINE COMPANY, MUNICIPAL BOND INVESTORS ASSURANCE CORPORATION. SINCE DECEMBER, 1986, MY DEPARTMENT HAS LICENSED 3 NEW INSURERS WITH TOTAL SURPLUS IN EXCESS OF $200 MILLION; 3 OTHER LICENSES APPLICATIONS ARE PENDING AND WE ARE AWARE OF 4 ADDITIONAL ENTITIES WHICH HAVE COMPANIES IN THE PLANNING STAGE.

TO PUT THE MONOLINE VS. MULTILINE DISPUTE INTO PERSPECTIVE, IT IS IMPORTANT TO NOTE THAT VIRTUALLY ALL MUNICIPAL BOND INSURANCE (WHICH REPRESENTS ALMOST 90% OF THE TOTAL EXPOSURES WRITTEN) IS NOW WRITTEN BY MONOLINE INSURERS. IT IS ONLY THE ADMITTEDLY RISKIER TYPES OF GUARANTIES (AS DEMONSTRATED BY THE LOWER AGGREGATE RISK LIMITS ADVOCATED BY ALL PARTIES), INCLUDING GUARANTIES OF NON-INVESTMENT GRADE DEBT AND INTEREST RATES, THAT IS WRITTEN BY MULTILINE INSURERS. A GOOD PORTION OF THE GUARANTIES OF INVESTMENT GRADE CORPORATE DEBT IS ALSO WRITTEN BY MONOLINE INSURERS AND WILL BE WRITTEN BY TWO OF THE FOUR NOW BEING FORMED. FINALLY THERE IS EVEN A MONOLINE COMPANY (NOT YET LICENSED IN NEW YORK) THAT WAS FORMED TO GUARANTY NON-INVESTMENT GRADE DEBT. SO THE ARGUMENT THAT THE MONOLINE REQUIREMENT WILL SHRINK CAPACITY IS LARGELY A SMOKE SCREEN INTENDED TO PRESERVE THE STATUS QUO.

FURTHER, CREATION, BY MULTILINE INSURERS, OF MONOLINE SUBSIDIARIES WILL NOT REDUCE CAPACITY OF THE MULTILINE PARENT. THIS CAN BEST BE ILLUSTRATED BY THE MBIA CONVERSION. EACH OF THE PARTICIPANTS CONVERTED SURPLUS FUNDS INTO AN ASSET REPRESENTING ITS EQUITY IN THE NEW CORPORATION. WHAT WAS ACCOMPLISHED, HOWEVER, WAS THE WALLING OFF OF SURPLUS DEDICATED TO THE NEW CORPORATION, THUS LIMITING THE MAXIMUN AMOUNT AT RISK TO THE AMOUNT INVESTED.

THERE HAVE BEEN CONCERNS EXPRESSED THAT CERTAIN SOCIALLY DESIRABLE, NON-GOVERNMENTAL GUARANTIES SUCH AS HIGHER EDUCATIONAL LOANS WOULD NOT BE AVAILABLE IN A MONOLINE ENVIRONMENT. FROM MY DISCUSSIONS WITH MONOLINE INSURERS, I HAVE BEEN ASSURED THAT THE MARKET IS THERE, READY, WILLING AND ABLE TO WRITE THIS BUSINESS. THE PREMIUM, HOWEVER, MAY BE HIGHER AS A MONOLINE'S PRICING IS DISCIPLINED BY THE NEED TO DEDICATE CAPITAL.

FINANCIAL GUARANTY BUSINESS CLEARLY REQUIRES SUBSTANTIAL AND SPECIAL RESOURCES. THIS BUSINESS DOES NOT LEND ITSELF TO AMATEUR OR BOUTIQUE OPERATIONS. QUITE APART FROM THE CONSIDERABLE CAPITAL NEEDED TO OBTAIN TRIPLE-A RATINGS FROM THE RATING AGENCIES (e.g., STANDARD & POORS AND MOODY'S), SPECIALIZED INVESTMENT BANKING, LEGAL, TAX, CREDIT AND ECONOMIC EXPERTISE ARE AREAS THAT FEW PROPERTY/CASUALTY INSURERS CAN MUSTER. IN LIGHT OF THE RECENT AVAILABILITY AND AFFORDABILITY CRISIS THAT REQUIRED OMNIBUS LANDMARK LEGISLATION TO RECTIFY IN NEW YORK AND OTHER STATES, WE MUST ALL BE EXTREMELY WARY OF INSURERS THAT PROFESS TO HAVE THE RESOURCES AND EXPERTISE TO UNDERWRITE SOPHISTICATED FINANCIAL GUARANTY BUSINESS SUCCESSFULLY AS A SIDELINE TO THEIR PRIMARY OPERATIONS.

THERE ARE OPTIONS OPEN TO THE SMALLER MULTILINE FINANCIAL GUARANTY OPERATIONS WHICH WILL BE PRECLUDED FROM CONTINUING IN THEIR PRESENT FORM IF A FINANCIAL GUARANTY BILL IS ENACTED. MY DEPARTMENT HAS OPENED THE DOORS TO

DISCUSSIONS WITH THE RATING ORGANIZATIONS TO PERMIT THESE SMALL OPERATIONS TO ORGANIZE WITH LESS HARD CAPITAL THAN WOULD OTHERWISE BE REQUIRED TO OBTAIN THE NECESSARY TRIPLE OR DOUBLE A RATING. THE HARD CAPITAL REQUIREMENT, SUBJECT TO THE MINIMUMS ESTABLISHED BY THIS LEGISLATURE, WOULD BE SUFFICIENT TO SUPPORT THEIR OPERATIONS AND WOULD BE SUPPLEMENTED WITH "SOFT CAPITAL" IN THE FORM OF GUARANTIES FROM THE PARENTS. SUGGESTIONS HAVE ALSO BEEN MADE THAT THE MULTILINE INSURERS SELL THEIR UNDERWRITING "EXPERTISE" FOR THE TYPES OF FINANCIAL GUARANTIES THEY SPECIALIZE IN TO ONE OF THE MONOLINE INSURERS. TWO OF THE PRINCIPLE OPPONENTS OF MONOLINE ARE PARTNERS IN MBIA AND PRESUMABLY COULD ACT AS MGAS FOR THE BUSINESS THEY NOW WRITE DIRECTLY. A THIRD ALTERNATIVE SUGGESTED WOULD INVOLVE THE FORMATION OF A CONSORTIUM. I AM SURE THAT THERE ARE OTHER METHODS BY WHICH THESE MULTILINE COMPANIES CAN PARTICIPATE IN THIS BUSINESS UNDER A MONOLINE APPROACH. FINALLY, IT SHOULD BE NOTED THAT THE TERM "MONOLINE" IS ACTUALLY A MISNOMER SINCE, IN ADDITION TO FINANCIAL GUARANTIES, THESE SPECIAL PURPOSE CORPORATIONS WOULD BE PERMITTED TO WRITE CREDIT, SURETY AND RESIDUAL VALUE INSURANCE. IN FACT, THE AUTHORITY TO WRITE THESE ADDITIONAL LINES WAS AN ACCOMMODATION TO THE MULTILINE COMPANIES.

SUMMARY OF NAIC MODEL FINANCIAL GUARANTY INSURANCE ACT

THE NAIC MODEL BILL REQUIRES THAT FINANCIAL GUARANTY BUSINESS BE CONFINED TO MONOLINE INSURERS WITH MINIMUM CAPITAL REQUIREMENTS AND LIMITATIONS ON THE TYPES OF GUARANTIES WHICH MAY BE WRITTEN. THE BILL DEFINES FINANCIAL GUARANTY INSURANCE AND THEN LIMITS THE TYPES OF GUARANTIES WHICH MAY BE INSURED. THIS FORMAT RESULTS IN A PROHIBITION AGAINST WRITING FINANCIAL GUARANTIES OF THE TYPE CONTAINED IN THE DEFINITION THAT ARE NOT SPECIFICALLY AUTHORIZED. THE TYPES OF GUARANTIES THUS PROHIBITED INCLUDES INTEREST RATE GUARANTIES, CURRENCY RATE GUARANTIES, AND GUARANTIES OF CONVERTIBILITY OF FOREIGN CURRENCY. THE ONLY TYPES OF GUARANTIES WHICH MAY BE WRITTEN ARE GUARANTIES OF SPECIFIED TYPES OF DEBT, EACH SUBJECT TO AGGREGATE LIMITS REFLECTING THEIR

RELATIVE RISKINESS.

NEW YORK'S CURRENT REGULATION NO. 61 PROVIDES FOR A SINGLE AGGREGATE LIMIT (300 to 1) FOR ALL MUNICIPAL BONDS GUARANTIED. THE TASK FORCE DIVIDED MUNICIPAL BONDS INTO THREE CATEGORIES (GENERAL OBLIGATIONS, SPECIAL REVENUE AND IDBs) AND SET DIFFERENT AGGREGATE LIMITS FOR EACH BASED UPON THEIR RELATIVE "RISKINESS". THIS APPROACH REQUIRES MORE CAPITAL FOR THOSE COMPANIES SPECIALIZING IN INSURING THE RISKIER TYPES OF MUNICIPAL BONDS AND IDBs. IN TOTAL, THE MODEL BILL ESTABLISHED EIGHT DISTINCT CATEGORIES AND FOR EACH PRESCRIBED SINGLE RISK LIMITATIONS AND AGGREGATE RISK LIMITATIONS, BOTH MEASURED AGAINST CAPITAL AND SURPLUS.

THE BILL PROVIDES FOR PERIODIC CONTRIBUTIONS TO A CONTINGENCY RESERVE BASED ON A PERCENTAGE OF PRINCIPLE GUARANTIED. CONTINGENCY RESERVES ARE REQUIRED TO PROVIDE FOR CATASTROPHIC LOSSES THAT MAY OCCUR IN THE EVENT OF A SEVERE ECONOMIC DOWNTURN. THIS RESERVE REQUIREMENT, TOGETHER WITH THE AGGREGATE RISK LIMITATIONS, WILL PREVENT PREMATURE DISTRIBUTION TO SHAREHOLDERS OF FUNDS THAT MAY BE NEEDED TO PAY FUTURE LOSSES. EXISTING CONTINGENCY RESERVE REQUIREMENTS (SUCH AS THOSE IN NEW YORK'S REGULATION 61) BASE THE BUILD UP OF THE CONTINGENCY RESERVE ON EARNED PREMIUMS, SO THE SMALLER THE PREMIUM THE SMALLER THE RESERVE. THE MODEL BASES CONTRIBUTIONS ON EXPOSURES WRITTEN. IT SHOULD BOTH PREVENT UNDERPRICING AND RESULT IN ADEQUATE RAINY DAY RESERVES. THE UNDERWRITERS' ABILITY TO PROJECT A CORPORATION'S FINANCIAL HEALTH IS MOST ACCURATE FOR THE NEAR TERM; THE FURTHER OUT THE PROJECTION, THE LESS RELIABLE THE PROJECTION WILL BE. THE MODEL BILL ALSO PROVIDES FOR AN UNEARNED PREMIUM RESERVE WHICH IS EARNED PROPORTIONATELY WITH THE EXPIRATION OF THE EXPOSURE.

THE MODEL BILL PERMITS CREDIT FOR REINSURANCE WITH AUTHORIZED COMPANIES,

SUBJECT TO LIMITATIONS IN THE EVENT THE REINSURER IS A MULTILINE COMPANY, AND PROVIDES THAT ALL REINSURANCE CONTRACTS ARE NONCANCELLABLE ON THE PART OF THE ASSUMING COMPANY. CREDIT IS PERMITTED FOR REINSURANCE PLACED WITH A MULTILINE REINSURER ONLY BECAUSE OF THE PRESENT LACK OF MONOLINE REINSURANCE CAPACITY. FINALLY, UNDER THE MODEL BILL FINANCIAL GUARANTY INSURANCE IS NOT COVERED BY THE STATE GUARANTY FUNDS.

IN CONCLUSION, IT IS ESSENTIAL THAT FINANCIAL GUARANTY INSURERS BECOME SUBJECT TO ADEQUATE REGULATION. I AM HOPEFUL THAT THIS HEARING TODAY WILL HELP STATE INSURANCE REGULATORS IN THEIR EFFORTS TO ENACT THE NAIC MODEL FINANCIAL GUARANTY BILL AND PROVIDE FOR MEANINGFUL REGULATION OF THIS RAPIDLY GROWING LINE OF INSURANCE.

FINANCIAL GUARANTY INSURANCE (EX 4) STUDY GROUP
FIRST AMENDMENT

(12/09/86)

BILL SECTION 1. The Insurance Law is amended by adding thereto a new Article ___, to read as follows:

Article___

FINANCIAL GUARANTY INSURANCE

Section 1. Definitions as used in this article:

(a) (1) "Financial guaranty insurance" means a surety bond, insurance policy or, when issued by an insurer, an indemnity contract and any guaranty similar to the foregoing types, under which loss is payable, upon proof of occurrence of financial loss to an insured claimant, obligee, or indemnitee, as a result of any of the following events:

(A) failure of any obligor on any debt instrument or other monetary obligation (including common or preferred stock guarantied under a surety bond, insurance policy or indemnity contract) to pay when due principal, interest, premium, dividend or purchase price of or on such instrument or obligation, when such failure is the result of a financial default or insolvency, regardless of whether such obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted;

(B) changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products;

(C) changes in the rate of exchange of currency;

(D) inconvertibility of one currency into another for any reason, or inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental authority;

(E) changes in the value of specific assets or commodities, financial or commodity indices or price levels in general; or

(F) other events which the commissioner determines are substantially similar to any of the foregoing.

(2) Notwithstanding paragraph (1) of this subsection, "financial guaranty insurance" shall not include:

(A) insurance of any loss resulting from any event described in paragraph (1) of subsection (a) of this section, if the loss is payable only upon the occurrence of any of the following, as specified in a surety bond, insurance policy or indemnity contract:

(i) a fortuitous physical event;

(ii) a failure of or deficiency in the operation of equipment; or

(iii) an inability to extract or recover a natural resource;

(B) any individual or schedule public official bond;

(C) any contract bond, including bid, payment or maintenance bond, or a performance bond where the bond is guarantying the execution of any contract other than a contract of indebtedness or other monetary obligation;

(D) any court bond required in connection with judicial, probate, bankruptcy or equity proceedings, including waiver, probate, open estate and life tenant bond;

(E) any bond running to the federal, state, county, municipal government, or other political subdivision, as a condition precedent to granting of a license to engage in a particular business or of a permit to exercise a particular privilege;

(F) any loss security bond or utility payment indemnity bond running to a governmental unit, railroad or charitable organization;

(G) any lease, purchase and sale or concessionaire surety bond;

(H) credit unemployment insurance, meaning insurance on a debtor in connection with a specific loan or other credit transaction, to provide payments to a creditor in the event of unemployment of the debtor for the installments or other periodic payments becoming due while a debtor is unemployed;

NOTE: (H) TO BE USED BY STATES WHICH DO NOT AUTHORIZE CREDIT UNEMPLOYMENT INSURANCE AS A SEPARATE LINE OF BUSINESS BUT DO PERMIT THIS LINE TO BE WRITTEN.

(I) credit insurance, meaning insurance indemnifying manufacturers, merchants or educational institutions extending credit against loss or damage resulting from nonpayment of debts owed to them for goods or services provided in the normal course of their business;

(J) guarantied investment contracts issued by life insurance companies which provide that the life insurer itself will make specified payments in exchange for specific premiums or contributions;

(K) residual value insurance authorized by paragraph ___ of section ___ of this chapter;

(L) mortgage guaranty insurance authorized by paragraph ___ of section ___ of this chapter;

(M) indemnity contracts or similar guaranties, to the extent that they are not otherwise limited or proscribed by this chapter, in which a life insurer:

(i) guaranties its obligations or indebtedness or the obligations or indebtedness of a subsidiary (as defined in section ____ of this chapter) other than a financial guaranty insurance corporation, provided that:

(I) to the extent that any such obligations or indebtedness are backed by specific assets, such assets must at all times be owned by the insurer or the subsidiary; and

(II) in the case of the guaranty of the obligations or indobtedness of the subsidiary that are not backed by specific assets of the life insurer, such guaranty terminates once the subsidiary ceases to be a subsidiary; or

(ii) guaranties obligations or indebtedness (including the obligation to substituts assets where appropriate) with respect to specific assets acquired by a life insurer in the course of normal investment activitiss and not for the purpose of resale with credit enhancement, or guarantiss obligations or indebtedness acquired by its subsidiary, provided that the assets acquired pursuant to this item (ii) have been:

(I) acquired by a special purpose entity, whose sole purpose is to acquire specific assets of the lifs insurer or the subsidiary and issue securities or participation certificates backed by such assets; or

(II) sold to an independent third party; or

(iii) guaranties obligations or indebtedness of an employee or agent of the life insurer; or

(N) any other form of insurance covering risks which the commissioner determines to be substantially similar to any of the foregoing.

(b) "Affiliate" means a person which, directly or indirectly, owns at least ten but less than twenty five percent of the financial guaranty insurance corporation or which is at least ten percent but less than twenty five percent, directly or indirectly, owned by a financial guaranty insurance corporation.

(c) "Average annual debt service" means the amount of insured unpaid principal and interest on an obligation multiplied by the number of such insured obligations (assuming that each obligation represents a $1,000 par value), divided by the amount equal to the aggregate life of all such obligations. This definition, expressed as a formula in regard to bonds, is as follows:

$$\text{Average Annual Debt Service} = \frac{\text{Total Debt Service} \times \text{Number of Bonds}}{\text{Bond Years}}$$

$$\text{Total Debt Service} = \text{Insured Unpaid Principal} + \text{Interest}$$

$$\text{Number of Bonds} = \frac{\text{Total Insurer Principal}}{1{,}000}$$

$$\text{Bond Years} = \text{Number of Bonds} \times \text{Term in Years}$$

(d) "Collateral" means cash or the market value of investment grade securities, other than securities evidencing an interest in the project or projects financed with the proceeds of the insured obligations, in an amount not to exceed the principal amount of the insured obligation; if

(1) deposited with the corporation, or

(2) held in trust by a trustee acceptable to the commissioner for the benefit of the corporation; or

(i) guaranties its obligations or indebtedness or the obligations or indebtedness of a subsidiary (as defined in section ____ of this chapter) other than a financial guaranty insurance corporation, provided that:

(I) to the extent that any such obligations or indebtedness are backed by specific assets, such assets must at all times be owned by the insurer or the subsidiary; and

(II) in the case of the guaranty of the obligations or indebtedness of the subsidiary that are not backed by specific assets of the life insurer, such guaranty terminates once the subsidiary ceases to be a subsidiary; or

(ii) guaranties obligations or indebtedness (including the obligation to substitute assets where appropriate) with respect to specific assets acquired by a life insurer in the course of normal investment activities and not for the purpose of resale with credit enhancement, or guaranties obligations or indebtedness acquired by its subsidiary, provided that the assets acquired pursuant to this item (ii) have been:

(I) acquired by a special purpose entity, whose sole purpose is to acquire specific assets of the life insurer or the subsidiary and issue securities or participation certificates backed by such assets; or

(II) sold to an independent third party; or

(iii) guaranties obligations or indebtedness of an employee or agent of the life insurer; or

(N) any other form of insurance covering risks which the commissioner determines to be substantially similar to any of the foregoing.

(b) "Affiliate" means a person which, directly or indirectly, owns at least ten but less than twenty five percent of the financial guaranty insurance corporation or which is at least ten percent but less than twenty five percent, directly or indirectly, owned by a financial guaranty insurance corporation.

(c) "Average annual debt service" means the amount of insured unpaid principal and interest on an obligation multiplied by the number of such insured obligations (assuming that each obligation represents a $1,000 par value), divided by the amount equal to the aggregate life of all such obligations. This definition, expressed as a formula in regard to bonds, is as follows:

$$\text{Average Annual Debt Service} = \frac{\text{Total Debt Service x Number of Bonds}}{\text{Bond Years}}$$

$$\text{Total Debt Service} = \text{Insured Unpaid Principal} + \text{Interest}$$

$$\text{Number of Bonds} = \frac{\text{Total Insurer Principal}}{1{,}000}$$

$$\text{Bond Years} = \text{Number of Bonds x Term in Years}$$

(d) "Collateral" means cash or the market value of investment grade securities, other than securities evidencing an interest in the project or projects financed with the proceeds of the insured obligations, in an amount not to exceed the principal amount of the insured obligation; if

(1) deposited with the corporation, or

(2) held in trust by a trustee acceptable to the commissioner for the benefit of the corporation; or

(3) held in trust, pursuant to the bond indenture, by a trustee acceptable to the commissioner, for the benefit of bondholders in the form of sinking funds or other reserves which may be used solely for the payment of debt service.

(e) "Contingency reserve" means an additional liability reserve established to protect policyholders against the effects of adverse economic cycles or other unforeseen circumstances.

(f) "Financial guaranty insurance corporation" means an insurer licensed to transact the business of financial guaranty insurance in this state.

(g) "Governmental unit" means a state, territory, or possession of the United States of America, the District of Columbia, a province of Canada, a municipality, or a political subdivision of any of the foregoing, or any public agency or instrumentality thereof.

(h) "Guaranties of consumer debt obligations" means insurance policies indemnifying regulated financial institutions against loss or damage resulting from non-payment of debts owed to them for extensions of credit to individuals for non-business purposes provided in the normal course of their business. Policies providing such coverage shall contain a provision that all liability terminates upon sale or transfer of the underlying obligation to any transferee which is not an insured of the financial guaranty insurance corporation under a similar policy.

(i) "Industrial development bond" means any security, or other instrument under which a payment obligation is created, issued by or on behalf of a governmental unit to finance a project serving a private industrial, commercial or manufacturing purpose and not payable or guarantied by a governmental unit.

(j) "Investment grade" means that the obligation has been determined to be in one of the top four generic lettered rating classifications by a securities rating agency acceptable to the commissioner, that the obligation has been identified in writing by such a rating agency as an insurable risk deemed to be of investment grade quality for purposes of insurance, or that the obligation has been determined to be investment grade (as indicated by a "yes" rating) by the Securities Valuation Office of the National Association of Insurance Commissioners.

(k) "Municipal obligation bond" means any security, or other instrument, including a state lease but not a lease of any other governmental entity, under which a payment obligation is created, issued by or on behalf of a governmental unit to finance a project serving a substantial public purpose, and

(1) payable from tax revenues, but not tax allocations, within the jurisdiction of such governmental unit; or

(2) payable or guarantied by the United States of America or any agency, department or instrumentality thereof, or by a state housing agency; or

(3) payable from rates or charges (but not tolls) levied or collected in respect of a non-nuclear utility project, public transportation facility (other than an airport facility) or public higher education facility; or

(4) with respect to lease obligations, payable from future appropriations.

(l) "Reinsurance" means cessions qualifying for credit under section 5 of this article.

(m) "Security" or "secured" means:

(1) a deposit at least equal to the full amount of the principal of the insured obligation; or

(2) collateral, as defined by subsection (d) of this section, at least equal to the full amount of the principal of the insured obligation, or the scheduled cash flow from which is equal to or greater than the scheduled debt service on the insured obligation and is due prior to the date when the scheduled debt service is payable; or

(3) property; provided the corporation has possession of evidence of the right, title or authority to claim or foreclose thoreon or otherwise dispose of such property for value, the scheduled cash flow from which, or market value thereof, is at least equal to the scheduled debt service on the insured obligation and is due prior to the date when the scheduled debt service is payable.

(n) "Special revenue bond" means any security, or other instrument under which a payment obligation is created, issued by or on behalf of a governmental unit to finance a project serving a substantial public purpose and not payable from the sources enumerated in subsection (k) of this section in connection with the payment of municipal obligation bonds.

(o) "Total liability" of a financial guaranty insurance corporation means the aggregate amount of insured unpaid principal, interest and other monetary payments, if any, of guarantied obligations insured or assumed, less reinsurance and less collateral.

Section 2. Organization; Financial Requirements.

(a) A financial guaranty insurance corporation may be organized and licensed in the manner prescribed in section ____ of this chapter, except as modified by the following provisions:

(1) a corporation organized for the purpose of transacting financial guaranty insurance may, subject to all the provisions of this chapter applicable thereto, be licensed to transact the following additional kinds of insurance:

(A) residuel value insurance, as authorized by section____of this chapter;

(B) surety insurance, as authorized by section____of this chapter; and

(C) credit insurance, as authorized by section____of this chapter;

(2) a corporation may only assume those lines of insurance for which it is licensed to write direct business;

(3) prior to the issuance of a license, a corporation shall submit for the approval of the commissioner a plan of operation detailing the types and projected diversification of guarantiee that will be issued, the underwriting procedures that will be followed, managerial oversight methods, investment policies, and such other matters as may be prescribed by the commissioner;

(4) a financial guaranty corporation shall be subject to all of the provisions of this chapter applicable to property/casualty insurers to the extent that such provisions are not inconsistent with the provisions of this article; and

(5) a financial guaranty insurance corporation's investments in any one entity insured by that corporation shall not exceed one percent of its admitted assets at last year-end.

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(b) A financial guaranty corporation shall not transact business unless:

(1) it has paid-in capital of at least ten million dollars and paid-in surplus of at least forty million dollars, and shall at all times thereafter maintain a minimum surplus to policyholders of thirty-five million dollars;

(2) it establishes a contingency reserve, net of reinsurance, as follows:

(A) the contributions to the reserve shall be calculated by applying the following porcentagas to the net principal written each calendar year of guaranties of:

(i) municipal obligation bonds, 0.8 percent;

(ii) special revenue bonds, 1.2 porcent;

(iii) industrial development bonds, 1.6 percent;

(iv) secured investment grade obligations, 1.6 parcent;

(v) investment grade obligations not secured, 2.5 percent; and

(vi) all other obligations guarantied, 3.0 percent;

(B) (i) quarterly additions to the reserve for items (i), (ii) and (iii) of subparagraph (A) above shall be equal to the greater of 1/80th of the amounts derived by applying the appropriate contribution specified in subparagraph (A) or fifty percent of the quarterly earned premiums on such guarantios and shall be maintained for a poriod of twenty years; and

(ii) quarterly additions to the reserve for items (iv), (v) and (vi) of subparagraph (A) abova shall be equal to the greatar of 1/40th of the amounts derived by applying the appropriate contribution specified in subparagraph (A) or fifty percent of the quarterly earned premiums on such guaranties and shall be maintained for a period of ten years;

(C) the reserve may be released thereafter in the same manner, except that a part of the reserve may be released proportional to the reduction in net total liabilities resulting from reinsurance and the reinsurer shall, on the effective date of the reinsurance, establish a reserve in an amount equal to the amount released; and

(D) withdrawals from the contingency reserve, to the extent of any excess, may be made from the earliest contributions to such reserve remaining therein:

(i) with the approval of the commissioner, in any year in which the actual incurred losses exceed thirty-five percent of earned premiums, or

(ii) upon thirty days prior notice to the commissioner, provided that the contingency reserve has been in existence for forty quarters, for reserves subject to item (i) of subparagraph (B) of this paragraph, and twenty quarters, for reserves subject to item (ii) of subparagraph (B) of this paragraph, upon demonstration that the amount carried is excessive in relation to the corporation's outstanding obligations;

(3) in addition to the contingency reserve, the case basis method or other method as may be prescribed by the commissioner shall be used to determine loss reserves, in a manner consistent with section ____ of this chapter, which shall include a reserve for claims reported and unpaid net of collateral. A deduction from

loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the insurer as of the date of the computation of any such reserve. The discount rate shall be adjusted at the end of each calendar year; and

(4) it shall maintain an unearned premium reserve, net of reinsurance, computed on the monthly pro rata basis, where such premiums are paid on an installment basis. All other such premiums paid shall be earned proportionately with the expiration of exposure, or by such other method as the commissioner may prescribe or approve.

Section 3. Limitations.

(a) Financial guaranty insurance may be transacted in this state only by a corporation licensed for such purpose.

(b) Permissible guaranties.

(1) Financial guaranty insurance shall be written only to insure timely payment of contractual obligations, including principal and interest, of:

(A) municipal obligation bonds;

(B) special revenue bonds;

(C) industrial development bonds;

(D) Corporate obligations;

(E) limited partnership obligations;

(F) pass through securities, other than those secured by mortgages on real property which are insurable by a mortgage guaranty insurer;

(G) installment purchase agreements executed as a condition of sale;

(H) consumer debt obligations; and

(I) any other debt instrument or monetary obligation that the commissioner determines to be substantially similar to any of the foregoing.

(2) A corporation may only issue a financial guaranty insurance policy to a policyholder who discloses in any prospectus or advertisement that makes mention of the financial guaranty that such insurance is not covered by the guaranty fund specified in article___ of this chapter.

(c) At least 95% of a corporation's outstanding total liability on the kinds of obligations enumerated in paragraphs (1), (2) and (3) of subsection (b) of this section shall be investment grade.

(d) Aggregate risk limits. The corporation must at all times maintain capital, surplus and contingency reserve in the aggregate no less than the sum of:

(1) 0.2857 percent of the total liabilities outstanding under guaranties of municipal obligation bonds; and

(2) 0.5714 percent of the total liabilities outstanding under guaranties of special revenue bonds; and

(3) 1.0 percent of the total liabilities outstanding under guaranties of:

(A) industrial development bonds; and

(B) secured obligations issued by entities which had an investment grade rating independent of the security pledged; and

(C) secured obligations which were given an investment grade rating as a result of the security pledged, provided, however, that if the security is property, it is not property financed with the proceeds of the insured obligations; provided that,

(D) if the amount of security required by subparagraph (B) or (C) of this paragraph is not maintained, that proportion of the obligation insured which is not so secured shall be subject to the aggregote limits specified in paragraph (4) of this subsection; and

(4) 4.0 percent of the total liabilitios outstanding under guaranties of any other obligations of investment grade, and consumer debt obligations; and

(5) 10.0 percent of the total liabilities outstanding under guaranties of other obligations not of investment grade, other than consumer debt obligations; and

(6) surplus determined by the commissioner to be adequate to support the writing of residual value insurance, surety insurance and credit insurance, if the corporation has elected to transact such kinds of insurance pursuant to subsection (a) of section 2 of this article.

(e) Single risk limits. A financial guaranty insurance corporation doing business in this state shall limit its exposure to loss, net of collateral and reinsurance, as follows:

(1) for municipal obligation bonds and special revenue bonds:

(A) the insured average annual debt service with respect to any one entity and backed by a single revenue source may not exceed ten percent of the aggregate of the corporation's capital, surplus and contingency reserve; and

(B) the insured unpaid principal issued by a single entity and backed by a single revenue source may not exceed fifty percent of the aggregate of the corporation's capital, surplus and contingency reserve;

(2) for all other financial guaranties, the insured unpaid principal for any one entity may not exceed ten percent of the aggregate of the corporation's capital, surplus and contingency reserve.

(f) If a corporation's exposure to loss shall at any time exceed the limitations proscribed by subsection (d) above, it shall cease transecting any new business until its exposure to loss no longer exceeds said limitations.

(g) Notwithstanding the provisions of this article, an insurer writing, but which is not licensed to write, financial guaranty insurance in this state, shall be subject to all the provisions, except for subsection (a) and paragraph (1) of subsection (b) of section 2, of this article, and:

(1) may continue to write financial guaranties of the type authorized by subsection (b) of this section:

(A) for a period not to exceed two years from the effective date of this article, provided that within six months of the effective date of this article, application shall be made to the commissioner to organize a financial guaranty insurance corporation, controlled by or under common control with such insurer, which financial guaranty insurance corporation, once licensed, shall immediately assume all of the financial guaranty insurance in force on the books of the insurer which was written on or after the effective date of this article; or,

(B) for a period not to exceed twelve months from the effective date of this article, in the case of an insurer transacting only financial guaranty insurance prior to the effective date of this article and which has complied with all of the requirements for licensing as a financial guaranty insurer under section 2 of this article, provided that it makes application to amend its current license to that of a financial guaranty insurance corporation within 60 days of the effective date of this article;

(2) which does not make application for a financial guaranty insurance corporation pursuant to paragraph (1), shall cease writing any new financial guaranty insurance business within six months of the effective date of this article. Such insurer:

(A) may reinsure its net in force business with a licensed financial guaranty insurance corporation; or

(B) may, subject to the prior approval of its domiciliary commissioner, reinsure all or part of its net in force business in accordance with the requirements of paragraph (2) of subsection (a) of section 5 of this article, except that subparagraphs (B), (D), (E), (F) and (G) of paragraph (2) thereof shall not be applicable. The assuming insurer shall maintain reserves for such reinsured business in the manner applicable to the ceding insurer under paragraph 3 hereof; or

(C) may thereafter continue the risks then in force and, with thirty days prior written notice to its domiciliary commissioner, write new financial guaranty policies provided the writing of such policies is reasonably prudent to mitigate either the amount of or possibility of loss in connection with business written prior to the effective date of this act. Provided, however, that an insurer must receive the prior approval of its domiciliary commissioner before writing any new financial guaranty insurance policies that would have the effect of increasing its risk of loss;

(3) shall, for all guaranties in force prior to the effective date of this article, including those which fall under the definition of financial guaranty insurance contained in paragraph (a) of section 1 of this article, be subject to the reserve requirements applicable for general obligation municipal bond guaranties in effect prior to the effective date of this article. To the extent that the insurer's contingency reserves maintained as of the effective date of this article are less than those required for municipal bond guaranties, the insurer shall have three years to bring its reserves into compliance, except that a part of the reserve may be released proportional to the reduction in net total liabilities resulting from reinsurance, provided that the reinsurer shall, on the effective date of the reinsurance, establish a reserve in an amount equal to the amount released and, in addition, a part of the reserve may be released with the approval of the commissioner upon demonstration that the amount carried is excessive in relation to the corporation's outstanding obligations; and

FOR STATES WHICH DO NOT CURRENTLY HAVE MUNICIPAL BOND INSURANCE IN EFFECT SUBPARAGRAPH (3) SHOULD READ AS FOLLOWS:

(3) shall, for all guaranties in force prior to the effective date of this article including those which fall under the definition of financial guaranty insurance contained in paragraph (a) of section 1 of this article, maintain a special reserve which shall consist of allocations of sums representing fifty percent of the earned premiums on financial guaranty insurance policies. Allocations to such reserve made during each calendar year shall be maintained for a period of at least 240 months, except that withdrawals may be made by the insurer in any year in which the actual paid losses on the said type of policy exceed 35 percent of the earned premiums thereon, but no such releases shall be made without the prior written approval of the commissioner. Provided that the contingency reserve has been in existence for at least 120 months, the insurer may apply to the commissioner for a release of a reasonable percentage of the reserve upon a demonstration that the amount carried is excessive in relation to the insurer's obligation on financial guaranty insurance policies; and

(4) shall be subject to the reserve requirements applicable to financial guaranty insurance corporations, for business written on and after the effective date of this article.

Section 4. Filing of Policy Forms and Rates.

(a) Policy forms and any amendments thereto shall be filed with the commissioner within thirty days of their use by the insurer. Every such policy shall provide that there shall be no acceleration of payments due under the guarantied obligations except at the option of the corporation. The commissioner may proscriba additional minimum policy provisions determined by the commissioner to be necessary or appropriate to protect policyholders, claimants, obligees or indemnitees.

(b) Rates shall not be excessive, inadequate, unfairly discriminatory, destructive of competition or detrimental to the solvency of the insurer.* Criteria and guidelines utilized by insurers in establishing rating categories and ranges of rates to be utilized shall be filed with the commissioner for information prior to their use by the insurer.

(c) All such filings shall be available for public inspection at the insurance department.

Section 5. Reinsurance.

(a) For financial guaranty insurance which takes effect on or after the effective date of this article, a financial guaranty insurance corporation shall receive credit for reinsurance in accordance with the provisions of this chapter applicable to property and casualty insurers as an asset or as a reduction from liabilities provided that such reinsurance is subject to an agreement that for its stated term and with respect to any financial guaranty insurance in force, the reinsurance agreement may only be terminated or amended at the request of the ceding company or at the discretion of the commissioner acting as rehabilitator, liquidator or receiver of the ceding or assuming company and that such reinsurance:

*NOTE: IF THIS STANDARD IS CONTAINED IN THE STATE'S INSURANCE LAW A SECTION REFERENCE MAY BE SUBSTITUTED.

(1) placed with another financial guaranty insurance corporation licensed under this article or an insurer writing only financial guaranty insurance as is or would be permitted by this article; or

(2) placed with another type of insurer licensed to write surety insurance, if such insurer:

(A) has and maintains surplus to policyholder's of at least thirty five million dollars;

(B) establishes and maintains the reserves required in section 2 of this article, except that if the reinsurance agreement is not pro rata the contribution to the contingency reserve shall be equal to 50 percent of the quarterly earned reinsurance premium;

(C) complies with the provisions of subsections (d) and (f) of section 3 of this article, except that its maximum aggregate assumed total liability shall be one half that permitted for a financial guaranty insurance corporation;

(D) complies with the provisions of subsection (e) of section 3 of this article;

(E) is not a parent, another subsidiary of the parent of the financial guaranty insurance corporation, or a subsidiary of the financial guaranty insurance corporation. Direct or indirect ownership interest of 25 percent or more shall be deemed a parent/subsidiary relationship;

(F) is an affiliate of the financial guaranty insurance corporation, such affiliate shall not assume a percentage of the corporation's total liability in excess of its equity interest in the corporation; and

(G) assumes, together with all other reinsurers subject to this paragraph, less then 50 percent of the total liability remaining after deducting any reinsurance placed with another financial guaranty insurance corporation; and

(3) if placed with an unauthorized or unaccredited reinsurer which otherwise meets the provisions of the opening paragraph, paragraph (1) or subparagraphs (A), (E), (F), and (G) of paragraph (2) of subsection (a) of this section, in an amount not exceeding the liabilities carried by the ceding insurer for amounts withheld under a reinsurance treaty with such reinsurer or amounts deposited by such reinsurer as security for the payment of obligations under the trsaty, if such funds or depasit are held subject to withdrawal by, and under the control of the ceding insurer.

(b) In determining whether the corporation meets the limitations imposod by subsection (d) of section 3 of this article, in addition to credit for other types of qualifying reinsurance, the corporation's aggregate risk may be reduced to the extent of the limit for aggregate excess reinsurance but, in no event, in an amount greater than the amount of the aggregate risk which will become due during the unexpired term of such reinsurance agreement in excess of the corporation's retention pursuant to such reinsurance agreement.

BILL SECTION 2. The Insurance Law is amended by adding thereto a new subsection ___ to section ___, to read as follows:

Subsection ___. "Residual value insurance" meaning insurance issued in connection with a lease or contract which sets forth a specific termination value at the end of the term of the lease or contract for the property covered by such lease or contract, and which insures against loss of economic value of tangible personal property or real property or improvements thereto except loss due to physical damage to property, provided, however, that no insurance may be written as residual value insurance if it may be written as financial guaranty insurance by a financial guaranty insurance corporation pursuant to article ___ of this chapter.

SECTION 2 NOTE: TO BE ADDED BY STATES WHICH DO NOT NOW SPECIFICALLY AUTHORIZE RESIDUAL VALUE INSURANCE AS A SEPARATE KIND OF INSURANCE.

BILL SECTION 3. The Insurance Law is amended by adding thereto a new subsection ___ to section ___, to read as follows:

Subsection ___. "Financial guaranty insurance" meaning the kind of insurance specified in article ___ of this chapter.

SECTION 3 NOTE: TO BE ADDED TO SECTION OF INSURANCE LAW WHICH AUTHORIZES SPECIFIED KINDS OF INSURANCE.

BILL SECTION 4. The Insurance Law is amended by amending subsections and to section , to read as follows:

SECTION 4 NOTE 1: FOR THOSE STATES WHICH HAVE A SEPARATE DEFINITION OF "SURETY INSURANCE ADD TO THE END OF THE DEFINITION:

Subsection ____ ...., provided, however, that no insurance may be written as surety insurance if it falls within the definition of financial guaranty insurance as set forth in paragraph one of subsection (a) of section (1) of article ____ of this chapter;

SECTION 4 NOTE 2: FOR THOSE STATES WHICH COMBINE FIDELITY AND SURETY AUTHORITY IN A SINGLE DEFINITION A CLEAN UP PROVISION IS NECESSARY TO DEFINE THEM SEPARATELY. SUGGESTED SIMPLIFIED LANGUAGE FOLLOWS:

Subsection_____. "Fidelity insurance," means:

(A) Guaranteeing the fidelity of persons holding positions of public or private trust; and indemnifying banks, thrifts, brokers and other financial institutions against loss of money, securities, negotiable instruments, other specified valuable papers and tangible items of personal property caused by larceny, misplacement, destruction or other stated perils including loss while being transported in an armored motor vehicle or by messenger; and insurance for loss caused by the forgary of signatures on, or alteration of, specified documents and valuable papers; and

(B) Insurance against losses that financial institutions become legally obligated to pay by reason of loss of customers' property from safe deposit boxes.

Subsection ____. "Surety insurance" means:

(A) A contract bond; including a bid, payment or maintenance bond, or a performance bond where the bond is guarantying the exeсution of any contract other then a contract of indebtedness or other monetary obligation; and

(B) An indemnity bond for the benefit of a public body, railroad or charitable organization; a lost security or utility payment bond;

(C) Becoming surety on, or guaranteeing the performance of, any lawful contract, not specifically provided for in this paragraph, where the bond is guarantying the execution of any contract other then a contract of indebtedness or other monetary obligation, except:

(i) mortgage guaranty insurance, which may only be written by an insurer authorized to write such insurance pursuant to article _____ of this chapter, or

(ii) financial guaranty insurance as defined by paragraph one of subsection (a) of section (1) of article _____ of this chapter, or

(iii) any insurance contract except as authorized pursuant to section ____ (INSERT REFERENCE TO SECTION AUTHORIZING REISURANCE BUSINESS); and

(D) Becoming surety on, or guaranteeing the performance of, bonds and undertakings required or permitted in all judicial proceedings or otherwise by law allowed, including surety bonds accepted by states and municipal authorities in lieu of deposits as security for the performance of insurance contracts.

Subsection ____. "Credit insurance " means....., provided, however, that no insurance may be written as credit insurance if it falls within the definition of financial guaranty insurance as set forth in paragraph one of subsection (a) of section (1) of article ____ of this chapter;

SECTION 4 NOTE 3: TO BE ADDED TO SECTION OF INSURANCE LAW WHICH AUTHORIZES SPECIFIED KINDS OF INSURANCE.

BILL SECTION 5. This act shall take effect on the first day of January next succeeding the date on which it shall becomm law, provided, however, that the Commissioner may, prior to such date, promulgate such rules and regulations as are necessary for the timely implementation of this act.

NOTE: Section 3 of the proposed POST-ASSESSMENT PROPERTY AND LIABILITY INSURANCE GUARANTY ASSOCIATION MODEL ACT and appropriate provisions of existing state laws defining the scope of their security fund should be amended to exclude the following kinds of insurance:

1. surety insurance;
2. mortgage guaranty insurance;
3. residual value insurance;
4. financial guaranty insurance; and
5. credit insurance.

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FINANCIAL GUARANTY INSURANCE (EX 4) STUDY GROUP

MODEL BILL MEMO

TO ACCOMPANY FINANCIAL GUARANTY INSURANCE MODEL BILL
AS AMENDED DECEMBER 9,1986

1. **Purpose**:

-- To define "financial guaranty insurance" as a separate kind of insurance.

-- To authorize the formation and licensing of financial guaranty insurance corporations which would essentially be monoline insurers but would also be permitted to write surety, residual value and certain types of credit insurance.

-- To prohibit multiline property/casualty insurers from writing financial guaranty insurance after a phasing-out period.

-- To specify the types of obligations for which financial guaranties may be written by a financial guaranty insurance corporation which would include municipal and corporate bonds.

-- To prohibit the writing of guaranties for other types of obligations (unless substantially similar) without further enabling legislation.

-- To establish a regulatory framework including realistic capital and reserve requirements, prudent aggregate and single risk limitations and appropriate reinsurance requirements.

-- To redefine surety insurance by eliminating the kinds of transactions which become financial guaranty insurance subject to the provisions of new Article ___.

-- To redefine credit insurance by eliminating the kinds of transactions which become financial guaranty insurance subject to the provisions of new Article ___.

-- To provide that financial guaranty insurance, surety insurance, residual value insurance and certain types of credit insurance are kinds of insurance which will not be covered by the Property/Casualty Insurance Security Fund (EACH STATE TO USE NAME OF ITS GUARANTY FUND).

2. <u>**Summary of Provisions**</u>:

-- <u>Bill Section 1</u> --

Adds a new Article ___ to the Insurance Law defining and authorizing the sale of financial guaranty insurance in the following manner:

<u>Section 1</u> contains definitions.

<u>Subsection (a)(1)</u> lists six types of transactions which, when effected by an insurer, are financial guaranty insurance. These include:

A. guaranties of indebtedness;
B. interest rate guaranties;
C. currency rate guaranties;
D. guaranties of payment in the event of inconvertibility of or inability to withdraw foreign currency;
E. guaranties of financial or commodity indices; and
F. any other guaranties found to be substantially similar by the Insurance Commissioner.

<u>Subsection (a)(2)</u> provides that, notwithstanding their falling within the literal definitions of (a)(1), certain enumerated transactions shall not be considered financial guaranty insurance. These include traditional types of surety contracts and credit insurance. In addition, residual value insurance, mortgage guaranty insurance and credit unemployment insurance (FOR STATES WHICH DEFINE THIS AS A SEPARATE KIND OF INSURANCE) would not be treated as financial guaranty insurance. Nor would

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-- To establish a regulatory framework including realistic capital and reserve requirements, prudent aggregate and single risk limitations and appropriate reinsurance requirements.

-- To redefine surety insurance by eliminating the kinds of transactions which become financial guaranty insurance subject to the provisions of new Article ___.

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F. any other guaranties found to be substantially similar by the Insurance Commissioner.

Subsection (a)(2) provides that, notwithstanding their falling within the literal definitions of (a)(1), certain enumerated transactions shall not be considered financial guaranty insurance. These include traditional types of surety contracts and credit insurance. In addition, residual value insurance, mortgage guaranty insurance and credit unemployment insurance (FOR STATES WHICH DEFINE THIS AS A SEPARATE KIND OF INSURANCE) would not be treated as financial guaranty insurance. Nor would guarantied investment contracts and certain indemnity contracts issued by life insurers be treated as financial guaranty insurance. Such contracts are subject to limitations contained in the Insurance Law and are entered into for investment portfolio management purposes and not to do a financial guaranty insurance business.

Subsections (b) through (o) contain definitions of the following key terms:

Affiliate;

Average annual debt service;

Collateral;

Contingency reserve;

Financial guaranty insurance corporation;

Governmental unit;

Guaranties of consumer debt obligations;

Industrial development bond;

Investment grade;

Municipal obligation bond;

Reinsurance;

Security or secured;

Special revenue bond; and

Total liability.

Section 2(a) specifies procedures for the organization and licensing of a financial guaranty insurance corporation, which parallel those for property/casualty insurers with three exceptions:

-- In addition to financial guaranty insurance, a corporation may only be empowered to transact residual value, surety and certain types of credit insurance.

-- A financial guaranty insurance corporation's reinsurance assumptions are limited to those lines it may write directly.

-- A plan of operation must be submitted to and approved by the Insurance Commissioner. The plan must detail the types of guaranties to be issued, underwriting procedures, managerial oversight methods, investment policies and any other matters prescribed by the Commissioner.

-- A corporation may not invest more than 1% of its admitted assets in any entity it insures.

Section 2(b) prescribes minimum capital, minimum surplus, surplus to be maintained, and contingency, loss and unearned premium reserve requirements for a corporation as follows:

-- paid-in capital of at least $10 million;

-- paid-in surplus of at least $40 million;

-- minimum surplus to policyholders to be maintained of at least $35 million;

-- contingency reserve computed on the basis of the net outstanding exposure to loss, with different requirements for each class of obligations guarantied. The reserve will be accumulated over time and provision is made for release after a specified period,

(i) if it is determined that the reserve is excessive (e.g., reserves for liabilities that have expired because their term was shorter than the required reserve period), (ii) whenever the losses incurred exceed 35%, or (iii) if a portion of the risk has been reinsured. The reinsurer must initially establish a reserve in an amount equal to the amount released by the ceding insurer; and

-- prescribes methods for maintaining loss reserves and unearned premium reserves.

Section 3(a) limits the doing of financial guaranty insurance to a corporation licensed for such purpose, which corporation may only be licensed to write financial guaranty, surety, residual value and credit insurance.

Section 3(b)(1) enumerates permissible guaranties. Section 1(a) of the bill defines six types of transactions which, if effected by an insurer, would constitute doing a financial guaranty insurance business. Section 3(b)(1) limits guaranties that may be issued by financial guaranty insurance corporations to those transactions of the first type only, i.e., guaranties of indebtedness. It further limits the types of indebtedness on which principal and interest may be guarantied to:

-- municipal obligations;
-- special revenue and industrial development bonds;
-- corporate or limited partnership obligations;
-- specified pass through securities;

-- installment purchase agreements;

-- consumer debt obligations; and

-- other instruments or obligations which the Commissioner determines to be substantially similar to the foregoing.

Section 3(b)(2) further limits the writing of guaranties to policyholders who agree to disclose in any prospectus or advertisement that makes mention of the financial guaranty that such insurance is not covered by the Property/Casualty Insurance Security Fund (EACH STATE TO USE NAME OF ITS GUARANTY FUND).

Section 3(c) provides that 95% of municipal obligation, special revenue and industrial development bonds guarantied must be of investment grade.

Section 3(d) entitled "aggregate risk limits", requires the corporation to maintain capital, surplus and contingency reserve in the aggregate of a specified percentage of the total liabilities outstanding, depending upon the type of indebtedness guarantied. Those types of indebtedness considered to be riskier require the maintenance of a larger amount of capital, surplus and contingency reserve. The actual amounts required under the bill will reflect the corporation's mix of business. For example, a corporation would have to maintain twice as much to guaranty the same amount of special revenue bonds as it would to guaranty only municipal obligation bonds. The risk limits provided are as follows:

-- 350 to 1 for municipal obligation bonds;

-- 175 to 1 for special revenue bonds;

-- 100 to 1 for industrial development bonds; secured (by a deposit, collateral, or real or personnal property) corporate obligations of investment grade; and corporate obligations which are of investment grade because they are secured, provided, however, that the security pledged may not have been purchased with the proceeds of the insured obligations;

-- 25 to 1 for other investment grade obligations and consumer debt; and

-- 10 to 1 for all other obligations which may be guarantied.

Section 3(e) limits a corporation's net exposure to loss on guaranties of any one entity backed by a single revenue source. (Limitation of risk is a concept applicable to most kinds of insurance.)

Section 3(f) provides that if the aggregate limits specified in Section 6703(d) are exceeded, a financial guaranty insurance corporation shall cease transacting any new business until its exposure to loss no longer exceeds the limits.

Section 3(g) contains "grandfather" provisions which permit a property/casualty insurer currently writing financial guaranty insurance to:

-- continue writing financial guaranty insurance for up to two years, provided that within six months it shall commence the organization of a financial guaranty insurance corporation which, when licensed, will assume all of the financial guaranty insurance written on and after the effective date of this law; or

-- if it is only writing financial guaranty insurance, continue writing such insurance for up to twelve months, provided that within sixty days it shall apply to amend its license to that of a financial guaranty insurance corporation; or

-- if it elects not to organize a financial guaranty insurance corporation, it shall cease writing financial guaranties within six months of the effective date of this law. Provision is made for appropriate run-off of the in-force business.

Section 4(a) provides that corporations must file all policy forms within thirty days of their use. All policies must provide that there shall be no acceleration of payments except at the option of the financial guaranty insurance corporation. The Commissioner is authorized to prescribe additional minimum policy provisions determined to be necessary or appropriate to protect interested persons.

Section 4(b) and (c) contain traditional rating standards and criteria and require that guidelines used in establishing rating categories and ranges of rates shall be filed with the Commissioner prior to their use and are available for public inspection.

Section 5(a) establishes reinsurance standards for financial guaranty insurance corporations. In order for a corporation to receive credit for reinsurance, the reinsurance agreement must provide that it may only be cancelled or amended at the request of the corporation or at the discretion of the Commissioner acting as rehabilitator, liquidator or receiver and it must place such reinsurance with:

1. a licensed financial guaranty insurance corporation or an insurer writing only financial guaranty insurance permitted by Article ; or

2. another type of insurer licensed to write fidelity and surety insurance, subject to the following limitations applicable to the reinsurer;

-- it has and maintains a surplus to policyholders of at least $35 million;

-- it establishes and maintains the reserves required of a corporation in Section 2, except that for other than pro rata assumptions the prescribed method for establishing a contingency reserve is modified;

-- the aggregate exposure that may be assumed is one-half that permitted for a corporation;

-- it complies with the single risk limitations applicable to financial guaranty insurance corporations;

-- it is not a parent or another subsidiary of the parent of the financial guaranty insurance corporation or a subsidiary of the financial guaranty insurance corporation itself. A parent/subsidiary relationship shall be deemed if there is direct or indirect ownership interest of 25% or more;

-- if it is an affiliate of the financial guaranty insurance corporation, it does not assume total liability of the financial guaranty insurance corporation in an amount in excess of the affiliate's equity interest in the financial guaranty insurance corporation. Affiliate is defined in Section 1(c) as a person which owns, directly or indirectly, at least 10% but less than 25% of the financial guaranty corporation, or an entity in which the financial guaranty corporation, directly or indirectly, owns at least 10% but less than 25%; and

-- it assumes, together with all other qualifying property/casualty insurers, less than 50% of the total liability remaining after deducting reinsurance ceded to insurers writing only financial guaranty insurance.

3. a reinsurer which is not authorized or accredited, meeting certain specified requirements of those set forth in 2 above. Credit for such reinsurance is limited to amounts withheld by the ceding financial guaranty insurance corporation or deposits furnished by the reinsurer and under the control of the financial guaranty insurance corporation.

<u>Section 5(b)</u> limits credit for aggregate excess reinsurance in determining compliance with the aggregate risk limitation provisions of Section 3(d).

-- <u>Bill Section 2</u>

Adds a definition of "residual value insurance" and provides that no insurance may be written as residual value insurance if it may be written as financial guaranty insurance by a financial guaranty insurance corporation.

-- <u>Bill Section 3</u>

Adds a definition of "financial guaranty insurance" as that kind of insurance defined in Subsection (a)(1) of Section 1 of Article ____.

-- <u>Bill Section 4</u>

1a. FOR STATES WHICH HAVE A SEPARATE DEFINITION FOR SURETY INSURANCE:

A provision that no insurer can write business as surety insurance if it fits within the definition of financial guaranty insurance in Article ____. (Bill Section 1)

1b. FOR STATES WHICH COMBINE FIDELITY AND SURETY AUTHORITY IN A SINGLE DEFINITION:

A provision to define fidelity and surety insurance separately with simplified language and a provision that no insurer can write business as surety insurance if it fits within the definition of financial guaranty insurance in Article ____. (Bill Section 1)

2. A provision that no insurer can write business as credit insurance if it fits within the definition of financial guaranty insurance in Article ____. (Bill Section 1)

Bill Section 5

Provides for a January first effective date and empowers the Commissioner to promulgate rules and regulations which are necessary for the timely implementation of the act.

NOTE: SECTION 3 OF THE PROPOSED POST-ASSESSMENT PROPERTY AND LIABILITY INSURANCE GUARANTY ASSOCIATION MODEL ACT AND APPROPRIATE PROVISIONS OF EXISTING STATE LAWS DEFINING THE SCOPE OF THEIR SECURITY FUNDS SHOULD BE AMENDED, WITH RESPECT TO POLICIES ISSUED OR RENEWED ON AND AFTER SUCH DATE TO EXCLUDE THE FOLLOWING KINDS OF INSURANCE:

1. Surety insurance;
2. Mortgage guaranty insurance;
3. Residual value insurance;
4. Financial guaranty insurance; and
5. Credit insurance.

STATEMENT IN SUPPORT

Financial guaranty insurance is a new type of coverage which has grown at a phenomenal rate. Although it was a relatively minor line of business ten years ago, financial guaranty insurance has, in recent years, become a significant marketing factor for the financial community. Financial guaranty insurance is currently subject to rules applicable to property/casualty insurance generally but it is a unique kind of coverago requiring specialized treatment. Property/casualty insurance is based on the law of large numbers -- a large group of homogeneous risks joined together to create a pool of money to pay for the losses of a few. The number of losses incurred is generally frequent, and severity in relation to surplus is relatively low. In contrast, under financial guaranty insurance, a single loss, e.g., the failure of a bond issuer to meet its obligations, could result in a potentially catastrophic financial loss affecting large numbers of insured bondholders. It is prudent to project that a severe economic downturn affecting either the general economy or a class thereof (e.g., oil producers and the localities dependent for revenue thereon) would result in more widespread defaults. It is therefore necessary that the Insurance Law define and appropriately regulate this line of business. Under current law financial guaranty insurance is not a defined kind of business, which prevents implementation of necessary regulation.

In its early years, financial guaranty insurance was principally limited to guaranties of municipal bond debt underwritten by monoline companies. Municipal bond insurance has been regulated in New York and Wisconsin by regulation which prescribes reserve and capital requirements and limitations on single risk and aggregate exposure. Recently, California and Illinois have adopted similar rules. There is no body of law or regulations which addresses financial guaranty insurance generally. In recent years, multiline property/casualty companies have been writing municipal bond insurance as well as the non-traditional types of financial guaranties discussed below.

The magnitude of financial guaranty business is substantial. It has been estimated that insurers' current exposure to loss under municipal bond guaranties alone exceeds $220 billion. There is currently no reliable reporting for non-municipal guaranties, thus the magnitude of these exposures is unknown. Financial guaranties have been issued to minimize risk of loss to insured obligees or indemnitees for: the payment of principal and interest on public and private debt, fluctuations in interest rates, fluctuations in currency rates, convertibility of currency, financial or commodities indices or price levels and changes in value of assets. In the area of publicly traded debt, a principal purpose of the guaranty has been "credit enhancement" which generally results in the "AAA" credit rating of an insurer adhering to a lower rated obligation by virtue of the guaranty. This is financially advantageous to a governmental or corporate borrower because the premium charged by the insurer for "credit enhancement" or the "rented rate" is only about one-half the savings generated by the lower interest rate which results from a "AAA" rating. Since the insurer is only charging a portion of the interest differential perceived by the investment community as reflective of the increased risk between lower rated and AAA rated issues, it must be betting that the investors are wrong or be relying on the law of large numbers. A particular insurer's book of business may not be large enough or sufficiently diversified to justify such optimism and reliance.

Guaranties of debt cover a wide spectrum of obligations, from general obligation municipal bonds and industrial development bonds to corporate bonds and limited partnerships. While the insurers point to meticulous analysis of each risk before it is written, in practice, competition for business and severe time limitations may conflict with ideal underwriting. Even with ideal underwriting, the ability to predict the future when evaluating risks, whether municipal or private, is far less than perfect. The longer the term of the debt obligation, the greater the unpredictability of the risk. There are indications that some financial guarantors are becoming less concerned with conservative underwriting and more concerned with increasing their market share with the result that in recent months rates charged have begun to erode; some so low they no longer cover underwriting expenses. This attitude can turn a good underwriting record into a disaster.

The principal tools used by the insurers to predict risk exposures have been models of the historical experience of the Great Depression. Today's world does not mirror the past. The types of municipal bonds written today are not, for the most part, comparable to the general obligation bonds which were issued before and during the Depression. There is little history or experience for insuring corporate bonds, limited partnerships or industrial development bonds. Thus, the types of obligations issued today and the purposes thereof differ significantly from prior debt obligations which do have a historical track record, and the assumptions made by financial guarantors have yet to weather severe financial strains. In addition, Federal tax reform is expected to have serious repercussions for guaranties of industrial development bonds and limited partnerships.

As discussed earlier, some regulation exists prescribing reserves and capital requirements and maximum exposure limits for municipal bond insurance. However, it does not distinguish between the different types of municipal bonds. More importantly, no such safeguards of solvency and claims paying ability currently exist for the much riskier non-municipal bond guaranties. Nor are there any contingency reserve requirements or other limitations on non-municipal guaranties. These newer types of guaranties cover obligations involving such enterprises as oil drilling, fast food, and real estate investment and development (e.g., apartment buildings, hospitals, airports, shopping centers and factories). It is improbable that the concept of a state's economy turning around from boom to bust in a matter of months was built into the analysis made by the financial guaranty insurers when they assumed the risk of covering obligations of those states and municipalities and the business enterprises therein which are now suffering because of the drop in oil prices. These new factors were certainly not built into the premium charged for what are now riskier guaranties. Furthermore, in contrast to property/casualty coverages, where the premium can be adjusted on annual renewal to reflect changing risk factors, the up front premium charged for financial guaranty insurance covers the life of the obligation, which could be as long as 30 years. There is no opportunity to adjust the premium if the hazard changes.

Even in the "good times" of recent years there have been substantial losses, some of which are discussed below.

Recently, Fireman's Fund Insurance Company, Industrial Indemnity Insurance Company, Cal-Farm Insurance Company and Glacier General Assurance Company have sustained catastrophic losses on financial guaranties, resulting

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in the insolvencies of the latter two insurers. In addition, American Municipal Bond Assurance Corp. (AMBAC) insured various unit trusts which held $23.6 million in principal in Washington Public Power Supply System Projects 4 and 5 (WPPSS) bonds which defaulted in 1983. AMBAC's loss exposure, including interest payment guaranties of $52.6 million, is $76.2 million. The premium charged was insignificant compared to the exposure. In addition, four industrial development bond issues insured by AMBAC involving the same Tennessee developer, recently went into default with an aggregate par value of $79 million.

Another recent example is Mutual Fire, Marine and Inland Insurance Company which, from 1983 through August, 1984, guarantied limited partnerships involving tax sheltered oil and gas and real estate ventures. Aggregate gross premium was $13.4 million and potential loss exposure before reinsurance is $435 million. Incurred losses to date exceed premium income. The Company has defaulted on these claims, asserting that it was defrauded by managing general agent, and is now under the protection of the Pennsylvania Insurance Department.

The primary concerns of the insurance regulator in the financial guaranty sector are treated in this bill in a manner which will permit profitable operations and adequate regulation. Multiline insurers would be prohibited from writing financial guaranties after a phase out period because the multiline format creates the following problems:

1. **Potential to bankrupt company.** When written as a sideline by a multiline insurer, financial guaranty insurance has the potential to bankrupt a company or to so limit its capacity as to prevent it from

maintaining its market share for traditional and more essential lines of business. As noted earlier, so far three multilines companies have been rendered insolvent by their financial guaranty writings. The monoline approach protects property/casualty insurance policyholders from the negative impact of adverse experience of financial guaranty business. Multiline insurers would not be tampted to divert currently insufficient resources to financial guaranty business for the enhancement of cash flow.

2. **Burdening the Guaranty Fund.** Even if not covered by the Guaranty Fund, an insolvency of a multiline insurer resulting from financial guaranty losses would expose the Fund to claims for all the property/casualty lines written by the insurer which are covered by the guaranty fund. Insurers which did not write financial guaranties and the vast majority of the public who never benefit from the guaranties would be burdened with the cost of losses covered by the Guaranty Fund.

3. **Lack of accountability.** In a multiline operation capital supports many lines of business. A monoline structure would enable the regulator to readily identify the risks insured and the capital supporting the business. This identification is necessary because of the unique nature of financial guaranties, which are a hybrid of insurance and investment banking.

4. **Lack of line of business reporting.** Since multiline insurers report financial guaranty business as surety, credit or another line of insurance, the premium, total exposure, underwriting experience and types of guaranties covered by financial guaranty insurance are not ascertainable from statements filed with the Insurance Department or other state regulators.

5. **Diversion of capacity.** At a time when insurance for essential property and casualty coverages is unavailable to many businesses and localities, writing financial guaranty insurance is a misuse of limited multiline insurance capacity. The need for financial guaranties on risks other than municipal bonds, for which monoline insurers are readily available, cannot be viewed as essential.

6. **Lack of expertise.** Few multiline insurers will have the necessary expertise to write financial guaranties, especially of the new and more exotic products. The expertise required to underwrite financial guaranties bears no relationship to traditional property/casualty underwriting, which utilizee actuarial and loss experience to evaluate and price a risk. Financial guaranty business requires in depth expertise of investment bankers and economists, as is the case with existing monoline financial guaranty insurers. Some multiline insurers, particularly the smaller ones, in an attempt to enter the market, may be tempted to "borrow" expertise from managing general agents who have a financial interest in placing the business. Reliance upon the expertise of others with diverse financial interests to underwrite business invites disaster, as was the case with Mutual Fire, Marine and Inland Insurance Company.

7. **Regulatory constraints.** Because of its nature, underwriting financial guaranty insurance in a multiline environment adds undue complexity to the analysis and monitoring of an insurers' financial condition with no discernable benefit. It is an unwarranted diversion from the pressing regulatory responsibilities of the Insurance Department's to expend finite resources in monitoring this line of business in a multiline environment.

Significantly, Municipal Bond Insurance Association (MBIA), the largest financial guaranty insurer (which is currently operated as an underwriting association by five major multiline insurers and is the only significant insurer of municipal bonds not now operating as a monoline insurer) has filed for reorganization. The new company, Municipal Bond Investors Assurance Corporation (MBIAC), whose stock will be owned by four of the five current principals, will operate as a New York domestic monoline financial guaranty insurer. Thus, the only financial guaranty business written by multiline insurers which will be affected by enactment of this bill are the high risk guaranties, such as limited partnerships, consumer debt obligations and corporate debt (which is also written in the monoline market). For limited partnerships, consumer obligations and corporate obligations guarantied by multiline insurers the premium volume is low and, because this business is ancillary to the traditional property and casualty business of these companies, there is a likelihood that executive oversight will not be commensurate with the loss exposures assumed. In any event, these types of guaranties are not essential coverages and do not warrant putting the traditional multiline operation and the security fund into jeopardy.

It is evident from the amount of capital which has been and is being attracted by the monoline financial guaranty insurers that investors view monoline carriers as attractive investments which will operate profitably. Therefore, monoline underwriting can provide adequate capacity to meet the demand.

Further provisions of the bill would prohibit insurers from issuing certain kinds of contracts such as interest rate guaranties, and currency fluctuations or convertibility of currency guaranties. The Insurance

Department does not consider the subject of these contracts to be insurable risks. These guaranties are at best speculative and should be viewed as gambling contracts. A basic requirement of an insurable risk is that the peril should not produce a loss that will affect a large section of the insured group at the same time. The writing of a large number of these proscribed contracts does not spread the risk. Rather, it increases the potential loss to the insurer and does not reduce the amount of uncertainty since these contracts do not meet the criteria for insurable risks.

The bill also excludes financial guaranty, surety, residual value and non-consumer oriented credit insurance from Guaranty Fund protection. The purchasers of these products are, or should be, financially astute bankers, investment bankers, and limited partnership syndicators. There is a danger that "risk free investments" will remove discipline from the investment community. Having insurers assume the investor's risk is not the most prudent or socially beneficial use of today's limited multiline insurance capacity. Removing these lines from Guaranty Fund protection will add discipline to the market. In order to discharge their prudent person responsibilities, purchasers of these products, rather than using price as the primary criterion, will have to more closely evaluate the financial condition and ability of the insurer to meet its obligations, as the Guaranty Fund will no longer be available.

The typical guaranty fund contains a "per claim" cap which would be applicable today to financial guaranty claims. It is unclear whether the cap applies to each individual investor who has purchased insured obligations or to the aggregate liability of the Guaranty Fund in the event of default on a particular bond issue or issues in a unit trust. If the cap is per issue or per trust, investors get little protection since it would be divided among many investors, perhaps thousands. If the Guaranty Fund is liable for up to the amount of the cap for each investor, its exposure is astronomical. In either event, the Guaranty Fund is not an appropriate vehicle for financial guaranties.

Surety has already been excluded from the guaranty funds of many states because it is a highly specialized line whose losses should not be passed on to the general public. Residual value and non-consumer oriented credit insurance are also inappropriate kinds of coverage for guaranty fund protection.

In sum, this bill will encourage the doing of responsible financial guaranty insurance business in this state, make such business attractive to investors and minimize the financial mishaps which are likely in the absence of the proposed controls and limitations. Its prompt enactment is imparative.

Fiscal Implications:

None.

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Mr. FLORIO. Thank you very much.

We are now going to proceed with our next panel of witnesses. It is made up of—and I would like the witnesses to kindly come forward—Mr. Michael Satz, President of the Association of Financial Guaranty Insurors. He will be accompanied, I understand, by Mr. Aaron Stern, President of the Old Republic Financial Guaranty Underwriters, and Mr. Patrick Foley, Vice President of American International Group.

Then our next witnesses on this panel will be Mr. Gerald Friedman of the Financial Guaranty Insurance Company, Mr. William Murray, Vice President and Counsel of Chubb and Son, and Mr. William Jacobs, Executive Vice President, Financial Security Assurance.

Gentlemen, I appreciate your participation here. As I have stated, your statements will be put into the record in their entirety, and I would appreciate your proceeding in a summary fashion.

Mr. Satz.

STATEMENTS OF MICHAEL E. SATZ, PRESIDENT; AARON B. STERN, VICE PRESIDENT; AND PATRICK J. FOLEY, CHAIRMAN, BOARD OF DIRECTORS, ASSOCIATION OF FINANCIAL GUARANTY INSURORS; GERALD L. FRIEDMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FINANCIAL GUARANTY INSURANCE CO.; WILLIAM J. MURRAY, VICE PRESIDENT AND COUNSEL, CHUBB AND SON, INC.; AND WILLIAM JACOBS, CHIEF OPERATING OFFICER AND EXECUTIVE VICE PRESIDENT, FINANCIAL SECURITY ASSURANCE

Mr. SATZ. Mr. Chairman, I will try to restrain myself from becoming hysterical and try to present a fairly calm presentation.

I am speaking in my capacity as president of the association. I would like to note that the association does not include in its membership mortgage guarantee insurers.

As you noted, testifying on behalf of the association also will be Aaron Stern, who is a vice president of the association and president of Old Republic Financial Guaranty Underwriters, and Patrick Foley, who is chairman of the association and a senior vice president and the general counsel of National Union Fire Insurance Company of Pittsburgh, which is a subsidiary of AIG.

We appreciate the opportunity to provide the subcommittee with information regarding financial guarantees and we hope this will only be the beginning of a dialogue between this committee or subcommittee and the association and the industry-at-large.

I would like to state to begin with and note specifically that the association has made a commitment to the development of insurance regulation that strikes a meaningful balance between the maintenance of the financial solidity of insurers, the protection of policyholders, and the continued availability of financial guarantee insurance to the market.

This is not an easy topic. I don't think there are safe or obvious elixirs that solve the perceived illnesses of all the parties.

However, I will say that there are some specific facts about the industry that may be brought to light very quickly, and then I will pass along the microphone.

One, financial guarantee insurance is regulated, at least generally, as Mr. Corcoran has indicated, as a type of surety under the insurance laws of the various States.

It provides for an indemnity for the timely payment of third party payment obligations, generally of investment grade quality. And my remarks will generally relate to what I would term the rated financial guarantee insurance industry.

That is the major portion of the financial guarantee insurance industry as it exists in the United States and with respect to which both Standard & Poor's and Moody's Investors Service provide triple-A ratings to the financial guarantors in relation to the claims-paying ability relative to the obligations which they insure.

Mr. FLORIO. Are they all multi-line companies?

Mr. SATZ. No. I would say the majority of the most active participants in this area are mono-line companies. There are certain multi-line companies that also participate in the rated area.

In terms of the rated financial guarantee insurance industry, this is in fact the only triple-A financial services industry. As a practical matter, the triple-A is a price of admission. It is what you are, in a sense, selling in terms of your own participation in a particular transaction.

Another point I would like to make, other than the obvious points which I think are all agreed to, that financial guarantee insurance can provide a benefit to capital formation and provide an important cost savings to various sectors of our society, including the municipal sector, which was the primary sector for this business in the beginning and still is a major portion of this sector.

Mr. FLORIO. Cost saving primarily in the credit rating?

Mr. SATZ. To the borrower.

Mr. FLORIO. In the credit rating aspects?

Mr. SATZ. Yes, to the borrower. That is an explanation of how a financial guarantee insurer determines whether a credit qualifies for insurance. And I think a general statement could be made, again, particularly in the rated area.

The determination by a financial guarantee insurer that a credit qualifies for insurance requires the judgment, based on empirical data and probabilities, that the credit does not involve a perceived risk of loss.

The goal of underwriting is the minimization of loss, and credits to financial guarantee insurance are normally underwritten to a standard of no loss. That does not mean to says that this is a riskless business.

And indeed, on a portfolio basis, losses are expected to be incurred and the incurrence of those losses are modeled on a fairly sophisticated basis, premised on extrapolations of the depression era scenario described by Dr. Hemple originally, as enhanced by both rating agencies in their determination of the credit quality of the insurers themselves, and further enhanced by most of at least the rated insurers by in-house modeling as to what would occur if you had a downturn in the economy, and what level of defaults you would recognize in various sectors of the insured portfolio.

Beyond that, I think I will leave this conversation to my associates.

[The prepared statement of Mr. Satz follows:]

Statement of Michael E. Satz

My name is Michael E. Satz. I will be speaking today in my capacity as President of the Association of Financial Guaranty Insurors, a trade association formed to communicate an industry consensus on public policy issues which affect the capacity of insurance companies to meet the growing demand for financial guarantees. The members of the Association are AMBAC Indemnity Corporation; Bond Investors Guaranty Insurance Company; CNA Insurance Companies; Capital Guaranty Insurance Company; Continental Guaranty & Credit Corporation, a subsidiary of Continental Insurance; Financial Guaranty Insurance Company; Enhance Reinsurance Company; Financial Security Assurance Company, Municipal Bond Investors Assurance Corporation; National Union Fire Insurance Company of Pittsburgh, PA, a subsidiary of American International Group; and Old Republic Financial Guaranty Underwriters, Inc., an affiliate of Old Republic Insurance. The Association does not include mortgage guaranty insurers in its membership.

Testifying on behalf of the Association will also be Aaron Stern, a Vice President of the Association and President of Old Republic Financial Guaranty Underwriters, and Patrick J. Foley, Chairman of the Association's Board of Directors and Senior Vice President and General Counsel of National Union Fire Insurance Company of Pittsburgh.

The Association appreciates the opportunity to provide the subcommittee with information regarding the financial guaranty insurance business and current issues relating to the regulation of that business. In this regard, it should be noted that the Association has made a commitment to the development of insurance regulation that strikes a meaningful balance between the maintenance of the financial solidity of insurers, the protection of policyholders, and the continued availability of financial guaranty insurance to the market.

My testimony will focus on the function of financial guaranty insurance, the nature of the insured risks, and the role of financial guaranty insurance in the attainment of specific public policy and economic goals.

Mr. Stern will discuss the development of appropriate regulation in the context of recent economic history.

Mr. Foley will address the necessity, as a matter of public policy, for regulation which encourages the availability of capital capacity in both the financial guaranty and the general insurance market.

Financial guaranty insurance is a type of surety regulated under the insurance laws of the various States. Financial guaranty insurance provides an indemnity for the timely payment of third party payment obligations of investment grade quality. Generally, upon nonpayment, the liability of the insurer to make payment in accordance with the original payment schedule cannot be accelerated other than at the option of the insurer. Municipal bond insurance is a form of financial guaranty insurance, and provides for the credit enhancement of obligations issued for public purposes by governmental units, i.e., municipal bonds.

In the area of "rated" financial guaranty insurance, which represents the major portion of the financial guaranty insurance business, Standard & Poor's Corporation and Moody's Investors Service, Inc. each apply a triple-A credit rating to insured obligations based on their rating of the claims-paying ability of the insurance company. It is the only triple-A financial services industry. As a result of the credit enhancement of the insured obligation, financial guaranty insurance lowers the cost of borrowing to the obligor and, further, may act (1) to simplify the explanation of the exposure attendant to the otherwise complex security structure of an underlying credit in order to facilitate its public sale, (2) to normalize a type of credit which customarily trades on a discounted basis to its apparent market value, or (3) to diversify and expand the potential market, thereby providing greater market access.

The determination by a financial guaranty insurer that a credit qualifies for insurance requires the judgment, based on empirical data, that the credit does not involve a perceived risk of loss. The goal of underwriting is the minimization of loss, and credits subject to financial guaranty insurance are normally underwritten to a standard of no-loss. On a portfolio basis, however, it is expected that losses will be incurred. A loss ratio of 20–30 percent of earned premiums is commonly assumed for the purposes of financial projections, a loss ratio which compares quite favorably to traditional property and casualty insurance.

In evidence of the salutary role of financial guaranty insurance in the capital markets, much can be cited. Since the introduction of municipal bond insurance in 1971, governmental issuers in every State have saved billions of dollars in borrowing costs and achieved enhanced access to the capital markets. Financial guaranty insurance has produced substantial savings for industrial development, among other things facilitating the continued presence of the Pittsburgh Pirates baseball team in the city of Pittsburgh. Similarly, the cost of higher education loans, including such loans offered in Washington, D.C., has been lowered. Recently, financial guaranty insurance was utilized in the United States Government asset sale program in the public offering of approximately $2 billion in rural housing loans. There are, in fact, many examples of the beneficial impact of financial guaranty insurance on the financing of municipal infrastructure, resource recovery facilities, highway and mass transit, utilities, educational facilities, hospitals, housing and industrial and commercial development. This is accomplished by an industry which is profitable and is characterized by financial solidity.

Thank you.

Mr. FLORIO. Mr. Stern.

STATEMENT OF AARON B. STERN

Mr. STERN. Chairman Florio, my name is Aaron Stern, and I am President of Old Republic Financial Guaranty Underwriters, which is an underwriting manager for one of the multi-line insurance companies in this business. I am also a Director and Vice President of the Association of Financial Guaranty Insurors, and have been involved in various aspects of the financial guarantee industry since 1974.

Over the last 2½ years, I have been actively engaged in discussions with regulators and others aimed at establishing a balanced regulatory framework for the financial guarantee business.

I would like to emphasize that participants in this industry universally recognize the need for and the desirability of governmental regulation of the business. Regulation must be designed to achieve two principal goals.

The first and foremost is to assure that, for the benefit of policyholders, the financial integrity of the companies issuing the guarantees remains intact.

And second, to continue to encourage economic growth by permitting qualified governmental borrowers and private entities low cost access to the financial markets.

At this point I would deviate from the rest of my testimony and try to, in the interest of brevity, explain two fundamental differences that exist in the financial guarantee business.

First of all, it is a business that encompasses two very broad markets. One is the credit enhancement business, the lending of a rating of a triple-A rating company to the borrowing of an investment grade, triple-B or better, borrower, whether it be municipal or government.

The second sector of the business is financial risk insurance. Financial risk insurance are the types that encompass interest rate guarantees, currency guarantees, and other types of guarantees that are based upon taking an exposure without having a specific indemnity from a creditworthy party.

And I will concur with the regulators' view that that sector of the business has a tremendous lack of data, lack of availability of information, to be able to determine and price exposure.

In the credit enhancement sector, I differ completely from the views of the regulators. There is a strong body of disciplined research that has taken place over this entire century.

That body of research is contained in the rating agencies and in governmental studies that have been done, in the National Bureau

STATEMENT OF MICHAEL E. SATZ

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And second, to continue to encourage economic growth by permitting qualified governmental borrowers and private entities low cost access to the financial markets.

At this point I would deviate from the rest of my testimony and try to, in the interest of brevity, explain two fundamental differences that exist in the financial guarantee business.

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And I will concur with the regulators' view that that sector of the business has a tremendous lack of data, lack of availability of information, to be able to determine and price exposure.

In the credit enhancement sector, I differ completely from the views of the regulators. There is a strong body of disciplined research that has taken place over this entire century.

That body of research is contained in the rating agencies and in governmental studies that have been done, in the National Bureau of Economic Research, known as the Hickman Studies, studying corporate bond default experience from the 1900's through the post-war era, and studies that have updated that, in the NAIC studies themselves in evaluation of securities reserves for life insurers, and further updates that have been done recently by Professor Altman for New York University and for the investment banking community.

These studies definitely demonstrate that it is possible to view the rating of a financial guarantee insurer on a portfolio basis, conditioned upon that insurer sticking to certain underwriting precepts, the first of which is that debt service on long-term obligations, the $152 billion number quoted by Commissioner Corcoran, are sums that are payable over terms extending beyond 30 years.

The obligation of the financial guarantee insurer is to pay the debt service that falls due at the time of a default.

The history of the depression shows that 97 percent of municipality defaults were recovered fully within a 4-year time frame. That enabled or would have enabled guarantee insurers, if they could survive 4 years of defaults, to be able to recoup virtually all of the losses they had incurred.

And in fact, in the corporate sector, as shown by the Hickman Studies, the annual default rate on investment grade corporate debt, from 1928 to 1931 was only 1.4 percent; from 1932 to 1935 it was 6.2 percent; and from 1936 to 1939, it was 3.3 percent.

Studies covering the years from 1972 through 1983 show that investment grade debt of publicly held corporations averaged defaults of 0.1 percent annually.

And when you include only the recession years from 1972 through 1976, that annual default experience was 0.16 percent.

Mr. Florio. How about 1981 or 1982 through 1984? Let's talk about the tough period.

Mr. Stern. 1978 through 1983 is a period of breakdown. It was 0.16 percent. And data encompassed with my testimony goes into further detail on it.

The point here is that on an aggregate basis, it is possible to determine the default experience of a portfolio of homogeneous type risks.

Collateralization and underwriting standards must be encompassed, and regulation must be based on these concepts, on the past default histories overall, setting capital standards, aggregate risk limitations, limiting the single risk and concentration of risks by product areas.

And, in fact, the regulators do agree on that and have accepted much of the work done by the industry in establishing ratios that would govern these areas.

The principal difference from the regulators' perspective and from those of us in the industry is that the question of multi-line and mono-line has arisen, whether or not it is necessary to wall off the insurance industry's involvement in financial guarantees in a separate subsidiary. And we strongly believe that is not required.

If the business can be regulated at all, which is the premise we start from, it can be regulated regardless of the corporate structure. The necessity of walling it off can be eliminated simply by applying the same ratios, the same standards, and analyzing the capital involved in the multi-line companies the same way a rating agency does.

Look at the total financial guarantees that the insurer has undertaken, look at the ability he has to withstand that within his capital structure, extract that from his capital structure simply by doing the mathematics and determining whether or not he has adequate capital to support the rest of his business.

Basically, in summary, we do agree that regulation is necessary. More so, it is desirable.

The impact of this business is economic. There will be adverse cycles. We do not claim that this is a riskless business.

We do claim that this is a standard of no loss underwriting, to attempt to structure transactions in which losses that can be predicted are eliminated or provided for by means of collateral, debt reserve funds, et cetera, so that we are lending our credit rating to the credit rating of quality borrowers, principally municipal borrowers. And those municipal borrowers have demonstrated a tremendous history of paying their debts as they come due.

I thank you for the opportunity to give this testimony.

[Testimony resumes on p. 339.]

[The prepared statement of Mr. Stern follows:]

TESTIMONY OF AARON B. STERN, VICE PRESIDENT, ASSOCIATION OF FINANCIAL GUARANTY INSURORS BEFORE A HEARING OF THE U.S. HOUSE OF REPRESENTATIVES, SUB-COMMITTEE OF COMMERCE, CONSUMER AFFAIRS AND COMPETITIVENESS, WASHINGTON D.C., WEDNESDAY, OCTOBER 14, 1987

Chairman Florio, my name is Aaron B. Stern. I am President of Old Republic Financial Guaranty Underwriters, Inc., an underwriting affiliate of the Old Republic Insurance Company. I am also a Director and Vice President of the Association of Financial Guaranty Insurors, and have been involved in various capacities in the financial guaranty insurance business since 1974. Over the last two and one half years, I have been actively engaged in the discussions aimed at establishing a balanced regulatory framework for the financial guarantee business.

Participants in the industry universally recognize the need for and desirability of government regulation of the financial guarantee business. Regulation must be designed to achieve two principal goals; (1) to assure, for the benefit of policyholders, the financial integrity of the companies issuing guarantees, and (2) to continue to encourage economic growth by permitting qualified government and private borrowers low cost access to the financial markets. The business of financial guarantees is affected by the overall economic climate, therefore development of effective regulation must take into account and be based to a great extent on the ability of government and private borrowers to continue to meet debt service schedules when the economic climate turns unfavorable. The answer to the question of how well government and private borrowers have met their obligations during the many economic cycles of the past should govern the establishment of capital ratios needed to support guarantees outstanding, as well as the level of reserves necessary to pay cyclical losses caused by unfavorable economic events such as a major recession or worse.

Fortunately, much disciplined research and analysis has been invested in tracking the past impact of adverse economic conditions on default rates. The results of those major efforts show that even in the worst of times, this nation's municipal and corporate borrowers have compiled a surprisingly good record for paying their debts on time. And, in cases where defaults have occurred, payments have resumed within relatively short periods of time.

Even in the historical worst case scenario, the Great Depression, 97 percent of the municipalities which defaulted had recovered totally within four years.

The annual default rate on investment grate corporate debt from 1928 to 1931, was only 1.4 percent; from 1932 to 1935, it was 6.2 percent; and from 1936 to 1939, it was only 3.3 percent.

Recent studies show that the default rate on all corporate debt, (investment grade as well as non-investment grade) issued by publicly held corporations, averaged only 0.1 percent annually in the record high interest years from 1978 to 1983, and was only 0.16 percent in the years that included the deep recession from 1972 to 1976.

Most recently, the experience on one insured, non-investment grade, private college, higher education loan portfolio showed one default out of 4000 loans for a default rate of .0004 four ten thousandth of one percent.

TESTIMONY OF AARON B. STERN, VICE PRESIDENT,
ASSOCIATION OF FINANCIAL GUARANTY INSURORS
BEFORE A HEARING OF THE U.S. HOUSE OF
REPRESENTATIVES, SUB-COMMITTEE OF COMMERCE,
CONSUMER AFFAIRS AND COMPETITIVENESS,
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Most recently, the experience on one insured, non-investment grade, private college, higher education loan portfolio showed one default out of 4000 loans for a default rate of .0004 four ten thousandth of one percent.

Of all the municipal bond insurers in business today only one has experienced default. Even in what has been described as the worst municipal bond default in U.S. history, the Washington Public Power Service Systems disaster, AMBAC Indemnity, insurer of some WPPSS bonds, has been meeting obligations as they come due.

Chairman Florio, what I have laid out is a record of past and present default experience spanning more than three quarters of this century. The record shows no evidence that would support speculation as to a future economic catastrophe which would precipitate a crisis in the guarantee insurance industry. It shows there is no evidence to support statements, made by certain insurance regulators that an inevitable series of defaults will have a severe impact on the insurance security funds established to protect property casualty and life and health insurance policyholders in the event of insurer insolvency. The fact is that financial guarantees written by the large multiline insurers active in the business today have contributed to improving their financial solvency through profitable underwriting.

And indeed there is nothing in that 80 plus year record to show that companies bearing financial guaranty risks should be segregated from the rest of the insurance business and walled off in separately capitalized monoline companies for safety's sake.

Actually, the record bears strong evidence which points in just the opposite direction. Take the mortgage guaranty industry which has been conducted by so called monoline companies since the early 1900's. Those companies all became insolvent during the depression partly because they did not have alternative sources of income. They enjoy limited spread of risks and are, therefore, more vulnerable to economic downturns affecting their business concentration. And once in financial difficulty they are less apt to recover because they do not have a diversified source of revenues and can only draw upon the resources of a willing parent or affiliate companies.

We recognize concerns for solvency on the part of insurance regulators and have been working toward the development of legislation which will allow for adequate solvency safeguards and allow the market to develop to its fullest potential. We believe that regulation can accomplish this, not by restricting participation of strong companies, but through establishment of risk to capital ratios that accurately reflect default experience and, at the same time, allow the market for financial guarantees to grow. These ratios, along with the minimum capital requirement we have recommended, are designed to assure that all insurers would be able to withstand an economic downturn equal in severity to that of the Great Depression. The Association's position on ratios in this regard are contained in the attached letter of May 30, 1986 to New York State Senator John R. Dunne of New York and in the attached comparison of ratios that would have been provided by three alternative bills introduced in New York in 1986, both of which I would ask be entered into the record along with this statement.

We support specially tailored legislation that would establish prudent bench marks and, at the same time, would not overly restrict capacity or competition and, thereby, frustrate the public and private sector growth to which our indstry now contributes.

Thank you.

I look forward to your questions.

Association of Financial Guaranty Insurors

122 South Swan Street
Albany, New York 12210

520 Madison Avenue
New York, New York 10022

May 30, 1986

The Honorable John Dunne
New York State Senate
The Capitol
Albany, New York 12224

Dear Senator Dunne:

Re: S. 9078

This letter is being submitted on behalf of the Association of Financial Guaranty Insurors (the "Association"), of which I am the President. The members of our Association are:

AMBAC Indemnity Corporation;
Bond Investors Guaranty Insurance Company;
Continental Guaranty Credit Corporation, a subsidiary of Continental Insurance;
Financial Guaranty Insurance Company;
Financial Security Assurance;
Municipal Issuers Service Corporation, the managing general agent for the Municipal Bond Insurance Association;
National Union Fire Insurance Company of Pittsburgh, PA., a subsidiary of American International Group; and
Old Republic Financial Guaranty Underwriters, Inc., an affiliate of Old Republic International Corp.

We believe that our membership reflects a significant part of the financial guaranty insurance industry that is writing such business in New York.

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Among the more significant of our recommendations are the following:

* permit multiline insurers to issue policies of financial guaranty insurance with respect to all payment guarantees specified in Section 6901(a)(1)(A) (i.e., essentially guarantees of the failure of an obligor on a debt instrument or other monetary obligations to pay when due principal, interest, premium, dividend or purchase price of or on such instrument or obligation due to financial default or insolvency), rather than only with respect to municipal bond insurance.

* decrease the levels of prescribed contributions to the special reserve to reasonable yet not excessive levels.

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520 Madison Avenue
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May 30, 1986

The Honorable John Dunne
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The Capitol
Albany, New York 12224

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Re: S. 9078

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CONSUMER DEBT
OBLIGATIONS

Proposed Amendment to Section 6901(k)

6901(k) "Guaranties of consumer debt obligations" means surety bonds or insurance policies indemnifying {regulated financial institutions against loss or damage resulting from debts} obligations owed {to them for extensions of credit to} by individuals. {for non-business purposes provided in the normal course of their business}. Guaranties of securities backed by obligations of individuals as well as limited partner note obligations shall be included herein. {Delete last sentence}.

Commentary

The Association proposes a technical amendment to the definition of "Guaranties of consumer debt obligations" contained in 6901(k). The proposed language is intended to differentiate "guaranties of consumer debt obligations" from "credit insurance" which is excluded from the definition of financial guaranty insurance pursuant to 6901(a)(2)(H). This change will clarify the treatment of limited partner notes as well as guaranties of securities which are backed by obligations of individuals so that the appropriate aggregate risk limitations and special reserve requirements are utilized.

Proposed Amendment to Section 6901(1)

(1) "Collateral" means (1) cash, or (2) the scheduled cash flow from investment grade debt obligations scheduled to be received on or prior to the date of scheduled debt service on the insured obligation, in an amount at least equal to the full amount of scheduled debt service on the insured obligation, or (3) the market value of investment grade debt obligations, {in an amount at least equal to the principal amount of the insured obligation} which do meet the conditions specified in (1) either as to amount or timing of scheduled cash flow, or (4) the stated amount of a clean, unconditional, irrevocable letter of credit issued or confirmed by a bank or trust company that is a member of the Federal Reserve System, chartered by the State of New York or otherwise acceptable to the Superintendent; deposited with the insurer or held in trust for the benefit of the insurer, or held in trust for the benefit of bondholders whether in the form of debt service, sinking funds or other reserves pursuant to the bond indenture by a trustee acceptable to the Superintendent.

Commentary

The Association proposes an expanded definition of collateral to permit the inclusion of cash and letters of credit and to recognize market value of investment grade obligations in amounts less than the full principal amount of insured obligations.

Expanding the definition to include cash permits recognition of those situations in which funds are deposited with banks pursuant to terms of a trust indenture. Allowing credit up to the market value of investment grade debt obligations which do not meet criteria related to scheduled cash flow but are not the less available for payment of debt service such as debt service reserve funds is a logical extension of the definition.

The addition of letters of credit as collateral is proposed since such instruments are recognized as an acceptable method of obtaining credit for recoverables from unauthorized reinsurers under conditions outlined in Circular Letter No. 19 (September 15, 1983) issued by the Superintendent. The Association respectfully submits that such letters of credit are implicitly recognized as providing at least as good a form of security as investment grade obligations deposited by an unauthorized reinsurer under a collateral trust agreement for the benefit of the cedant.

AVERAGE ANNUAL DEBT SERVICE

Proposed Amendment to Section 6901(p):

(p) "Average annual debt service" means the amount of insured unpaid principal and interest on an obligation multiplied by the number of such insured obligations (assuming that each obligation represents a one thousand dollar par value), divided by the amount equal to the aggregate life of all such obligations (assuming that each obligation represents a $1,000 par value). This definition, expressed as a formula in regard to bonds, is as follows:

$$\text{Average annual debt service} = \frac{\text{total debt service} \times \text{number of bonds}}{\text{Bond Years}}$$

$$\text{Number of bonds} = \frac{\text{total insurer principal}}{1{,}000}$$

$$\text{Bond years} = (\text{number of bonds} \div 1{,}000) \times \text{term in years}$$

Commentary:

The Association suggests that this section be amended to reflect that the amount of municipal bonds which represent a single credit risk and which are underwritten by a company writing financial guaranty insurance should be limited by the relationship between the weighted average annual debt service of such municipal bonds to the capital of such insurance company. This interpretation comports with an understanding reached with the NAIC Financial Guaranty Study Group in previous discussions with the Industry Advisory Committee but which, due to drafting error, was not reflected in the Study Group's definition of Average annual debt service. It is the Association's view that the amendment is necessary since the limitation as currently worded would relate to average annual debt service not properly weighted to reflect bond life.

INVESTMENTS

Proposed Amendment to Section 6902(a)(3)

6902 (a)(3) A financial guaranty insurance corporation's investments in any one entity insured by that corporation shall not exceed {one} two percent of its admitted assets as of the end of the prior calendar year.

Commentary

The Association proposes a substantive amendment to 6902(a)(3) which increases the maximum permitted investment by a financial guaranty insurer in obligations of entities which are insured by such insurer to 2% of admitted assets. Regulations governing investments of insurers generally permit an insurer to invest up to 5% of admitted assets in the obligations of an issuer. The proposed restriction of one percent (1%) of admitted assets is unnecessarily restrictive and does not consider the fact that a single entity can have many different issues outstanding often secured by different revenue sources thereby constituting exposures which could be substantially different from insured obligations. The proposed adjustment to 2% will allow insurers greater flexibility in their investment practices without creating undue concentration of risk.

PERMISSIBLE RISKS FOR
SURETY INSURERS

Proposed Amendment to Section 6902(c)

6902(c) line 16.,.of financial guaranty insurance {with respect to municipal bonds} on risks described in subparagraph (A) of paragraph one of subsection (a) of section six thousand nine hundred one of this article. Provided, however, that investments in any one entity insured by such an insurer shall not exceed {one} two percent of its admitted assets as of the end of the prior calendar year.

Commentary

The Association recommends a substantive amendment to 6902(c) which would permit insurers licensed to write surety insurance to also write financial guaranty insurance on risks described in subparagraph (A) of 6901(a)(1). The bill already permits such insurers which have surplus to policyholders of at least $75 million to write municipal bond insurance. The Association believes that other forms of payment guaranty present risks that are substantially similar to those contained in municipal bond insurance and that insurers are well equipped to analyze such exposures partly due to their significant experience in investment activities. Studies reviewed by the Association which relate to default experience that occurred during the Great Depression support a conclusion that default experience on investment grade corporate obligations was not materially different from that of investment grade municipal bonds. The definitive study of municipal defaults prepared by Professor George Hempel demonstrated peak default rates at a little less than 16% of debt service falling due. A study done by the National Bureau of Economic Research entitled, "Corporate Bond Quality and Investor Experience", known as the "Hickman" study which covered all corporate bonds outstanding from 1900 to 1943 (other than convertible or real estate mortgage bonds) showed that the default rate for all investment grade corporate obligations outstanding in the periods 1928-1931 was 1.4%, 1932-1935 was 6.2% and in 1936-1939 was 3.3%. The highest default experience was concentrated in the railroad industry where the default rates were .8%, 10.5% and 6.3% for the respective periods (See chart attached. Note that rating category I-IV constitute AAA, AA, A & BBB ratings respectively). The principal difference in actual losses experienced by investors in municipal bonds versus corporate bonds is not the default frequency but rather the amount and timing of recovery subsequent to default. Given the comparative experience, it is fair to say that investment grade corporate obligations present a default loss risk which is roughly 2 to 3 times that of municipal bonds. The bill contains aggregate risk limitations and single risk limitations which fully recognize the difference in degree of risk and therefore should adequately protect the solvency of a multiline insurer. Given these considerations, the Association respectfully submits that insurers qualifying under proposed 6902(c) be permitted to write all payment type financial guaranty risks other than those defined in subparagraphs (B), (C), (D) and (E).

A conforming amendment is also suggested which would restrict such insurers investments in obligations of insured entities to two percent (2%) of admitted assets as proposed in 6902(a)(3) for financial guaranty insurers.

SPECIAL RESERVES

Proposed amendment to section 6903:

Sec. 6903. Special reserves. (a) An insurer issuing policies of financial guaranty insurance with respect to municipal bonds shall establish a contingency reserve in a minimum amount calculated [not to exceed] by multiplying the principal amount of the outstanding insured obligations [multiplied] by the following percentages:

(1) In the case of municipal obligation bonds: [seven-tenths] one-third of one percent;

(2) In the case of investment grade industrial development bonds [secured by collateral or having a term of seven years or less]: one percent; and

[(3) In the case of other investment grade industrial development bonds: one and one-half percent; and]

[(4)](3) In the case of industrial development bonds not of investment grade: two [and one-half] percent.

(b) An insurer issuing policies of financial guaranty insurance other than with respect to municipal bonds shall establish a financial guaranty reserve in a minimum amount calculated [not to exceed] by multiplying the principal amount of the outstanding insured obligations [multiplied] by the following percentages:

(1) In the case of investment grade obligations secured collateral or having a term of seven years or less: one percent;

(2) In the case of other investment grade obligations and guaranties of consumer debt obligations: one and one-half percent;

(3) In the case of [guaranties of consumer debt obligations] non-investment grade obligations secured by a conveyance or mortgage of property for the insurer's protection: two percent; and

(4) In the case of non-investment grade obligations not secured by a conveyance or mortgage of property for the insurers's protection: two and one-half percent.

(c) (1) [Quarterly additions to the] The reserve for paragraphs one, two[,] and three [and four] of subsection (a) of this section shall be established and maintained by quarterly contributions at least equal to the greater of one-eightieth of the amounts derived by applying the appropriate contribution specified in subsection (a) of this section or fifty percent of the quarterly earned premiums on such guaranties [and] until there shall be a deposit in the such reserve of an amount in excess of fifty percent of the amounts specified in subsection (a) of this section. At such time, quarterly contributions to the such reserve shall be at least equal to the lesser of one-eightieth of the amounts derived by applying the appropriate contribution specified in subsection (a) of this section or fifty percent of earned premium. Such reserve shall be maintained for a period of twenty years;

(2) [Quarterly additions to the] The reserve for paragraphs one, two, three and four of subsection (b) of this section shall be

established and maintained by quarterly contributions at least equal to the greater of one-fortieth of the amounts derived by applying the appropriate contribution specified in subsection (a) of this section or fifty percent of the earned premiums on such guaranties [and] until there shall be a deposit in the financial guaranty reserve of an amount in excess of fifty percent of the amounts specified in subsection (b) of this section. At such time, quarterly contributions to such reserve shall be at least equal to the lesser of one-fortieth of the amounts derived by applying the appropriate contribtuion specified in subsection (b) of this section or fifty percent of earned premiums. Such reserve shall be maintained for a period of ten years;

(3) The reserve may be released thereafter in the same manner, except that a part of the reserve may be released proportional to the reduction in aggregate net liabilities resulting from reinsurance [and] if the reinsurance agreement requires that the reinsurer shall, on the effective date of the reinsurance, establish a reserve in an amount equal to the amount released; and

(4) Withdrawals from the [contingency] special reserve [, to the extent of any excess,] may be made with the approval of the superintendent from the earliest contributions to such reserve remaining therein:

(A) in any year in which the actual incurred losses exceed thirty-five percent of earned premiums, or

(B) provided that the contingency reserve has been in existence for forty quarters[, for reserves subject to paragraph one of this subsection,] and the financial guaranty reserve has been in existence for twenty quarters, [for reserves subject to paragraph two of this subsection,] upon demonstration that the amount carried is excessive in relation to the insurer's outstanding obligations.

Commentary:

The Association proposes identical technical amendments to subsections (a) and (b). Though the language was adopted from the Industry Advisory Committee's draft, we believe that the language contains an unintended contradiction. The subsection refers to "minimum amount", with the intention of allowing voluntary contributions by the insurer in excess of the prescribed levels. However, "not to exceed" coming thereafter conflicts by placing a cap on the contribution. We suggest deleting "not to exceed" and changing the language as indicated to allow for such voluntary excess contributions to special reserves.

We propose to decrease the level of the prescribed contribution applicable to municipal obligation bonds contained in paragraph (a)(1) from 0.7% to 0.33%. Our proposed level would produce a sufficient reserve to withstand two-thirds of the permanent defaults on municipal bonds during the Depression, which, according to the Hempel studies of such defaults, amounted to less than 1/2 of 1% of the total par outstanding. Models prepared by the Association, which we would be pleased to provide to you, indicate that use of our suggested level, as well as the proposed change in methodology discused below, would result after twenty years in a contingency reserve equal to 3.42% of the debt service falling due in one year. By itself, such reserve would be more than sufficient to fund the losses incurred in the first two years of the Depression.

In contrast, the proposed 0.7% level would result in contributions far in excess of that required and eventually would result in a disproportionate amount of the insurer's effective capital being placed in the special reserve.

We suggest that the categories of industrial development bonds be reduced from three -- (1) investment grade secured by collateral or having a term of seven years or less, (2) other investment grade and (3) non-investment grade -- to two -- (1) investment grade and (2) non-investment grade. We do not believe that in the case of industrial development bonds, the additional restrictions of collateral security or a term of seven years or less significantly lowers the risk so as to warrant different treatment. We also believe that a contribution rate of 1%, being three times our proposed rate for municipal obligations bonds, provides adequate security. Moreover, these changes would make the contingency reserve categories of industrial development bonds consistent with the aggregate risk limit provisions, which distinguishes only between investment grade and non-investment grade industrial development bonds.

We suggest that both non-investment grade industrial development bonds and other obligations secured by a conveyance or mortgage of property for the protection of the insurer be treated the same and require special reserve contribution of two percent. Industrial development bonds generally are secured by a mortgage or other security and thus essentially are equivalent in risk to other obligations so secured. We believe that such obligations are

Commentary:

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We propose to decrease the level of the prescribed contribution applicable to municipal obligation bonds contained in paragraph (a)(1) from 0.7% to 0.33%. Our proposed level would produce a sufficient reserve to withstand two-thirds of the permanent defaults on municipal bonds during the Depression, which, according to the Hempel studies of such defaults, amounted to less than 1/2 of 1% of the total par outstanding. Models prepared by the Association, which we would be pleased to provide to you, indicate that use of our suggested level, as well as the proposed change in methodology discused below, would result after twenty years in a contingency reserve equal to 3.42% of the debt service falling due in one year. By itself, such reserve would be more than sufficient to fund the losses incurred in the first two years of the Depression.

In contrast, the proposed 0.7% level would result in contributions far in excess of that required and eventually would result in a disproportionate amount of the insurer's effective capital being placed in the special reserve.

We suggest that the categories of industrial development bonds be reduced from three -- (1) investment grade secured by collateral or having a term of seven years or less, (2) other investment grade and (3) non-investment grade -- to two -- (1) investment grade and (2) non-investment grade. We do not believe that in the case of industrial development bonds, the additional restrictions of collateral security or a term of seven years or less significantly lowers the risk so as to warrant different treatment. We also believe that a contribution rate of 1%, being three times our proposed rate for municipal obligations bonds, provides adequate security. Moreover, these changes would make the contingency reserve categories of industrial development bonds consistent with the aggregate risk limit provisions, which distinguishes only between investment grade and non-investment grade industrial development bonds.

We suggest that both non-investment grade industrial development bonds and other obligations secured by a conveyance or mortgage of property for the protection of the insurer be treated the same and require special reserve contribution of two percent. Industrial development bonds generally are secured by a mortgage or other security and thus essentially are equivalent in risk to other obligations so secured. We believe that such obligations are significantly less risky than other non-investment grade obligations without such security and thus warrant a 2% contribution level instead of the Bill's 2 1/2% level for all non-investment grade obligations. The proposed definition of a qualifying conveyance or mortgage is identical that contained in section 4118 of the Insurance Law, which pertains to the single risk limit applicable to surety and fidelity insurers.

The Association recommends a decrease in the level applicable to guaranties of consumer debt obligations contained in paragraph (b)(3) from 2% to 1.50%. We have researched consumer loan experience going back to the 1930's, which we would be pleased to share with you. The default rate of those types of loans supports our suggested percentage.

The Association proposes identical technical amendments to paragraphs (c)(1) and (c)(2) to make it clear that the special reserves required by subsection (a) and (b) are to be funded from the quarterly contributions provided by these paragraphs. Otherwise, the provision may be subject to an interpretation requring an immediate funding upon enactment of a Bill of the reserve applicable to outstanding liabilities. Incidentally, the NAIC Study Groups Exposure Draft 4 provides for a similiar gradual build-up of the special reserves of current insurers. The Association suggests amending paragraphs to (c)(1) and (c)(2) provide for a reduced rate of special reserve once the special reserve has reached one-half of the required amount. These amendments will allow the insurer to make contributions to complete the funding in an amount that will not exceed 50% of earned premium. Contributions in excess of 50% of earned premium are not deductible under section 832(e) of the Internal Revenue Code.

We propose amending paragraph (c)(3) so that the reinsured is required to establish and maintain the special reserve in reinsured transactions if the reinsurance agreement does require the reinsurer to do so, rather than absolutely requiring the reinsurer to do so in every instance. This matter is discussed in detail in connection with a proposed amendment to section 6407(a)(2).

The Association recommends several technical changes to paragraph (c)(4). We believe that the references to "contingency reserve" should be to "special reserve" or "financial guaranty reserve" as indicated since this section pertaining to withdrawals is meant to apply to both types of reserves. We also believe that "to the extent of any excess" should be deleted so as to allow the insurer to withdraw from the special reserve in the event of actual incurred losses in excess of 35% of earned permium, even though the special reserve may not have reached the levels specified in subsections (a) and (b). Also, "insurers" in subparagraph (B) should be "insurer's".

PERMISSIBLE CONFORMING AMENDMENT

Proposed Amendment to Section 6904

6904. Limitations. (a) Financial guaranty insurance may be transacted in this state only by a corporation licensed for such purpose; provided, however, that an insurer authorized pursuant to subsection (c) of section six thousand nine hundred two of this article may issue policies of financial guaranty insurance {with respect to municipal bonds} on risks described in subparagraph (A) of paragraph one of subsection (a) of section six thousand nine hundred one of this article.

Commentary

The Association's proposed amendment to 6902(c) give rise to the need for the conforming amendment proposed to 6904(a).

AGGREGATE RISK LIMITS

Proposed amendment to section 6904(c):

(c) An insurer issuing policies of financial guaranty[insurance in this state must at all times maintain surplus to policyholders and special reserves in the aggregate no less than the sum of:

(1) one-third of one percent of the aggregate net liability under guaranties of municipal obligations bonds;
(2) one percent of the aggregate net liability under guaranties of (i) investment grade industrial development bonds and (ii) other investment grade obligations secured by collateral or having a term of seven years or less;
(3) one and one-third percent of aggregate net liability under guaranties of consumer debt obligations;
[(3)] (4) one and one-half percent of the aggregate net liability under guaranties of [other] investment grade obligations other than those specified in paragraph (1) or (2) of this subsection;
[(4) two percent of the aggregate net liabilty under guaranties of consumer debt obligations;]
(5) two percent of the aggregate net liability under guaranties of obligations not of investment grade and secured by a conveyance or mortgage of property for the insurer's protection;
[(5)] (6) four percent of the aggregate net liability under guaranties of obligations not of investment grade and not secured by a conveyance or mortgage of property for the insurer's protection; and
[(6)] (7) in the case of a financial guaranty insurance corporation, an amount determined by the superintendent to be adequate to support the writing of residual value insurance, fidelity and surety insurance and credit insurance if the corporation has elected to transact such kinds of insurance pursuant to subsection (a) of section six thousand nine hundred two of this article;

Commentary:

We recommend a technical change to paragraph (c)(2) to make it clear that "secured by collateral or having a term of seven years of less" refers only to "other investments grade obligations" and not to "industrial development bonds." As discussed above, we believe that all investment grade industrial developments bonds warrant the same aggregate risk and contingency reserve treatment.

The Association proposes increasing the aggregate risk limit for consumer debt obligations from 2% to 1 1/3%. This increase is supported by the loss data of this type of loan referred to above.

We suggest creating an additional category of non-investment grade obligations that are secured by a conveyance or mortgage of property and providing an aggregate risk limit of 2% for the new category. As discussed above, since these obligations are secured by mortgages or property they provide a significantly lower risk than other unsecured non-investment grade obligations.

SINGLE RISK LIMIT

Proposed amendment to section 6904(d):

(d) An insurer issuing policies of financial guaranty insurance in this state shall limit its exposure to loss, net of collateral and qualified reinsurance under section six thousand nine hundred seven of this article, as follows:

(1) With respect to policies of insurance on municipal bonds:

(A) the insured average annual debt service, with respect to obligations issued by a single entity and backed by a single revenue source, may not exceed ten percent of the aggregate of the insurer's surplus to policyholders and contingency reserve; and

(B) the insured unpaid principal, with respect to obligations issued by a single entity and backed by a single revenue source, may not exceed [fifty] one hundred percent of the aggregate of the insurers's surplus to policyholders and contingency reserve.

(2) With respect to policies of insurance on all other classes of financial guaranty insurance, the insured unpaid principal with respect to [obligations for] any [one entity] single risk may not exceed ten percent of the aggregate of the insurer's surplus to policyholders and special reserves. Such single risk shall be defined as the obligations of any one entity or issuer, except that if the insured obligation is secured by a specified revenue source or adequately collateralized by qualified assests, such risk is to be defined by revenue source.

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Commentary:

The Association submits that subparagraph (1)(A) requires two technical amendments to conform its wording to that of subparagraph (1)(B). First, the reference to "single entity" should be changed to "single entity backed by a single revenue source." While the Study Group's prior drafts contained a provision essentially identical to subparagraph (1)(A), we believe that the omission of the reference to a single revenue source in those drafts was inadvertent. The Study Group's Exposure Draft 4 adds the above underlined language to the first part of the test. Indeed, we can perceive no reason supporting its deletion. Second, subparagraph (1)(A), like subparagraph (1)(B), should refer to "the aggregate of the insurer's surplus to policyholders and contingency reserve." Since clearly an aggregate is intended, the additional language will prevent any future misconception.

The Association further proposes a substantive amendment to subparagraph (1)(B). We believe that the 50% limit with respect to the principal amount insured is unnecessarily restrictive and instead should be 100%. We understand that 50% is based on the premise that a municipal bond insurer should be able to withstand two total losses without becoming insolvent. The history of the frequency and duration of municipal bond defaults, both during the Depression and in more recent times, indicates that this premise is unfounded.

A municipal bond insurer's obligation only is to pay principal and interest as it becomes due over the term of the bond. The par amount can not be accelerated with respect to the insurer, so that a total loss will not require an immediate payment of outstanding principal. In addition, the insurer's loss reserves required by the section 6903(d) for a total loss will be substantially less than the principal of the insured obligation. Even if the total principal were reserved, the amount reserved would be reduced by salvage and the time value of money. Therefore, even a total loss equal to 100% of the policyholders' surplus and contingency reserve of the insurer cannot cause, by itself, an insolvency.

Moreover, ninety-seven percent of the municipal defaults that occurred during the Great Depression experienced total recovery within four years. Such historical trend is consistent with current experience of municipal bond insurers. Except for AMBAC Indemnity Corporation, no municipal bond insurer has suffered even one default. AMBAC has suffered approximately 14 defaults over a fifteen year period and has not only remained solvent but also has retained its "AAA" rating. Therefore, a statutory limit based upon the above premise is inconsistent with the historic strength and prosperity of municipal bond insurers, especially since these insurers currently are operating in New York under Regulation 61, which has no single risk limit based on principal amount of the insured obligation.

The proposed 50% single risk limitation would be especially restrictive for new companies attempting to enter the municipal bond insurance market. Since the base against which the 50% limit is applied includes capital, surplus <u>and</u> contingency reserve, and since newer companies will have a substantially smaller contingency reserve than established insurers, such new companies will find it difficult to compete for the longer, better quality municipal bonds.

The suggested addition concerning a single revenue source to the single risk limit applicable to non-municipal bonds contained in paragraph (2) is necessary to prevent an unduly restrictive result in certain circumstances. For example, under the provision in the Bill, a trustee for pass through securities backed by mortgages or automobile loans would be considered one entity and thus a single risk, thereby effectively prohibiting the insurance of this type of debt. Instead, the revenue source -- i.e., each loan -- should be considered a single risk since it, rather than the trustee, is source of the proceeds to pay the obligation.

RUN OFF OF EXISTING BUSINESS

Proposed Amendment to Section 6904(g)(3)

6904(g)(3) line 11...be subject to the special reserve requirements specified in section six thousand nine hundred three of this article for all policies in force on the effective date of this article. (Delete after the word, "article", line 11 - line 16).

Commentary

The Association proposes a technical amendment to 6904(g)(3) that is intended to cure an apparent oversight which would require companies that chose to run off their existing books of financial guaranty insurance to retroactively create a special reserve equal to 50% of earned premiums from the inception of the coverages issued. The existing language allows a company three years to build such reserve which could easily mean that they would have to contribute 100% or more of earned premiums over such three year period even though their exposure is declining over time. The proposed amendment would require such companies to establish special reserves for all exposures outstanding at the date of enactment of the bill in the same manner as if they were written on such date. This will cause the special reserves to be directly related to the risks outstanding rather than an arbitrary 50% of earned premiums and would produce a more realistic result.

SPECIAL LIMITATION ON INSURERS
LICENSED TO WRITE SURETY INSURANCE

Proposed Amendment to Section 6905:

6905. Special limitations on multiline insurers.

(a) With respect to an insurer that transacts other lines of insurance in addition to financial guaranty insurance, gross premiums written, including reinsurance assumed, from financial guaranty insurance must be less than twenty-five or greater than ninety percent of gross premiums written, including reinsurance assumed, from all lines of business.

(b) With respect to an insurer whose gross premiums written, including reinsurance assumed, from financial guaranty insurance are less than twenty-five percent of gross premiums written, including reinsurance assumed, from all lines of business, surplus to policyholders and special reserves required to be maintained under subsection (c) of section six thousand nine hundred four of this article must be less than the sum of (1) twenty-five percent of the insurer's surplus to policyholders, and (2) its special reserves.

(c) If an insurer shall at any time exceed the limitations prescribed by subsection (a) or (b) of this section, it shall cease issuing any new policies of financial guaranty insurance until it no longer exceeds said limitations.

Commentary:

The Association suggests that an amendment to Section 6905 is necessary in light of its proposed substantive amendment to Section 6902(c). If insurers licensed to write surety insurance are likewise permitted to write financial guaranty insurance on risks described in subparagraph (A) of Section 6901(a)(1), it is our view that any special limitations imposed on insurers licensed to write surety insurance should permit such insurers to write municipal bond insurance as well as other forms of payment guaranty in a manner which does not, in effect, force a choice between the two. The Association believes that a twenty-five percent limitation is less retrictive than the twenty percent limitation currently contained in the legislation but still imposes a meaningful constraint on insurers licensed to write surety insurance.

REINSURANCE

Proposed amendment to Section 6907(a)(2):

(2) placed with another type of insurer licensed to write fidelity and surety insurance, if the reinsurance agreement with such insurer requires that such insurer:

Commentary:

The Association proposes a technical amendment so that the requirements for acceptable reinsurance must be part of the reinsurance agreement, rather than absolutely requiring compliance by the reinsurer; for the reinsured to take credit for reinsurance. Under the wording of the Bill, the reinsured would have the heavy and unreasonable burden of policing its reinsurers. The proposed amendment makes the requirements contract obligations of the reinsurer.

REINSURANCE
(continued)

Proposed Amendment to Section 6907(a)(2)(A)

6907(a)(2)(A) has and maintains surplus to policyholders of at least {seventy} thirty-five million dollars;

Commentary

The Association proposes a substantive amendment to 6907(a)(2)(A) which would require a reinsurer to maintain surplus to policyholders' of at least $35 million rather than $75 million as contained in the bill. Statistics compiled by the Reinsurance Association of America indicate that only 15 of 56 member companies had policyholders' surplus in excess of $75 million at December 31, 1985. The proposed standard of thirty-five million dollars would add another 12 companies to the list of potential reinsurers. The Association believes that the availability of reinsurance is a critical factor in the management of exposure assumed by insurers and feels that a standard which permits approximately half of the members of the RAA to reinsure financial guaranty exposures is desirable while still providing quality security.

REINSURANCE
(continued)

Proposed Amendment to Section 6907(a)(2)(B)

6907(a)(2)(B) line 24...may only be terminated {or amended at the request} with the consent of the ceding company or at the discretion...

Commentary

The Association proposes a technical amendment to the requirements for reinsurance credit which would permit termination of treaties with the consent of the ceding company not just at the request of the ceding company. Typical treaties provide for run-off to natural expiry of all contracts in force in the event of cancellation or non-renewal by a reinsurer, while permitting the ceding company to allow termination on a cut off basis with its consent. Such consent will typically be granted when the ceding company is able to locate another reinsurer who will agree to assume the business in force.

REINSURANCE

(continued)

Proposed amendment to section 6907(a)(2)(C):

(C) establishes and maintains the special reserves required in section six thousand nine hundred three of this article except that if the reinsurance agreement is not pro rata the contribution to the special reserves shall be equal to fifty percent of the quarterly earned reinsurance premium[;] and except that the reinsurer need not establish and maintain such special reserves if the reinsured establishes and maintains such special reserves for the ceded risk;

REINSURANCE
(continued)

Proposed Amendment to Section 6907(a)(2)(A)

6907(a)(2)(A) has and maintains surplus to policyholders of at least {seventy} thirty-five million dollars;

Commentary

The Association proposes a substantive amendment to 6907(a)(2)(A) which would require a reinsurer to maintain surplus to policyholders' of at least $35 million rather than $75 million as contained in the bill. Statistics compiled by the Reinsurance Association of America indicate that only 15 of 56 member companies had policyholders' surplus in excess of $75 million at December 31, 1985. The proposed standard of thirty-five million dollars would add another 12 companies to the list of potential reinsurers. The Association believes that the availability of reinsurance is a critical factor in the management of exposure assumed by insurers and feels that a standard which permits approximately half of the members of the RAA to reinsure financial guaranty exposures is desirable while still providing quality security.

REINSURANCE
(continued)

Proposed Amendment to Section 6907(a)(2)(B)

6907(a)(2)(B) line 24...may only be terminated {or amended at the request} with the consent of the ceding company or at the discretion...

Commentary

The Association proposes a technical amendment to the requirements for reinsurance credit which would permit termination of treaties with the consent of the ceding company not just at the request of the ceding company. Typical treaties provide for run-off to natural expiry of all contracts in force in the event of cancellation or non-renewal by a reinsurer, while permitting the ceding company to allow termination on a cut off basis with its consent. Such consent will typically be granted when the ceding company is able to locate another reinsurer who will agree to assume the business in force.

REINSURANCE

(continued)

Proposed amendment to section 6907(a)(2)(C):

(C) establishes and maintains the special reserves required in section six thousand nine hundred three of this article except that if the reinsurance agreement is not pro rata the contribution to the special reserves shall be equal to fifty percent of the quarterly earned reinsurance premium[;] and except that the reinsurer need not establish and maintain such special reserves if the reinsured establishes and maintains such special reserves for the ceded risk;

Commentary:

The Bill requires the reinsurer to establish and maintain the special reserve based on the ceded risk. This requirement is an unnecessary restriction. The reinsurer should not have the obligation to carry a special reserve for the ceded risk if the reinsured does so. It should not matter which company carries the reserve, so long as the reserve is carried. Indeed, having the special reserve under the control of the reinsured adds security to the transaction.

It should be noted that the Bill as drafted would conflict with section 12106(b) of the California Insurance Code, in that it would require duplicate contingency reserve requirements for municipal bond insurers and their reinsurers in certain circumstances. Section 12106 allows credit for the contingency reserve established and maintained by the reinsurer only if the reinsurer is an authorized municipal bond or surety insurer. If the reinsurer is a nonadmitted foreign or alien reinsurer, the reinsured must continue to maintain the contingency reserve for the entire risk. Thus, where a municipal bond insurer is licensed in New York and California and is reinsuring with a reinsurer not admitted in California, the reinsured would have to carry a contingency reserve based on the entire risk to comply with New York law, while the reinsurer would have to carry the contingency reserve based on the ceded risk to comply with New York. The proposed amendment would alleviate the double reserving obligation.

Proposed Amendment to Section 6907(a)(2)(F)

6907(a)(2)(F) with respect to reinsurance of risks described in subparagraphs (B), (C), (D), (E), and (F) of paragraph one of subsection (a) of section six thousand nine hundred one of this article:

(1) is not a parent, another subsidiary of the parent of the insurer or a subsidiary of the insurer. Direct or indirect ownership interest of twenty-five percent or more shall be deemed a parent/subsidiary relationship;

(2) is an affiliate of the insurer, such affiliate shall not assume a percentage of the insurers' total liability in excess of its equity interest in the insurer; and

Commentary

The Association proposes a conforming amendment to 6907(a)(2)(F) which would limit the restrictions imposed on parent, subsidiary or affiliate reinsurance transactions only to those classes of business which are restricted to financial guaranty insurers. This will eliminate a problem which many multiline insurers would otherwise encounter since they frequently employ "Intercompany Pool" reinsurance programs designed to allocate risks assumed by a group of companies in accordance with their relative surplus to policyholders. In fact many of the Claims Paying Ability Ratings of companies are dependent on the existence of such Intercompany Pools. The concept of prohibiting reinsurance by a parent or subsidiary was introduced by the New York Department to avoid the possibility of a company circumventing monoline restrictions by creating a financial guaranty insurer and automatically reinsuring with the parent company or other affiliates. The proposed amendment retains this concept for classes of financial guaranty insurance other than municipal bonds and payment guaranties which could only be written by financial guaranty insurance companies licensed pursuant to this article.

REINSURANCE
(continued)

Proposed Amendment to Section 6907(a)(2)(H)

6907(a)(2){H} line 17... (G)

Commentary

Renumber (H) as (G) to reflect changes made.

DEFINITIONS OF LINES OF BUSINESS

Proposed Amendment to Page 20 Section 2.(B) and Section 3.(17) and (22)

page 20
2.(B) line 27...as defined {by paragraph one} of subsection (a)...

3. (17) line 23...as defined {by paragraph one} of subsection (a)...

(22) Delete underlined reference line 6 through 10.

Commentary

The Association proposes technical amendments to Section 2.(B) and Section 3. (17) and (22) to eliminate possible confusion as to whether a risk is defined as financial guaranty insurance or the specific line referenced in each paragraph. This is accomplished by expanding the reference to the complete definition of financial guaranty insurance including the relevant exclusions.

for utilities, exclusive of 1912–15, when few were rated, 20.6 percent and 2.1 percent; and for industrials for the same periods, 23.5 percent and 2.3 percent. The default rates on unrated issues stood about midway between the rates for the high and low grades, averaging 10.7 percent for rails, 16.3 percent for utilities, and 13.3 percent for industrials. Defaults were particularly heavy for high-grade rails in 1912–15 and 1932–35, for high-grade utilities in 1916–19, and for high-grade industrials in 1932–35.

TABLE 35—Quadrennial Default Rates for Outstandings with High and Low Agency Ratings at Beginning of Periods, 1912–43

PERIOD	I–IV	V–IX	*No Rating*	I–IV	V–IX	*No Rating*	I–IV	V–IX	*No Rating*
	All Issues			*Large Issues*			*Small Issues*		
1912–15	7.0%	49.3%	8.5%	5.9%	54.3%	8.7%	12.6%	19.0%	8.2%
1916–19	3.4	21.6	9.2	3.0	19.6	1.5	5.3	25.6	11.5
1920–23	1.0	18.2	14.9	0.9	17.8	22.0	1.2	18.7	13.4
1924–27	1.1	23.5	13.8	1.1	26.9		0.8	17.3	13.8
1928–31	1.4	22.6	7.2	0.8	21.5	6.3	4.6	24.1	7.5
1932–35	6.2	48.9	49.2	6.1	46.6	54.3	7.1	58.5	48.2
1936–39	3.3	21.7	8.0	3.3	24.2	0.0	3.3	10.3	12.2
1940–43	0.4	8.9	6.8	0.2	7.0	0.0	3.0	17.8	11.8
	Railroads			*Public Utilities*			*Industrials*		
1912–15	7.1	48.8	13.5	0.0*	100.0*	6.7	0.0*		11.2
1916–19	1.7	12.3	24.2	8.6	30.1	3.7	0.3	17.2	4.4
1920–23	1.0	20.1	11.1	0.9	16.6	25.2	1.0	28.1	3.6
1924–27	0.6	29.5	13.1	0.7	16.6	13.1	3.1	29.4	14.1
1928–31	0.8	23.6	0.0	3.3	18.1	2.9	2.9	27.6	8.4
1932–35	10.5	68.8	0.0	1.8	41.9	45.6	7.2	38.2	51.9
1936–39	6.3	43.4	0.0	9.1	10.9	14.5	1.4	12.2	8.7
1940–43	0.6	7.7	23.3	0.4	9.7	8.8	0.0	11.9	2.2

Based on Tables 164, 165, 167 and 168 of *Statistical Measures*: par-amount data for all large (straight) corporate issues in good standing at beginning of four-year periods, and for 10 percent of small issues adjusted quadrennially to universe totals.

* Based on less than five issues.

Data on quadrennial default rates for the individual rating grades I–IV are presented in Table 36 for four-year periods and for selected longer chronological periods. Again the table reflects the ability of the agencies to rank outstanding issues in order of default risk, the default rates rising with remarkable consistency

EXHIBIT B

CAPITAL REQUIREMENTS

(As Percentage of Total Liability Guaranteed)

	NAIC	Dunne	Advisory Committee
Muni Obligation Bonds	.2857 (350 to 1)	.33 (300 to 1)	.33 (300 to 1)
Special Revenue	.5714 (175 to 1)	.33 (300 to 1)	.33 (300 to 1)
Industrial Development Bonds			
. Investment Grade	1.0 (100 to 1)	1.0 (100 to 1)	.66 (150 to 1)
. Non-Investment Grade	1.0 (100 to 1)	4.0 (25 to 1)	.66 (150 to 1)
Investment Grade			
. Secured	1.0 (100 to 1)	1.0 (100 to 1)	1.0 (100 to 1)
. Less than 7 yrs.	-	1.0 (100 to 1)	1.0 (100 to 1)
. Other	4.0 (25 to 1)	1.5 (75 to 1)	1.0 (100 to 1)
Consumer Debt Obligations	4.0 (25 to 1	2.0 (50 to 1)	1.33 (75 to 1)
Non-Investment Grade	10.0 (10 to 1)	4.0 (25 to 1)	2.0 (50 to 1)

EXHIBIT A

SPECIAL RESERVE LEVELS
(Percentage of Par Value Guaranteed)

	NAIC	Dunne	Advisory Committee
Muni Obligation Bonds	.8	.7	.33
Special Revenue Bonds	1.2	.7	.33
Industrial Development Bonds			
. Investment Grade	1.6	1.0 (Secured) 1.5 (Not Secured)	1.0
Non-Investment Grade	1.6	2.5	1.0
Investment Grade			
. Secured	1.6	1.0	1.0
. Less Than 7 Years	-	1.0	1.0
. Other	2.5	1.5	1.0
Consumer Debt Obligation	3.0	2.0	1.5
Non-Investment Grade	3.0	2.5	2.0

November 1, 1986

COMPARISION OF PROPOSED AND IN EFFECT FINANCIAL GUARANTY INSURANCE LEGISLATION AND REGULATIONS

	CURRENT NEW YORK LAW (REGULATION 61)	CURRENT CALIFORNIA LAW (CH. 1014, LAWS 1985)	PROPOSED ILLINOIS REGULATION	NAIC MODEL ACT (N.Y.S. ASSEMBLY BILL BILL NO. 11347)	DUNNE BILL (N.Y.S. ASSEMBLY BILL NO. 11348)	INDUSTRY BILL (N.Y.S. ASSEMBLY BILL NO. 11349)
APPLICABILITY	Municipal bond insurance only only	Municipal bond insurance only	Municipal bond insurance insurance	All financial guaranty insurance	All financial guaranty insurance	All financial guaranty insurance
MONOLINE - MULTILINE:	Multiline allowed	Multiline allowed	Multiline allowed	Monoline only	Multiline allowed for municipal bond insurance	Multiline allowed
1. REQUIRED FINANCIAL STATEMENTS	None	None	None	None	Quarterly reports of aggregate risk limits	Quarterly reports of aggregate risk limits
2.SPECIAL MULTILINE LIMITS	None None	None	Aggregate risk limit of 60:1 for multiline insurers	Not applicable	Financial guaranty insurance premiums must constitute less than 20% or more than 90% of gross written premium	Financial guaranty insurance premiums must constitute less than 25% or more than 90% of gross written premium
3. SPECIAL INSOLVENCY PROVISIONS	None	None	None	Excludes financial guaranty insurance from property casualty	Excludes financial guaranty insurance from property casualty	Excludes financial guaranty insurance from property casualty

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	CURRENT NEW YORK LAW (REGULATION 61)	CURRENT CALIFORNIA LAW (CH. 1014, LAWS 1985)	PROPOSED ILLINOIS REGULATION	NAIC MODEL ACT (N.Y.S. ASSEMBLY BILL BILL NO. 11347)	DUNNE BILL (N.Y.S. ASSEMBLY BILL NO. 11348)	INDUSTRY BILL (N.Y.S. ASSEMBLY BILL NO. 11349)
MINIMUM CAPITAL	No specific requirement	No specific requirement	No specific requirement	Paid-in capital at least $10,000,000; paid-in surplus to be maintained at $35,000,000.	(a) Paid-in capital of at least $15,000,000; paid-in surplus of at least $60,000,000; minimum policy-holders' surplus to be maintained at $65,000,000 or (b) If already licensed to write fidelity and surety insurance, policyholders' surplus plus reserves of at least $75,000,000.	Last statement on file with super-intendent must must show policyholders' surplus and special reserves of at least $50,000,000.
ALLOWABLE WRITINGS	municipal bonds	municipal bonds	municipal bonds	Only specified obligations may be guaranteed; others subject to approval.	All payment and credit guarantees without approval; others subject to approval.	All payment and credit guarantees without approval; others subject to approval

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	CURRENT NEW YORK LAW (REGULATION 61)	CURRENT CALIFORNIA LAW (CH. 1014, LAWS 1985)	PROPOSED ILLINOIS REGULATION	NAIC MODEL ACT (N.Y.S. ASSEMBLY BILL BILL NO. 11347)	DUNNE BILL (N.Y.S. ASSEMBLY BILL NO. 11348)	INDUSTRY BILL (N.Y.S. ASSEMBLY BILL NO. 11349)
DEFINITION OF "INVESTMENT GRADE" OBLIGATIONS	None	None	None	1. Issues rated by a recognized rating agency 2. Nonrated issues only if approved by securities valuation office	1. Issues rated by a recognized rating agency 2. Nonrated issues must pass MSVR test No. 1; no approval of securities valuation office required	1. Issues rated by a recognized rating agency 2. Nonrated issues must pass MSVR test No. 1; no approval of securities valuation office required
DEFINITION OF COLLATERAL	None	None	None	Letters of credit and mortgages are not included	Unclear if Letters of credit and mortgages are not included	Letters of credit credit and and mortgages are included
CONTINGENCY OR SPECIAL RESERVE:						
1. AMOUNT	50% of earned premium	50% of earned premium	50% of earned premium	See Exhibit A attached hereto		

	CURRENT NEW YORK LAW (REGULATION 61)	CURRENT CALIFORNIA LAW (Ch. 1014, LAWS 1985)	PROPOSED ILLINOIS REGULATION	NAIC MODEL ACT (N.Y.S. ASSEMBLY BILL BILL NO. 11347)	DUNNE BILL (N.Y.S. ASSEMBLY BILL NO. 11348)	INDUSTRY BILL (N.Y.S. ASSEMBLY BILL NO. 11349)
2. METHODOLOGY	Held for 20 years; after 10 years may be released to the extent demonstrated to be excessive.	Held for 20 years or until equal to 1% of aggregate liability, whichever is longer.	Held for 20 years; may be released if exceeds 0.5% of aggregate liability or demonstrated to be excessive.	80 (40 for non-municipal obligations) quarterly additions equal to the greater of one-eightieth (one-fortieth for non-municipal obligations), of amounts required or 50% of of quarterly earned premiums. After 10 years (5 for non-municipal obligations), reserves may be released to the extent demonstrated to be excessive in relation to then outstand- guaranties.	80 (40 for non-municipal obligations) quarterly additions equal to the greater of one-eightieth (one forthieth for non-municipal obligations), of amounts required or 50% of of quarterly earned premiums After 10 years (5 for non-municipal obligations), reserves may ba released to the extent demonstrated to be excessive in relation to then outstand- guaranties.	Annual (rather than quarterly) additions equal to the greater of one-twentieth (one-tenth for non-municipal obligations) of amounts required or 50% of annual earned premiums. After the reserve is is half funded, funding on the the basis of the the lesser of one twentieth (one-tenth for non-municipal obligations) of the total requirement of amounts required calculated on the basis of then current outstanding insured obligations or 50% of earned premium. Additions shall maintained for 20 years (10 years for non-municipal

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	CURRENT NEW YORK LAW (REGULATION 61)	CURRENT CALIFORNIA LAW (CH. 1014, LAWS 1985)	PROPOSED ILLINOIS REGULATION	NAIC MODEL ACT (N.Y.S. ASSEMBLY BILL No. 11347	DUNNE BILL (N.Y.S. ASSEMBLY BILL NO. 11348)	INDUSTRY BILL (N.Y.S. ASSEMBLY BILL NO. 11349)
AGGREGATE RISK LIMITS	0.33% (300:1)	0.66% (200:1)	0.33% (300:1)	See Exhibit B attached hareto		
SINGLE RISK LIMITS	Unweighted average annual debt service cannot exceed 10% of capital, surplus and contingency reserve.	Unweighted average annual debt service cannot exceed 7 1/2% of capital, surplus and contingency reserve.	1. Weighted average annual debt service cannot exceed 10% of capital, surplus and and contingency reserve	Municipal Bonds: 1. Weighted average annual cannot exceed 10% of capital, surplus and contingency reserve, and	Municipal Bonds: 1. Weighted average annual cannot exceed 10% of capital, surplus and contingency reserve; and	Municipal bonds: 1. Weighted average annual cannot exceed 10% of capital surplus and contingency reserve.
			2. Par insured cannot exceed 75% of capital, surplus and contingency reserve.	2. Par insured cannot exceed 50% of capital, surplus and contingency reserve.	2. Par insured cannot exceed 50% of capital, surplus and contingency reserve.	2. Par insured cannot exceed 100% of capital, surplus and contingency reserve.
				Other obligations: Par insured cannot exceed 10% of capital, surplus and contingency reserve.	Other obligtions: Par insured cannot exceed 10% of capital, surplus and contingency reserve.	Other obligations: Par insured cannot exceed 10% of capital, surplus and contingency reserve.

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	CURRENT NEW YORK LAW (REGULATION 61)	CURRENT CALIFORNIA LAW (Ch. 1014, LAWS 1985)	PROPOSED ILLINOIS REGULATION	NAIC MODEL ACT (N.Y.S. ASSEMBLY BILL NO. 11347)	DUNNE BILL (N.Y.S. ASSEMBLY BILL NO. 11348)	INDUSTRY BILL (N.Y.S. ASSEMBLY BILL NO. 11349)
REINSURANCE	No specific provisions	1. Nonadmitted must have minimum capital and surplus of $25 million. 2. Reinsured must maintain contingency reserve for risk ceded to to nonadmitted reinsurer. 3. Single and aggregate risk limits are aggregated for affiliates	1. Reinsurer must have $25 million minimum policy-holders' surplus. 2. Single and aggregate risk limit are measured against combined surplus of affiliated issuers.	Multiline reinsurers must maintain policyholders' surplus of at least $35,000,000, are subject to same reserve requirements identical as insurers, are subject to aggregate risk limit 50% of insurer, is not affiliated with insurer; maximum aggregate cessions to any one reinsurer of 50%.	Multiline reinsurers must maintain policyholders' surplus of at least $75,000,000, are subject to reserve requirements identical to those applicable to insurers; maximum aggregate cessions of 50% to any one, and 80% to all, multiline re-insurers	Reinsurers must maintain policyholders' surplus of at least $25,000,000; policyholders' surplus of affiliates is combined for single and aggregate risk limits.

Mr. FLORIO. Thank you very much.
Mr. Foley.

STATEMENT OF PATRICK J. FOLEY

Mr. FOLEY. Thank you. Good morning.

My name is Patrick Foley. I am Chairman of the Board of Directors of the Financial Guaranty Association. I am also Senior Vice President and General Counsel of the National Union Fire Insurance Company.

I believe that this hearing on financial guarantees is in keeping with the comprehensive charge of the Subcommittee on Commerce, Consumer Protection, and Competitiveness.

I am going to reduce my remarks considerably.

I ask, what happens when financial guarantees involve the very important issue of whether regulated U.S. industries remain competitive, add to the job and tax base, enable governments to borrow at a lower rate, and in regard to each other, face a formidable challenge from less regulated government-supported overseas capital?

We cannot look at this market in the parochial attitude of U.S. business only, because that is not what the marketplace is.

My colleagues have stated that the association favors reasonable regulation. So do I. But it is opposed to regulation that is overly restrictive.

Unfortunately, the National Association of Insurance Commissioners has adopted the model act, which is most restrictive.

Now, I was one of those people who may have been characterized as hysterical when I exercised my constitutional right to petition the legislature in New York to change that bill. I was interested in a different type of transitional rule, and I will go on to explain it.

If adopted by the State, it will cut down on the availability of financial guarantees. It could hurt insurance capacity in other essential insurance lines. It would discourage competition and encourage concentration in the sale of financial guarantees and of other insurance.

It would encourage, if not compel, government and private borrowers to seek financial guarantees and other insurance coverages in the overseas or nonadmitted market.

The bill would require only mono-line insurance companies to be authorized to sell financial guarantees. In effect, the model would force multi-line carriers to invest $150 million in a mono-line subsidy if they decided to remain in the financial guarantee insurance business.

That size investment is necessary in order to meet Standard & Poor's rating requirement that mono-line insurers be capitalized at that amount.

The problem, Chairman Florio, is that the size of the market for financial guarantees on private risks, though growing, is not large enough to justify the dedication of that amount of capital.

The market of writable private risk is simply not large enough to earn a reasonable return on that capital under a mono-line concept for companies going into the business at this time.

An example. We are a major insurer with several billion dollars in policyholder surplus. We write about $10 million of financial guarantee. For me to put $150 million dedicated to the capital of a subsidiary would be foolish in that I would not be using that capital to its utmost ability.

We believe that given the choice of either overinvesting in the financial guarantee business or quitting the business, prudent managers will most probably elect to commit their resources elsewhere. That is no way to encourage private sector economic growth.

It would discourage managers from innovative and expanding ideas in the insurance market. It would discourage investors, who would find the comfort factor less available in the private sector.

On the other hand, if all nine of the largest multi-line carriers now in the business decide to remain in the financial guarantee business, a total of $1.35 billion in present insurance surplus would be taken out of the general market and put into mono-line financial guarantee subsidiaries.

That is enough to ensure more than $4 billion in hard to place liability insurance or any other liability insurance, assuming that those companies write at the traditional risk ratio of three-to-one. This is no way to encourage availability in lines, such as directors and officers, environmental products, governmental liability, especially when the market has barely stabilized following the recent availability and affordability crisis in commercial line.

And indeed, maybe the only way companies could remain in the market under a mono-line bill would be to institute a substantial price increase.

The imposition of a regulatory framework which would, in effect, immobilize capital, forcing management to either commit the financial guarantees at the expense of capacity in other property and casualty liability lines, or forsake the growing financial guarantee market entirely, will not bolster competition among American insurers or their competitors in the face of overseas based competition.

Both the financial and general insurance markets need capacity, but neither should have it at the expense of the other. Any public policy which would force insurers to cut capacity in either, and therefore reduce availability, will only send customers to other markets. Such a public policy would be a mistake.

We, instead, support a regulatory policy which would allow capital to serve both the general and financial guarantee insurance markets under prudent reserving requirements and risk limits, and we believe that such regulation would best advance U.S. commercial and consumer interests and the competitiveness that serves both of them.

Thank you.

[The prepared statement of Mr. Foley follows:]

STATEMENT OF PATRICK J. FOLEY

Good morning. My name is Patrick J. Foley. I serve as Chairman of the Board of Directors and Vice President of the Association of Financial Guaranty Insurors. I am also a Senior Vice President and General Counsel of National Union Fire Insurance Group which I also serve as Assistant General Counsel and Vice President.

Chairman Florio and members of the subcommittee, I too welcome your interest in the financial guarantee insurance business and the ongoing discussions regarding to what extent financial guarantees, as State licensed insurers, should be subject to regulations beyond those that govern them today.

I believe that this hearing on financial guarantees is in keeping with the comprehensive charge of this Subcommittee on Commerce, Consumer Protection and Competitiveness.

What happens with financial guarantees will affect the ability of public and private institutions to move ahead with projects that add to the job and tax base in communities across the country.

What happens in regard to the regulation of financial guarantees will affect the ability of government and business to cut borrowing costs and access capital markets.

What happens with financial guarantees will affect an even greater number of public and private institutions and individuals who depend on the availability of other essential insurances at affordable prices.

What happens with financial guarantees involves the security, not just of those who purchased financial guaranty insurance contracts, but that greater market of individual investors and institutions that invest in the borrowings that drive economic growth, many of whom now rely on the "comfort factor" that financial guarantees provide.

And, what happens with financial guarantees involves the very important issue of whether regulated industries remain competitive, both in regard to each other and in the face of a formidable challenge from less regulated, government supported overseas capital.

As my colleagues have stated, the Association favors reasonable regulation. But it is opposed to regulation that is overly restrictive. Unfortunately, the National Association of Insurance Commissioners has adopted a model act which is most restrictive. If adopted by the States it would cut down on the availability of financial guarantees. It could hurt insurance capacity in other essential insurance lines. It would discourage competition and encourage concentration in the sales of financial guarantees and/or other insurance. It would encourage, if not compel, government and private borrowers to seek financial guarantees and other essential insurance coverages in overseas markets.

The bill would require that only mono-line insurance companies be authorized to sell financial guarantees. In effect, the model would force multiline carriers to invest $150 million in a mono-line subsidiary if they decided to remain in the financial guaranty insurance business.

That size investment is necessary in order to meet Standard & Poor's requirement that mono-line insurers be capitalized at that amount. The problem, Chairman Florio, is that the size of the market for financial guarantees on private risks, though growing, is not large enough to justify the dedication of that amount of capital. That market of writable private risk is simply not large enough to earn a reasonable return of capital. And it will not grow large enough for at least a decade.

Thus, faced with the choice of either over investing in the financial guaranty business or quitting the business, prudent managements may elect to commit their resources elsewhere. That is no way to encourage private sector economic growth. It would discourage managers from initiative and expansion. It would discourage investors who would find the comfort factor less available in the private sector.

On the other hand, if all nine of the large multi-line companies now in the business decide to remain in the business, a total of $1.35 billion in present insurance surplus would be taken out of the general market and put into mono-line financial guaranty subsidiaries. That is enough to insure more than $4 billion in hard to place liability insurance, assuming that those companies write at the traditional risk to capital ratio of three to one. That is no way to encourage availability in lines such as directors and officers, environmental, products, and governmental liability, especially when the market has barely stabilized following the recent availability/affordability crises in commercial liability lines. (Indeed the only way companies could remain in other markets under a mono-line bill would be to institute substantial, if not prohibitive price increases in the general market.)

The imposition of a regulatory framework which would, in effect immobilize capital, forcing management to either over commit to financial guarantees at the expense of capacity in other property/casualty liability lines, or forsake the growing financial guaranty market entirely will not bolster competition among American insurers or their competitiveness in the face of overseas based competition. Despite predictable displacements in capacity, demand will persist. It will seek usable capital where it can find it—here or overseas. We have only to look at the recent inroads of overseas competition in regard to letters of credit to see what can happen.

Both the financial and the general insurance market need capacity. But neither should have it at the expense of the other. Any public policy which would force insurers to cut capacity in either, and thereby, reduce availability, will only send customers to overseas markets.

Such a public policy would be a mistake.

We instead support a regulatory policy which would allow capital to serve both the general and financial guaranty insurance market under prudent reserving requirements and risk limits.

And we believe that such regulation would best advance commercial and consumer interests and the competitiveness that serves them both.

Thank you. I look forward to your questions.

Mr. FLORIO. Thank you very much.

Mr. Friedman.

STATEMENT OF GERALD L. FRIEDMAN

Mr. FRIEDMAN. Thank you, Chairman.

In the 5 minutes that I have with you, rather than read my testimony, I would like to get to the heart of the issue, as I see it.

Mr. FLORIO. All the witnesses, by the way, can take some confidence in the fact that I did read all the testimony that was submitted to us in advance of the hearing. So, it is not that you haven't got an opportunity to make your thoughts, but please feel free.

Mr. FRIEDMAN. The subject is near and dear to my heart, and I thank you and your colleagues for paying attention to it.

By way of important background, I have been in this business for 20 years. I was in the mortgage guarantee business for 15 of those years, president of the largest company. During that time, I founded AMBAC, which is now a Citicorp owned municipal bond insurance company. And in 1983, I founded FGIC. So, I have been involved with three of these companies.

As usual, I think this hearing is about money. Thinking of your earlier questions to the commissioner, I don't think you can adequately underwrite with all the talent in the world long-term financial risks, because you are dealing with interest rate risk, liquidity risk and economic risk.

And that is why the subject of capital adequacy is so very, very important in this business, where there is a lack of actuarial basis, more so than in other more traditional insurance lines.

And it is capital adequacy in itself which allows room for underwriting judgments which may prove to be imprudent, in spite of how talented the group may be.

There is a substantial disagreement in this trade association, although we are a member of it, on the issue of mono-line versus multi-line.

FGIC controls 34 percent of the municipal bond insurance market, and MBIA, one of four companies, controls another 32 or 33 percent. But MBIA's largest shareholder is Aetna, which is a multi-line company.

And so, if you are wondering why the association is testifying as an association on the multi-line framework, I would hesitate to point out that there may be some varying interests for our differences.

Back to the point, the substance. I think that there is a quasi public interest in anybody buying financial guarantee insurance.

We shouldn't be worried about the premium levels, because even if the industry were mono-line, there is tremendous price competition going on in the mono-line industry in and of itself. So, premiums have come down 30 percent, for example, in the last 1½ years in municipal bond insurance.

The focus should be on these insurers paying their claims when they occur.

Mr. FLORIO. Is it totally detached? That is, the relationship between premiums and the availability of paying the claims at some point. I mean, in the property and casualty area——

Mr. FRIEDMAN. No, it isn't detached at all. You really can't control rates in the financial guarantee business. So, the way to control capital adequacy, therefore, the only way to do it, is with capital requirements, not so much the entry capital requirements but more importantly the capital related to risk requirements.

The aggregate risk to capital would be the singlemost important barometer. It doesn't foreclose good underwriting requirements, which are necessary. But there is no substitute in this business for adequate capital when you are insuring 20 year risks.

Now, the way to accomplish this control, I believe, is with State regulation. And I believe that the NAIC and Commissioner Corcoran and other commissioners are well on their way to trying to embrace this industry with the proper amount of regulation.

Three points in the legislation. One is mono versus multi-line, which you have heard a lot about.

The second point is that there must be conservative capital to exposure limited.

Now, the existing New York regulation, which Superintendent Corcoran tried to change, was 300-to-1. In other words, you had to have a dollar of capital for every $300 of risk. Risk is principal and interest outstanding.

The model bill would have taken that down to about 200, 225-to-1, which wasn't bad. It wasn't going as far as the rating agencies go.

Now, the rating agencies in rating FGIC made us capitalize at 100-to-1. In other words, three times more conservative than the existing New York legislation, and twice as conservative as the NAIC bill.

But after all, the rating agencies are judging, trying to rate a triple-A company, and so it is perfectly logical that an NAIC bill would not be as conservative as a rating agency.

Now, the rating agencies, when you spoke of them earlier today—remember, the rating agencies' responsibility is to only rate the health of the issuer at the time it rates, and they downgrade ratings every week, and they upgrade them every week.

So, if they were here today and you said, which do you prefer, they would say both, and when we judge that the capital of either a mono-line company or the multi-line company is inadequate, or other components are inadequate, we will downgrade the company.

But I think the role of regulation and anybody concerned with the long-term viability of the industry goes beyond the role of the rating agency. So, there is a distinct difference, in that if anything were to happen to the other companies, other than FGIC, that provide municipal bond insurance, it would really hurt the value of FGIC's insurance or the value of viable companies' insurance.

Therefore, my emotion around wanting just the strongest type of regulations governing the industry.

There is plenty of capital in the mono-line business. There is over a billion dollars that has been put into the municipal bond industry in just the last 3 or 4 years by very responsible owners.

Our company is owned by J.P. Morgan, by General Electric, by GenRe, by Shearson American Express, by Kemper, and certainly they have put a lot of capital in, and Citicorp recently added $200 million to AMBAC. And there is ample capital in this business.

My fear, however, quite frankly, is not that Aetna won't compete with us as a multi-line carrier. They are very responsible. But that other multi-line companies with less resources will compete, will be shortsighted, will leverage their capital and drop the rates and reserves in the business. So that it will not be a fair playing field for the mono-line companies that Commissioner Corcoran would wall off.

So, what I am asking for is a level playing field. I think there ought to be a lot of capital in this business. I think there is a lot of capital in America that would invest in the business.

So, in summary, then, I think the game is, leveraged capital, not news, versus unleveraged capital.

And finally, I would point out some recent facts that are not in any of the testimony that I read.

The Japanese banks, which were very competitive in the credit enhancement business on the short end side, up to 10 years, have recently been downgraded by Moody's and Standard & Poor's, the strongest banks in Japan.

Why? Because they leveraged their balance sheets, and the result is that credit enhancement of those issues lost market value to the bond holders.

They were only downgraded, mind you, to a double-A from a triple-A. But it is indicative of what happens when you don't wall off financial guarantee risks from other risks.

Finally, I would hope that you would ask Pat Foley and others that would propose multi-line insurance companies whether they would propose that for mortgage insurance companies, as well, because the whole mortgage insurance industry—and I note Steve Doehler will be testifying—has lived on a mono-line basis. And AIG, which also owns a very responsible mortgage guarantee company, is a mono-line company, and AIG has chosen to invest capital in that industry.

Or would they have the whole mortgage insurance industry also be accessed by multi-line companies?

And then finally, finally, when I was at MGIC, Baldwin-United tried to take over that company in the year 1981, and I left in opposition.

But I must tell you that had MGIC not been a mono-line company with $400 million of walled off reserves, Baldwin- United and Morley Thompson would have grabbed that money in a hurry.

The result was that the single premium deferred annuity policyholders in America were denied payoffs, which is well established throughout this country, but that the mortgage guarantee insurance policyholders' claims were not denied. They were paid all the way through.

And it is a real testimony to the mono-line structure, that the mortgage guarantee industry has paid claims in dramatic fashion over the last couple of years.

I wonder whether they would have been able to do that had they been structured as multi-line companies.

Thank you.

[Testimony resumes on p. 362.]

[The prepared statement of Mr. Friedman follows:]

U. S. HOUSE OF REPRESENTATIVES

COMMITTEE ON ENERGY AND COMMERCE

SUBCOMMITTEE ON COMMERCE, CONSUMER PROTECTION
AND COMPETITIVENESS

Testimony of Gerald L. Friedman

at the

October 14, 1987 Public Hearing on

Financial Guaranty Insurance

I. Introduction and Qualifications

I am Gerald L. Friedman, the founder, Chairman and Chief Executive Officer of Financial Guaranty Insurance Company ("FGIC"). My entire professional career has been devoted to financial guaranties. I began as an attorney at Mortgage Guaranty Insurance Company ("MGIC") in Milwaukee in 1961, and remained there for twenty years, through 1981. The last six of those years I served as President and resigned in December of 1981 in opposition to the Baldwin-United takeover. Unfortunately for MGIC, Baldwin-United went bankrupt a year or so later. During my MGIC tenure, I was one of the founders of American Municipal Bond Assurance Co. ("AMBAC").

I founded FGIC in September of 1983 with $85 million of capital invested by General Electric Credit Corporation, General Re Corporation, Lumberman's Mutual Casualty Company (Kemper), Merrill Lynch & Co., Inc., Shearson Lehman Brothers, Inc., and myself. J. P. Morgan & Co. Incorporated joined our group shortly thereafter. By the end of June 1987, primarily through steady infusions of additional capital to keep pace with the Company's growth, FGIC's statutory capital and surplus had grown to over $352 million. By adding contingency reserves of approximately $31 million, FGIC had $383 million available to pay claims. This dynamic capital growth has matched FGIC's increase in insured principal and interest in force -- $48.6 billion on June 30, 1986.

Until July 1986, FGIC's capital additions were accomplished in the private market, from the Company's original investors. On July 30, 1986, FGIC completed a successful public offering managed by Goldman, Sachs & Co. FGIC netted $104 million. Of its 27,206,390 shares outstanding on June 30, 1987, 4,600,000 shares held by the public are now traded on the New York Stock Exchange.

In May 1986, FGIC became a member of the Association of Financial Guaranty Insurors.

II. Overview

A. General

Financial guaranties can be dangerous. They frequently involve long term economic risks and are not generally digestible for actuarial analysis. Many insurance companies refuse to engage in financial guaranties and Lloyds of London prohibits it. Many intelligent people in government and in business feel that it should be confined to the government. I disagree. It can be done by private enterprise, but only with conservative capital adequacy requirements.

In part, this lack of confidence in private enterprise stems from the failure of private mortgage insurance as practiced in New York. The founding of the first American Title Insurance Company in 1886 led to the birth of financial guaranty insurance in New York State in the early 1900's. From the start, these financial guaranty insurance companies operated in an unregulated environment. Those companies overvalued properties, cut premiums and engaged in poor investment practices. By 1933, forty-seven title companies in New York State were engaged in mortgage guaranty insurance, having issued policies guaranteeing over $2.8 billion, secured by capital and surplus of $184 million (over 6-1/2% of exposure!). In March of 1933, all mortgage guarantors were liquidated.

Another example of the risks inherent in financial guaranties may be seen in the area of private mortgage insurance. Since 1984, even the highly regulated private mortgage insurance companies are not doing that well. In 1985 and 1986, the industry paid claims of $971 million and $1.2 billion, respectively. This claims experience resulted in 1985 and 1986 loss ratios of 116.2% and 138.8%, respectively, compared with 1983 and 1984 loss ratios of 79.4% and 73.8%, respectively.

We do not have to look to tha distant past to find embarassments when it comes to financial guaranty insurance. In 1979, Lloyds of London suffered over $340 million in claims filed by U. S. leasing companies covering their losses on cancelled computer leases. Lloyds had provided protection against losses resulting from the early cancellation of lsased computers. They bet on residual value, a form of financial guaranty. By 1979, Lloyds had provided $1 billion of coverage of computer lease payments, over one third with the ITEL Corporation, one third of which became losses.

In February 1985, the Glacier General Assurance Company of Montana, a multiline insurance company engaged in writing medical and legal malpractice insurance, commercial automobile coverage and financial guarantees, stopped making paymenta under some of its mortgage insurance policies. Glacier General was declared insolvent by the Orange County Superior Court of California in November 1985, and its assets were subsequently seized by the California Department of Insurance.

In October of 1985, the infamous "EPIC" program brought down a previously respected and well-regulated California-domiciled private mortgage insurance company--TICOR.

At this point it should be ncted that it does not inherently take insolvency to hurt some types of financial guaranty insurance policyholders. For example, a mere downgrading of the credit rating of municipal bonds insured by a company whose own rating was lowered can result in a substantial loss in market value to those bondholders.

On December 20, 1985, Standard & Poor's ("S&P") lowered the claime-paying rating of another financial guarantor, this tims a municipal bond insuranoe guarantor. The Industrial Indemnity Co. ("II"), a subsidiary of Crum and Forster, which in turn is owned by Xerox Corporation, was downgraded by S&P to AA- from AAA. Over two hundred sixty tax-exempt bond issues, totalling $5.2 billion in par amount, were downgraded to AA- as a result of this downgrading.

Interestingly, II was structured as a multiline insurance company and its financial guaranty insurance was not the cause of the downgrading. Operating losses in other lines of business, especially workers' compensation, eroded the company's surplus. Even capital infusions by Xerox in 1983 and 1984 totalling $360 million could not preclude balance sheet deterioration.

Finally, on April 28, 1986, S&P downgraded U. S. Fidelity and Guaranty Co. (USF&G") to AA from AAA. A total of seventy-three tax-exempt issues, representing $1.1 billion in par amount, were affected by this rating action. As with II, it was not its financial guaranty business which hurt the company, but poor underwriting results in its property/casualty lines.

B. Municipal Bond Insurance

Since AMBAC's founding in 1971, about $350 billion in principal and interest have been insured, representing over $140 billion of bond par value. Through 1986, this business has generated about $2.3 billion in premiums, almost 75% of which since 1983. In terms of volume, municipal bond insurance is relatively new, with most of its exposure having come into existence during the last three years. Of the approximately $723 billion of municipal bonds outstanding at year end 1986, about $100 billion, or 14%, are insured. The primary beneficiaries of this insurance are retail bondholders who, in recent years, purchased well over 70% of new tax-exempt bond issues.

In view of the billions of dollars of municipal bond insurance being issued, the recent attention focused on the industry is very appropriate. I wish to commend the National Association of Insurance Commissioners ("NAIC"), the New York Insurance Department, and this Subcommittee for the attention being paid to this subject. You should be concerned.

Today, the municipal bond insurance business is dominated by four insurance organizations: Financial Guaranty Insurance Company, Municipal Bond Investors Assurance Corporation, American Municipal Bond Assurance Company and Bond Investors Guaranty Insurance Company. In 1986, another monoline financial guarantor, Capital Guaranty Insurance Company was formed. The ownership and control of these firms is dominated by respected and very well-capitalized firms. I firmly believe they will provide whatever capital is deemed appropriate by legislators and regulators to support this potentially profitable line of business. This commitment was demonstrated in June 1987 by the infusion into AMBAC of $200 million in additional capital from Citibank, N.A., AMBAC's principal stockholder.

I say potentially, because that assumes limited losses over time and adequate premium levels. Recent developments, lower interest rates and intense competition, make me question both assumptions. Premium rates in the municipal bond insurance industry are slipping dramatically. When I was the Chairman of AMBAC in 1981, the average premium rated was close to 90 basis points. As recently as two years ago, that was FGIC's average premium rate. For the first half of 1987, FGIC's average premium rate declined to 81 basis points. Interest rates have dropped significantly, and the interest cost savings which normally accrue to municipalities by using insurance is diminishing and disappearing. Instead of letting business go, the industry has recently dropped its premium rates precipitously into the 40's and 50's (in one case, as low as 20 basis points) to continue writing premium income.

Underpricing is dangerous enough in the property and casualty business. However, it is absolutely insidious in the long term financial guaranty business. Compared to more traditional insurers, it is relatively easy for a municipal bond insurer to jeopardize bondholder security by compromising its balance sheet. In the property and casualty industry, normal underwriting loss cycles are quickly discernible, attracting the attention of the insurance regulators, the rating agencies and the financial press. Such focus routinely forces a combination of management change, higher premium rates and more capital investment. This will not be the case in the municipal bond business. Municipal claims will occur in abundance at the time of economic catastrophe, and such cycles are much longer in duration. Therefore, it is only at the time that current industry executives are in their rocking chairs that insurance commissioners of the future will discover how wholly undercapitalized municipal bond insurers were. So, unlike personal and commercial lines where public pressure pushes premiums down, rate-cutting is really a disaster in the financial guaranty business. It can only be compensated for by conservative capital adequacy requirements.

The other development is that some losses are occurring even now, and I would not be surprised to see a few more occur in the near future. In September 1986, two Kentucky and Tennessee industrial development bond issues with an aggregate par amount of $79 million sold on behalf of partnerships created by Chattanooga, Tennessee developer Franklin L. Haney and insured by AMBAC went into default and gave rise to claims. As a result of these claims and other prior defaults, AMBAC paid out $6.7 million in 1986 and ended that year with reserves for losses of $47.7 million. AMBAC's incurred loss ratio in 1986 was 35.2%, slightly above the 35% level established by the NAIC's Financial Guaranty Insurance Model Act (the "Model Act") at which withdrawals may be made from special reserves.

III. Proposed Legislation

FGIC supports the implementation of comprehensive legislation with respect to the financial guaranty industry, and I believe that the NAIC's Model Act addresses the main concepts required in such legislation. Rather than discuss each major section of the Model Act, I will confine the remainder of my testimony to the key features FGIC regards as most important with respect to the future viability of the industry.

A. Multiline vs. Monoline.

My MGIC/Baldwin-United ("Baldwin") "experience" is a real-life example of the importance of establishing "designated" capital requirements in the financial guaranty insurance law. By the and of 1981, MGIC had approximately $500 million in capital and contingency reserves to support its mortgage guaranty policies in force. When Baldwin bought MGIC for $1.2 billion in early 1982, it immediately tried to raid MGIC's capital and contingency reserves to help finance its acquisition. Because of the monoline character of private mortgage insurance companies, the Wisconsin Commissioner was able to stop the Baldwin group from removing these funds from the insurance company. In recent years, private mortgage insurance losses have increased dramatically and these monies could prove to be essential in protecting MGIC's policyholders. Had MGIC been a multiline company, these policyholders could very well have shared the plight of the unfortunate Baldwin SPDA (Single Premium Deferred Annuity) policyholders; a classic case of insurance company abuse, if there ever was one.

No doubt, the property/casualty industry will vigorously resist the implementation of the monoline approach for reasons that go far beyond the financial guaranty issues which are currently being debated. Historically, multiline insurance companies are not in the habit of quantifying their exposure for regulators or investors. Traditionally, insurance company analysts and rating agencies use premiums written or a percentage of capital and surplus as a meaningful financial barometer. But doesn't outstanding insurance exposure count? A brcader application of the ". . .financial guaranty designated capital-to-exposure" concept would roduce the ability of property/casualty companies to leverage their existing capital. This is not a precedent that traditional insurance companies relish.

Some parties that oppose the designated capital concept for financial guaranties have proposed "allocated" capital as an alternative. I submit that merely counting the capital and surplus resources and assigning them to specific lines of business, rather than legally segregating the capital, is a sham. There is no way that allocation of capital would have stopped Baldwin United from raiding MGIC.

Finally, I believe that failing financial guaranty companies should not be allowed to deplete state insurance guaranty funds, which were created for the protection of the small retail insurance policyholder. Such funds could become a much weaker back-stop if financial guaranty companies are able to access them. Certainly, the profile of a financial guaranty policyholder is not a "poor, little unprotected policyholder on the street"; someone who is socially entitled to guaranty fund protection.

B. Capital Adequacy

1. Contingency Reserves as a Percent of Net Bond Par Written

The concept of a contingency reserve which relates to insurance written (guaranteed par value written), rather than, as provided in current law, simply a percentage of the gross premiums, is a logical concept. Allowing for expenses, normal losses, and underwriting profits, the total of which will always equal at least 50%, FGIC believes that a municipal bond insurer cannot self-generate capital if its premium allocations to its contingency reserve with respect to its overall portfolio exceed 60%. In other words, the effect of a contingency reserve requirement based upon exposure is to penalize the municipal bond insurer who chooses to "buy" business with irresponsible rate reductions. The consequences of such rate reductions would be borne by that insurer's investors rather than its policyholders.

The need for a contingency reserve requirement based upon exposure becomes apparent in Exhibit 1. With a premium rate of .80%, a municipal bond insurer's lifetime claims paying tolerance is five claims per 100 policies; that is, for every 100 insurance policies (each with a 20-year life) written today, the premiums derived therefrom would be sufficient to pay five claims evolving over the life of that book of business. However, with a premium rate of .50%, the lifetime claims paying tolerance is cut in half--two and one-half claims per 100 policies. While two and one-half claims may be a sufficient claims tolerance in a normal economy, one must never forget that municipal bond insurance reserves are supposed to be sufficient to cover a Depression-type loss experience.

Contingency reserves, unlike case basis reserves funded in relation to specific credit problems, should not be funded and allocated with respect to particular risks. Such reserves must instead be viewed as an added overall cushion to aid the insurer in withstanding additional losses which may occur during a severe economic downturn. It is therefore necessary that the funding of such reserves be based upon the net amount of risk underwritten, rather than the net amount of risk in force at any given time. Linking reserve funding to current insurance in force will result in widely fluctuating reserves rather than a consistent buildup and maintenance of reserves at levels sufficient to protect the insurer and its policyholders in the event of multiple municipal defaults.

The Model Act's approach to the funding and maintenance of contingency reserves incorporates two important concepts. First, the Model Act recognizes the need for distinctions among different types of credit (and the varying degrees of risk associated with such credits), thus ensuring that required reserve amounts reflect the composition of the insurer's risk portfolio. FGIC and the other insurers charge premiums for municipal risks ranging from the middle 40-basis points to in excess of one percent against total exposure, depending upon the source pledged for repayment of the bonds, with general obligation bonds viewed as far less risky than health care and nuclear powered joint action agencies. The Model Act recognizes these distinctions by providing two contingency reserve requirements for municipal bonds (in addition to a third contingency reserve level for industrial development bonds).

Second, and most importantly, the Model Act avoids the risk of linking reserve funding to premium levels by requiring periodic deposits based on the principal amount of risk assumed rather than the premium charged for such risk. As noted above, this approach ensures that reserve funding will not be affected by rate reductions and may have the practical effect of discouraging overly aggressive price cutting.

Some proponents of more liberal legislation have proposed alternative approaches to the contingency reserve issue. These approaches include the lack of distinct categories to reflect different credit risks, lower overall reserve levels, a modified funding scheme which would allow reserve contributions to be adversely affected by premium rate reductions, and the use of exposure in force rather exposure written as the basis for reserve requirements. Each of these proposed modifications would adversely affect the continuous buildup of the contingency reserve to a level commensurate with its function as a buffer against periods of catastrophic loss. FGIC therefore strongly supports the approach of the Model Act on this issue.

2. Aggregate Risk Limitations

FGIC believes in aggregate risk limitations of not more than 225 to 1, with a ratio of not more than 150 to 1 for "Triple A" rated insurers. Both Moody's and S&P seem to be moving toward similar ratios. The Model Act measures aggregate net liability as the sum of the unpaid interest and the unpaid principal due on the policies in force. Other proposed legislation, however, has computed aggregate net liability for certain non-municipal risks as the sum of the principal and the discounted present value of insured interest, resulting in an aggregate risk limitation for these risks based essentially on principal alone.

Are there features of these non-municipal riske which distinguish them from municipal risks and thus justify this different treatment? The answer we believe is no. Both municipal and non-municipal riske can typically be accelerated at the option of the insurer, resulting in the potential for a claim less than the full amount insured. Additionally, municipal entities stand a batter overall chance of recovery after the initial claim, through the implementation of increased taxes or ratea and charges pledged to the payment of bonds. As a result of this proposed modification to the Model Act's approach, only half of many non-municipal guaranties would be counted in determining the aggregate risk limitation. For these reasons, FGIC supports the aggregate risk limitations set forth in the Model Act.

3. Initial Entry Requirements

FGIC believas that strong capital adequacy requirements are needed for entry into the capital intensive financial guaranty industry. FGIC would therefore recommend a requirement of paid-in capital of at least $15 million and paid-in surplus of at least $60 million, for a total of $75 million, as opposed to the Model Act's requirements of $10, $40 and $50 million, respectively.

IV. Conclusion

Establishing a monoline requirement and adequate capital and special reserve requirements for financial guaranty insurers will be the two most important factors in determining whether financial guaranty insurance has a viable future. The NAIC Model Act accomplishes both these objectives, whereas more liberal legislation could lead to insuficient capitalization and irresponsible price-cutting.

The long-term credibility of the municipal bond insurance industry hinges on the ability of its participants to withstand an unprecedented level of claims. While the loss experience to date has been very favorable, with only a modest number and amount of claims incurred to date, the industry has yet to be severely tested. More than $100 billion of bond par value has been insured since 1983, representing approximately 70% of total bond par value insured by the industry since its inception in 1971. Furthermore, most of the exposure is long-term with an average maturity of 15 to 20 years. No matter how well an insurer underwrites its businss, losses will occur due to unforeseen economic factors, and such losses are likely to exceed the insignificant level of claims to date.

EXHIBIT 1

Capital Adequacy for Municipal Bond Insurance Measured in Terms of Lifetime Claims Tolerance

Introduction

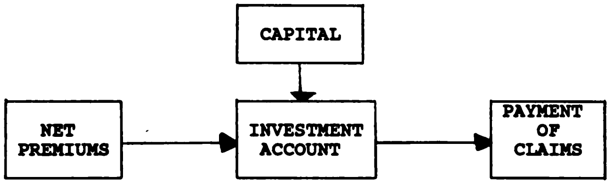
Set forth herein is FGIC's methodology for determining a municipal bond insurer's capacity to pay claims. Such claims-paying ability depends on the adequacy of both premium revenues and capital contributions.

Using a simplified business model and a conservative profile of assumed losses, we demonstrate that at a premium rate of .80% FGIC can pay 5 claims per 100 from premium revenues alone. While a premium rate of .80% is approximately FGIC's average premium rate, current rate cutting is driving premiums down towards .50% for certain categories of risk. At a premium rate of .50%, FGIC's claims paying ability from premiums alone is cut in half to 2-1/2 claims per 100.

With regard to capital, we demonstrate that by fully depleting capital we increase FGIC's claims-paying ability to 11.7 claims per 100. This conclusion is based on a 100:1 ratio of net risk to capital. At leverage ratios of 200:1 and 300:1, FGIC's claims tolerance per 100 policies drops to 8.4 and 6.3, respectively. Of course, FGIC's ability to raise capital to support incremental exposure is obviously dependent upon maintaining a quality stream of revenues (premiums), although such market access dependency is not further developed in this exhibit.

In conclusion, as a premium rate of .60% and a risk asset-to-capital ratio of 200:1 seem to be current market indicators, one final claims tolerance is offered. FGIC's claims tolerance at a premium rate of .60% and permitted leverage of 200:1 drops to 6.6 claims per 100--in sharp contrast to the 11.7 claims tolerance at former premium levels and a 100:1 ratio.

Business Model



From the perspective of the holder of an FGIC-insured municipal bond, FGIC is in business to pay claims. As depicted in the simplified business model above, claims are paid from the proceeds of an investment account. The investment account is funded with net premiums and capital. Accordingly, the ability to pay claims is directly dependent upon both capital and premiums. The capital/premiums relationship is critical to, but viewed differently by, regulators, shareholders, the "market" and reinsurers. These differences, and issues related thereto, are discussed below.

Claims Assumptions:

The credit risk analysis undertaken by FGIC and FGIC's high credit standards should be sufficient to screen out issuers likely to experience problems in the short-term. In constructing a conservative scenario for a FGIC claims profile, we assume that there are no claims for the first 5 policy-years and, thereafter, that a certain number of every 100 policies experience claims. We assume a typical claims pattern of 100% of total debt service (i.e., principal and interest payments) for policy years 6 and 7 and 25% of total debt service thereafter until maturity of the bond.(1)

Premium Cushion:

Claims-paying ability in the municipal bond business is sensitive to the fact that a bond default does not accelerate the insurer's payment guaranty. FGIC insurance only guaranties the timely and prompt payment of scheduled principal and interest. Premiums, however, are generally paid up-front and invested.

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(1) In our less simplified business model we actually employ loss profiles for each 14 risk categories of business; the claims profile scenario summarized above represents an average of these 14 profiles.

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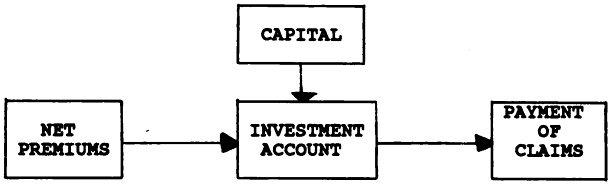

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To illustrate the economics of the compounding of invested premiums to pay debt service claims, consider a typical FGIC insured issue such as the revenue bond with the debt service schedule as set forth in Table I. Assuming an insurance premium of .80% of total debt service, a premium of $524,870 is due upon issuance of the bond insurance policy. Table II shows FGIC's cash flow results assuming that 100 such policies are written and that at the assumed premium level 75% of the initial premiums are available for claim payments after payment of FGIC's marketing, credit analysis, legal and other acquisition costs. The analysis shows that FGIC is able to service five claims per 100 without tapping its capital cushion.

As seen in Table II, net premiums of $39,365,000 support claims payments of $86,024,000. This is due to the compounding of invested premiums and the deferral (based on originally scheduled bond payments) of claims.

Capital Cushion:

In addition to income from invested premiums, dedicated cash capital provides an additional cushion for the payment of claims. From our business model of 100 policies (see Table I with total par value of $3,038,000,000 and total debt service exposure of $6,560,870,000, we can determine the capital required to support the $6,560,870,000 of net risk (*i.e.*, debt service exposure net of reinsurance). Assuming a 100 to 1 ratio of net risk to capital, FGIC is required to set aside $65,608,700 in capital.

We demonstrate in Table III that our claims tolerance increases to 11 3/4 claims par 100 from 5 claims per 100 when our investment account is increased by the full amount of the required capital.(2)

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(2) We assume in Table III that the 100 to 1 ratio is maintained until year 6 when the decision is made to retain all capital in the business. That is, as policies run-off over the first 5 years, net risk decreases and capital is remitted to shareholders to maintain the 100 to 1 ratio. In the sixth year, the decision is made to cease remitting due to the occurrence of claims for the full amount of debt service payable in that year.

TABLE I

Debt Service Structure of a Typical Issue
Example: A City Revenue Bond

Principal: $30,380,000 **Insurance Premium: 0.8% (assumed)**

Average Coupon: 9% **Serial Life: 1-20 years**

Year	Principal Due	Interest Due	Total Debt Service
1	$ 740,000	$ 2,622,175	$ 3,362,175
2	780,000	2,578,515	3,358,515
3	820,000	2,530,545	3,350,345
4	870,000	2,476,015	3,346,015
5	925,000	2,413,810	3,338,810
6	985,000	2,345,360	3,330,360
7	1,055,000	2,270,007	3,325,007
8	1,125,000	2,186,662	3,311,662
9	1,210,000	2,094,975	3,304,975
10	1,300,000	1,993,335	3,293,335
11	1,400,000	1,881,535	3,281,535
12	1,510,000	1,759,735	3,269,735
13	1,635,000	1,626,855	3,261,855
14	1,770,000	1,481,340	3,251,340
15	1,920,000	1,322,040	3,242,040
16	2,080,000	1,147,320	3,227,320
17	2,260,000	957,000	3,217,000
18	2,450,000	749,080	3,199,080
19	2,660,000	521,230	3,181,230
20	2,885,000	271,190	3,156,190
Total	$30,380,000	$35,228,725	$65,608,725

Gross Premium: $524,870
Premium Net of Acquisition Expense = $393,653

Note: 100 policies $3,038,000,000 principal
$6,560,870,000 debt service

TABLE II

Premium Breakeven Cash Flow Projection (a)
($000's)

Year	Premium and Net Investment Income (b)	5 Claims for Debt Service	Cumulative Cash Flow
0	39,365	-	39,365
1	3,149	-	42,514
2	3,401	-	45,915
3	3,677	-	49,589
4	3,967	-	53,556
5	4,284	-	57,840
6	4,627	(16,642)	45,816
7	3,665	(16,625)	32,856
8	2,628	(4,140)	31,344
9	2,508	(4,131)	29,721
10	2,378	(4,117)	27,981
11	2,238	(4,102)	26,118
12	2,089	(4,087)	24,120
13	1,930	(4,077)	21,973
14	1,758	(4,064)	19,667
15	1,573	(4,053)	17,187
16	1,375	(4,034)	14,528
17	1,162	(4,021)	11,669
18	934	(3,999)	8,604
19	688	(3,977)	5,315
20	425	(3,945)	1,795
		86,024	

(a) Assumes 100 policies, claims commencing after 5 years at the level of 100% of debt service for 2 years and 25% of debt service thereafter.

(b) Assumes premiums of 75% of total debt service x premium rate (.80%) and tax-free net investment income of 8% of cumulative cash flow.

Note: Assuming the same level of expenses and lowering the premium rates, the number of claims paid from premiums alone is reduced as follows:

Premium Rate	Claims Per 100
.80%	5.0
.70%	4.2
.60%	3.3
.50%	2.5
.40%	1.7

TABLE III

Premium and Capital Breakeven Cash Flow Projection (a)
($000's)

Total	Premium and Net Investment Income (b)	Capital Account Changes(c)(d)	11 3/4 Claims for Debt Service	Cumulative Cash Flow
0	39,365	65,609	-	104,974
1	8,398	(3,362)	-	110,010
2	8,801	(3,359)	-	115,452
3	9,236	(3,351)	-	121,337
4	9,707	(3,346)	-	127,698
5	10,216	(3,339)	-	134,575
6	10,766	-	39,132	106,209
7	8,497	-	39,069	75,637
8	6,051	-	9,729	71,959
9	5,757	-	9,708	68,007
10	5,441	-	9,675	63,773
11	5,102	-	9,640	59,235
12	4,739	-	9,604	54,370
13	4,350	-	9,581	49,138
14	3,931	-	9,550	43,519
15	3,482	-	9,525	37,476
16	2,998	-	9,480	30,994
17	2,480	-	9,449	24,024
18	1,922	-	9,398	16,548
19	1,324	-	9,346	8,526
20	682	-	9,271	(63)

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7	3,665	(16,625)	32,856
8	2,628	(4,140)	31,344
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6	10,766	-	39,132	106,209
7	8,497	-	39,069	75,637
8	6,051	-	9,729	71,959
9	5,757	-	9,708	68,007
10	5,441	-	9,675	63,773
11	5,102	-	9,640	59,235
12	4,739	-	9,604	54,370
13	4,350	-	9,581	49,138
14	3,931	-	9,550	43,519
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Mr. FLORIO. Thank you very much.
Mr. Murray.

STATEMENT OF WILLIAM J. MURRAY

Mr. MURRAY. Mr. Chairman, my name is William Murray, and I am Vice President and Counsel of Chubb and Son, which is the principal employer and manager of the property/casualty insurance business of the Chubb Group of Insurance Companies.

I appreciate the invitation to speak with you today on the subject of financial guarantee insurance.

We at Chubb have been active in the ongoing debate about the regulation of the financial guarantee insurance business and have been outspoken advocates of the so-called mono-line regulatory approach under which financial guarantees would be required to be written exclusively by special purpose corporations.

There are many reasons for our position, which are set forth at length in my written statement, which you can review at your leisure.

In the 5 minutes which I have been allotted for this oral presentation, I would like to concentrate on one principal reason for our mono-line preference, which I know concerns this subcommittee, and that is insurer solvency.

When I speak of solvency in this context, I am not referring to the solvency of the entities writing financial guarantee insurance, although that obviously is a subject which could become a serious concern in the future.

Chubb's solvency concerns center around the possibility that, if financial guarantees continue to be permissibly written by multi-line property/casualty insurers, there is a possibility that a financial guarantee problem could drive the multi-line insurer into insolvency, thereby triggering massive State guarantee fund liabilities and assessments on otherwise solvent insurers which have chosen not to participate in the financial guarantee marketplace.

As you can appreciate, a multi-line insurer which becomes, as they say, embarrassed on its financial guarantees, even if financial guarantees are not covered by State insolvency funds, inevitably leaves a book of traditional property/casualty business which is covered.

You are all keenly aware of insurer worries about widespread insolvency fund assessments themselves being the cause of additional insolvencies, a kind of domino effect which could have staggering implications for our industry and our society.

Our concern here is magnified by our perception that financial guarantees represent a kind of business which is materially different than the rest of the property/casualty classes.

For one thing, guarantees are long-term credit risks of the kind which are particularly difficult to underwrite.

When I began my career at Chubb, it was as an underwriter in our surety department. I spent 8 years making what were essentially credit decisions, and I know from personal experience how difficult, if not impossible, it is to predict what the financial condition of any entity will be in 5 or 10 years. And yet that is a not uncommon financial guarantee type bet.

Another characteristic which differentiates financial guarantee insurance from traditional business is in pricing.

Unlike our normal business, in which we attempt to set rates based upon an actuarial analysis of future loss costs, however imperfect that analysis might turn out to be, in the guarantee business insurers are told how much insurance premium the deal will bear based upon some arbitrary split of the savings in interest costs brought about by the guarantee.

A lot of considerations, obviously, enter into the amount of the interest rate spread. But the necessity to accumulate capital out of which to pay losses is most emphatically not one of them.

The collection of enough money to fund the losses is the essence of the traditional insurance transaction, and all of the problems we have recently experienced in the property/casualty business have resulted from either a failure to collect enough in the past to fund present obligations or an inability to ascertain how much to charge now for future claims.

Finally, we are particularly concerned with what those of us in the insurance business call the conflagration hazard.

Traditionally, property insurers avoid writing too much fire insurance in one neighborhood or geographic area, because a serious fire could jeopardize the company's solvency.

In the financial guarantee business, the neighborhood is the economy and the fire is an economic downturn.

You have only to look at the problems being experienced now by banks, and especially savings and loans, in the Farm Belt and oil regions of our country. This is the financial conflagration hazard in small.

In financial guarantees, it appears to be an unavoidable consequence of the business, but once again strongly suggests the folly of exposing the traditional insurance mechanism to the hazards of economy-wide distress which could occur at any time and must be considered in light of the financial guarantor's complete inability to do anything to manage an economic downturn, the business being fixed and noncancellable.

That, in brief, sets forth our solvency concern, which is the principal reason why Chubb supports the mono-line approach to financial guarantee regulation.

There are other reasons, such as ease of regulation and investor evaluation.

So, I stand ready to answer your questions. Thank you for your attention.

[Testimony resumes on p. 376.]

[The prepared statement of Mr. Murray follows:]

A Statement on Behalf of

THE CHUBB GROUP OF INSURANCE COMPANIES

Mr. Chairman, members of the Subcommittee, my name is William Murray and I am Vice President and Counsel of Chubb & Son Inc. which is the principal employer and manager of the property/casualty insurance business of the Chubb Group of Insurance Companies. Our subject today, financial guarantee insurance, has been a bit of a hot topic in the insurance business on both the industry and regulatory sides and much activity has occurred with respect to the regulation of financial guarantees through the National Association of Insurance Commissioners and at the State level, particularly in New York. During the protracted and still continuing consideration of this issue, Chubb has been outspoken in its position that the financial guarantee business ought to be done only by special single purpose corporations. This is the so-called "monoline" approach and, because we are one of the very few major multi-line insurance operations which has openly supported the concept, and because we know of this Subcommittee's oft-expressed concern with the issue of insurer solvency which is a major impetus for our position, I would like to briefly expand upon our reasons for feeling the way we do.

It is surprising to some to hear that the financial guarantee business is actually quite old, dating back to at least 1904 when the New York Insurance Law was amended to permit the guarantee by insurers of payments under bonds and mortgages covering real property. In about 1906, the so-called "guaranteed participation certificate" was devised which allowed investors to purchase an undivided share interest in a single or pool of mortgages which were guaranteed by an insurance company. What is

interesting about this is that, within the last few years, the concept of "securitization" of a whole variety of assets generating a payment stream--auto loans, credit card receivables and the like, has generated much interest as a new and innovative financial services product. Well, it is not new and it certainly is not innovative. The complete and, I might add, tragic story of this early financial guarantee business is told by the 1934 report of the New York Moreland Commission to Governor Lehman which details the collapse of the industry and the liquidation of 18 insurance companies having outstanding and unsatisfied guarantees in excess of 1 billion 700 million dollars. Very many ordinary and innocent people lost their life savings either directly or because savings institutions into which they had deposited failed as a result of that collapse. That so-called Alger Report is a frightening document, particularly because an informed reader can easily see how the abuses, conflicts of interest, and simple errors chronicled therein could reoccur in modern times with even more widespread and devastating impact.

There are some unusual and thought-provoking characteristics of financial guarantees which exist today, just as they did in the early part of this century which we at Chubb believe justify complete separation of financial guarantees from more traditional insurance lines. One of the most serious is the potential for abuse in any business where the immediate rewards are as incredibly large as they are here and the costs of those rewards so unclear and possibly remote. Let's make no mistake about it, the immediate rewards in the form of premium income are quite substantial. In fact, according to A.M. Best's 1985 statistics, of the 15 largest writers of surety in the United States, measured by net premiums written, 3 of them

write only financial guarantees and 2 of those 3 wrote their first dollar of premium in 1985. In that one year, those two companies wrote more surety premium than the majority of the traditional surety companies, many of which have been in the business for 50 years or more. Statistics for 1986 on this subject are not comparable because of differences in reporting rules but there is certainly no reason to believe that the trend has changed. With that much money available so quickly, it requires extraordinary innocence to believe that there are not those who will bend or break the rules or transgress what most of us would consider ethical business practices in their rush to get a slice of the pie. The Alger Report, to which I have alluded, demonstrates that, and I suggest to you that what was true in the 20's remains equally applicable today.

Opponents of the monoline approach will answer that a monoline requirement will not create honesty when it does not now exist, and that the majority of insurance companies are honest and ethical and should not be penalized for the as-yet-unperformed transgressions of a few bad apples. That first assertion is, unfortunately, true; monoline does not equal rectitude. But a monoline requirement protects traditional insurers and the people who rely on them for their financial security from the possible disastrous consequence of the headlong rush for premium income. On the other hand, the "only a few bad apples" argument misses the point. While I absolutely believe that the vast majority of insurance people are honorable, by definition, regulation must be targeted at the lowest strata of the regulated group; in order to regulate the business it is necessary to restrict those who are honest, ethical, smart and experienced. Moreover, we worry about those who may lack any of the aforementioned characteristics

and believe it makes prudent sense to protect the traditional insurance mechanism from them.

Another reason for the imposition of the monoline requirement is that because the financial guarantee business is such a swift and potent cash generator, we believe that traditional insurers which are in financial difficulty may have an irresistible incentive to enter the business in an attempt to see themselves through tough times. It is our understanding that insurance departments in several states are liquidating companies which were in the financial guarantee business in an attempt to generate fast cash. Writing financial guarantees under those circumstances just creates a new class of victims when the guarantor folds its tent. A separate licensing requirement, such as is supported by the multi-line proponents, would help but will not solve the problem because it is simply impossible in all cases for regulators to detect an insurer's financial difficulties in the context of a licensing investigation. A monoline requirement eliminates this concern.

In an attempt at brevity, let me take a few moments to summarize some of the other reasons for Chubb's position that financial guarantees be written only by monoline insurers.

1. We do not believe that the financial guaranty business will ultimately turn out to be as loss free as everyone now thinks. The amounts of liability involved are huge and premiums are divorced from any analysis of future payout requirements. Moreover, it is extremely difficult to underwrite since the

underwriting process requires looking into the distant future and forecasting events which are essentially unknowable.

According to numbers provided by the Surety Association of America, the financial guarantee business sustained a pure loss ratio in 1986 of over 90% with net incurred losses of almost $170 million. As I'm certain you are aware, the pure loss ratio includes no expenses, so it is quite clear that in 1986, the financial guarantee business was significantly unprofitable. There are certain caveats which must be stated--not all financial guarantors report their statistics to the Surety Association and so some of the data comes from an analysis of individual insurer Annual Convention Statements. But consider the following: the foregoing numbers include municipal bond insurance figures. Most of the premium collected for financial guarantees is in the municipal bond subclass and the loss ratio for that business was somewhere in the low 30's. Simple arithmetic suggests that for the aggregate numbers to be as bad as they are, the non-municipal bond experience had to be an unmitigated disaster.

While I will be the first to admit the difficulty in drawing broad general conclusions from only one year of experience in a long-tail line like financial guarantees, the only real data we have suggests there is something fundamentally wrong with the assertion by the multi-line proponents that the business is safe.

Let me give you a real-world example of how unpredictable events impact on financial guarantees to make the business less safe or loss free than expected. Many insurers have written guarantees of notes given by investors in private placement limited partnerships. One of the principal reasons those obligations were considered good risks was that the individual limited partner's interest in the partnership had significant collateral value and could be taken over and sold to a replacement investor to reduce or eliminate the insurer's loss under its guarantee. The day President Reagan signed the new tax bill, the collateral value of most of those units dropped precipitously because of the new passive loss rules. All limited partnership guarantees are not going to go into default, for a variety of reasons, but for the guarantors, the probability of an ultimate loss on that business has dramatically and unexpectedly increased and there is nothing anyone can do about it.

On the corporate side, most credit underwriters would undoubtedly admit that, if given the opportunity five years ago to guarantee the debt obligations of a Manville or A.H. Robins, they would have done so without hesitation, and yet today such a judgment would be extremely problematical.

2. Both past and recent history shows that there is another significant potential for abuse in the financial guarantee arena through the activities of managing general agents writing business on behalf of companies which are essentially unfamiliar with the

financial guarantee class and thus unable to adequately supervise their business. This is not only true with respect to activities of agents, but also to operations in the companies themselves, managed as they are by insurance people essentially unfamiliar with the investment environment in which financial guarantors must operate.

3. The large amounts of liability are capable of driving even well-financed insurers into insolvency if significant losses are sustained. This means that if multi-line insurers are allowed to write financial guarantees, all insurers may have to respond to an insolvency through the guarantee fund mechanism even if the guarantees themselves are not covered--an insurer which becomes insolvent on its financial guarantee business will be just as insolvent on its automobile and homeowners business. The industry cannot afford to have to pick up those pieces.

4. The writing of insurance and financial guarantees are essentially two separate disciplines. Trying to mix them in one entity makes that entity extremely difficult to examine and regulate. In the interest of the protection of the public, we need to avoid that.

In explaining a number of our concerns, I keep going back to the Alger Report because history in this area has an important lesson to teach--and it is a lesson for which the unfortunate people of those times paid significant tuition. The regulatory problems involved in controlling the early financial guarantors were most clearly summarized in the report by the following excerpt--as you read it you will find the comments to be similar to those made by many people today about the whole insurance regulatory process.

> "It is perfectly obvious that salaries such as were paid the greater number of these (insurance) examiners could not attract persons to the Department capable of handling thoroughly the examination of companies as large and complex as those under consideration. Few of the examiners were certified public accountants, although the examination they were supposed to conduct was primarily an audit. It should be remembered also that the companies themselves had in their employ expensive and expert accountants and counsel."
>
> "Properly to supervise these companies required from the examining staff of the Department a high degree of skill in the study of accounts, adequate understanding of the purposes of the law and courage and independence in presenting criticism of practices found contrary to its requirements. Except in rare instances, these qualities I found missing in the work of these examiners. It is only fair to add that as a group they impressed me as a conscientious, diligent and generally over-worked body of employees."

The regulatory difficulties which we believe exist in the financial guarantee business are significant for a number of reasons. First and most obvious is that the insurance regulators will have a tough time policing compliance with whatever regulatory scheme is eventually adopted, and this will be true regardless of whether financial guarantees are written by monoline or multi-line insurers. The principal result of this inherent difficulty is that solvency regulation will be less stringent--not because the regulators will be unduly compliant, but because examinations will take longer--and therefore the available qualified examination staffs will be more thinly spread. Evaluation of compliance with risk limitations, reinsurance restrictions and other requirements will necessitate an almost transaction-by-transaction analysis in a class of business where transactions are frequently both unique and extraordinarily complicated. We therefore think it likely that the insurance regulatory system as respects financial guarantees, will be even less effective in controlling insolvencies than it has been in the traditional insurance business. Once again, this will be true regardless of the extent of the license authority granted to financial guarantors, but we believe it provides a strong reason for the monoline approach.

The second point which flows from the difficulties inherent in regulating financial guarantees is somewhat more complex and revolves around the fact that many financial guarantees seek to ameliorate investment risk for the persons holding them. As you all know, our societal approach to the regulation of investment risk has been through full disclosure with individual investors being presumed responsible for the consequences of their own investment decisions. This makes the concept of financial guarantee insurance somewhat antithetical. The very word "insurance", conjures up an image of a closely regulated, absolutely solid undertaking being overseen by a conservative regulatory bureaucracy backed by state guarantee fund protection. Some of these images can be dealt with through disclosure of the lack of guarantee fund protection and of the necessity for investor evaluation of the insurer providing a particular guarantee. That evaluation will be much simpler if the insurer is a monoline company whose condition is uncomplicated by the complexities inherent in the other insurance lines. Irvestors will know that their analysis can be purely economic without worrying about the occurrence of fires, floods, tornadoes and the like.

5. By definition, the safety of the financial guaranty business is heavily dependent upon the state of the economy. An economic downturn could trigger widespread defaults as did the depression earlier this century. Writing a large book of financial guarantees is in some ways analogous to writing too large a book of fire insurance business in the same neighborhood. Insurers don't do that because they recognize and try to manage a conflagration hazard. In the financial guarantee business, the neighborhood is the economy and the fire an economic downturn. We don't see how that hazard can be effectively managed. The separation of financial guarantees from the insurance mechanism doesn't solve this inherent problem with the class, but at least it protects the traditional insurance industry.

Much of the argument advanced by those who consider financial guarantees to be low-risk business is based upon analysis of defaults on municipal bonds during the depression. Many of the reserve requirements and risk limitations contained in all of the proposed bills are based upon economic models which, to some extent, utilize historical default experience for a variety of financial risks including the so-called "depression default scenario." What companies are doing today and will do in the future is much different than what was done in the past. For example, in the depression

To illustrate the economics of the compounding of invested premiums to pay debt service claims, consider a typical FGIC insured issue such as the revenue bond with the debt service schedule as set forth in Table I. Assuming an insurance premium of .80% of total debt service, a premium of $524,870 is due upon issuance of the bond insurance policy. Table II shows FGIC's cash flow results assuming that 100 such policies are written and that at the assumed premium level 75% of the initial premiums are available for claim payments after payment of FGIC's marketing, credit analysis, legal and other acquisition costs. The analysis shows that FGIC is able to service five claims par 100 without tapping its capital cushion.

As seen in Table II, net premiums of $39,365,000 support claims payments of $86,024,000. This is due to the compounding of invested premiums and the deferral (based on originally scheduled bond payments) of claims.

Capital Cushion:

In addition to income from invested premiums, dedicated cash capital provides an additional cushion for the payment of claims. From our business model of 100 policies (see Table I with total par value of $3,038,000,000 and total debt service exposure of $6,560,870,000, we can determine the capital required to support the $6,560,870,000 of net risk (i.e., debt service exposure net of reinsurance). Assuming a 100 to 1 ratio of net risk to capital, FGIC is required to set aside $65,608,700 in capital.

We demonstrate in Table III that our claims tolerance increases to 11 3/4 claims per 100 from 5 claims per 100 when our investment account is increased by the full amount of the required capital.(2)

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(2) We assume in Table III that the 100 to 1 ratio is maintained until year 6 when the decision is made to retain all capital in the business. That is, as policies run-off over the first 5 years, net risk decreases and capital is remitted to shareholders to maintain the 100 to 1 ratio. In the sixth year, the decision is made to cease remitting due to the occurrence of claims for the full amount of debt service payable in that year.

TABLE I

Debt Service Structure of a Typical Issue
Example: A City Revenue Bond

Principal: $30,380,000 **Insurance Premium: 0.8% (assumed)**

Average Coupon: 9% **Serial Life: 1-20 years**

Year	Principal Due	Interest Due	Total Debt Service
1	$ 740,000	$ 2,622,175	$ 3,362,175
2	780,000	2,578,515	3,358,515
3	820,000	2,530,545	3,350,345
4	870,000	2,476,015	3,346,015
5	925,000	2,413,810	3,338,810
6	985,000	2,345,360	3,330,360
7	1,055,000	2,270,007	3,325,007
8	1,125,000	2,186,662	3,311,662
9	1,210,000	2,094,975	3,304,975
10	1,300,000	1,993,335	3,293,335
11	1,400,000	1,881,535	3,281,535
12	1,510,000	1,759,735	3,269,735
13	1,635,000	1,626,855	3,261,855
14	1,770,000	1,481,340	3,251,340
15	1,920,000	1,322,040	3,242,040
16	2,080,000	1,147,320	3,227,320
17	2,260,000	957,000	3,217,000
18	2,450,000	749,080	3,199,080
19	2,660,000	521,230	3,181,230
20	2,885,000	271,190	3,156,190
Total	$30,380,000	$35,228,725	$65,608,725

Gross Premium: $524,870
Premium Net of Acquisition Expense = $393,653

Note: 100 policies $3,038,000,000 principal
$6,560,870,000 debt service

TABLE II

Premium Breakeven Cash Flow Projection (a)
($000's)

Year	Premium and Net Investment Income (b)	5 Claims for Debt Service	Cumulative Cash Flow
0	39,365	-	39,365
1	3,149	-	42,514
2	3,401	-	45,915
3	3,677	-	49,589
4	3,967	-	53,556
5	4,284	-	57,840
6	4,627	(16,642)	45,816
7	3,665	(16,625)	32,856
8	2,628	(4,140)	31,344
9	2,508	(4,131)	29,721
10	2,378	(4,117)	27,981
11	2,238	(4,102)	26,118
12	2,089	(4,087)	24,120
13	1,930	(4,077)	21,973
14	1,758	(4,064)	19,667
15	1,573	(4,053)	17,187
16	1,375	(4,034)	14,528
17	1,162	(4,021)	11,669
18	934	(3,999)	8,604
19	688	(3,977)	5,315
20	425	(3,945)	1,795
		86,024	

(a) Assumes 100 policies, claims commencing after 5 years at the level of 100% of debt service for 2 years and 25% of debt service thereafter.

(b) Assumes premiums of 75% of total debt service x premium rate (.80%) and tax-free net investment income of 8% of cumulative cash flow.

Note: Assuming the same level of expenses and lowering the premium rates, the number of claims paid from premiums alone is reduced as follows:

Premium Rate	Claims Per 100
.80%	5.0
.70%	4.2
.60%	3.3
.50%	2.5
.40%	1.7

TABLE III

Premium and Capital Breakeven Cash Flow Projection (a)
($000's)

Total	Premium and Net Investment Income (b)	Capital Account Changes (c)(d)	[illegible] Claims for Debt Service	Cumulative Cash Flow
0	35,365	65,609	-	[illegible]
1	8,398	(3,362)	-	[illegible]
2	8,811	(3,359)	-	[illegible]
3	9,236	(3,352)	-	[illegible]
4	9,[illegible]	(3,346)	-	[illegible]
5	[illegible],216	(3,339)	-	[illegible]
6	11,766	-	39,132	[illegible]
7	8,457	-	39,063	[illegible]
8	6,351	-	9,[illegible]	[illegible]
9	5,757	-	9,708	[illegible]
10	5,441	-	9,675	[illegible]
11	5,[illegible]	-	9,647	[illegible]
12	4,739	-	9,624	[illegible]
13	4,350	-	9,581	[illegible]
14	3,931	-	9,552	[illegible]
15	3,482	-	9,525	[illegible]
16	2,998	-	9,480	[illegible]
17	2,480	-	9,449	[illegible]
18	1,922	-	9,398	[illegible]
19	1,324	-	9,346	[illegible]
20	682	-	9,271	[illegible]

(a) Assumes 100 policies, claims commencing after 5 years at the level of 100% of debt service for 2 years and 25% of debt service thereafter.

(b) Assumes premiums of 75% of total debt service x premium ([illegible]) and tax-free net investment income of 8% of cumulative cash flow.

(c) Assumes maintenance of 100:1 risk asset-to-capital ratio until year 6 when all capital remittance ceases (see footnote on preceding page).

(d) Assumes no reinsurance.

Mr. FLORIO. Thank you very much.
Mr. Murray.

STATEMENT OF WILLIAM J. MURRAY

Mr. MURRAY. Mr. Chairman, my name is William Murray, and I am Vice President and Counsel of Chubb and Son, which is the principal employer and manager of the property/casualty insurance business of the Chubb Group of Insurance Companies.

I appreciate the invitation to speak with you today on the subject of financial guarantee insurance.

We at Chubb have been active in the ongoing debate about the regulation of the financial guarantee insurance business and have been outspoken advocates of the so-called mono-line regulatory approach under which financial guarantees would be required to be written exclusively by special purpose corporations.

There are many reasons for our position, which are set forth at length in my written statement, which you can review at your leisure.

In the 5 minutes which I have been allotted for this oral presentation, I would like to concentrate on one principal reason for our mono-line preference, which I know concerns this subcommittee, and that is insurer solvency.

When I speak of solvency in this context, I am not referring to the solvency of the entities writing financial guarantee insurance, although that obviously is a subject which could become a serious concern in the future.

Chubb's solvency concerns center around the possibility that, if financial guarantees continue to be permissibly written by multi-line property/casualty insurers, there is a possibility that a financial guarantee problem could drive the multi-line insurer into insolvency, thereby triggering massive State guarantee fund liabilities and assessments on otherwise solvent insurers which have chosen not to participate in the financial guarantee marketplace.

As you can appreciate, a multi-line insurer which becomes, as they say, embarrassed on its financial guarantees, even if financial guarantees are not covered by State insolvency funds, inevitably leaves a book of traditional property/casualty business which is covered.

You are all keenly aware of insurer worries about widespread insolvency fund assessments themselves being the cause of additional insolvencies, a kind of domino effect which could have staggering implications for our industry and our society.

Our concern here is magnified by our perception that financial guarantees represent a kind of business which is materially different than the rest of the property/casualty classes.

For one thing, guarantees are long-term credit risks of the kind which are particularly difficult to underwrite.

When I began my career at Chubb, it was as an underwriter in our surety department. I spent 8 years making what were essentially credit decisions, and I know from personal experience how difficult, if not impossible, it is to predict what the financial condition of any entity will be in 5 or 10 years. And yet that is a not uncommon financial guarantee type bet.

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Unlike our normal business, in which we attempt to set rates based upon an actuarial analysis of future loss costs, however imperfect that analysis might turn out to be, in the guarantee business insurers are told how much insurance premium the deal will bear based upon some arbitrary split of the savings in interest costs brought about by the guarantee.

A lot of considerations, obviously, enter into the amount of the interest rate spread. But the necessity to accumulate capital out of which to pay losses is most emphatically not one of them.

The collection of enough money to fund the losses is the essence of the traditional insurance transaction, and all of the problems we have recently experienced in the property/casualty business have resulted from either a failure to collect enough in the past to fund present obligations or an inability to ascertain how much to charge now for future claims.

Finally, we are particularly concerned with what those of us in the insurance business call the conflagration hazard.

Traditionally, property insurers avoid writing too much fire insurance in one neighborhood or geographic area, because a serious fire could jeopardize the company's solvency.

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You have only to look at the problems being experienced now by banks, and especially savings and loans, in the Farm Belt and oil regions of our country. This is the financial conflagration hazard in small.

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It is surprising to some to hear that the financial guarantee business is actually quite old, dating back to at least 1904 when the New York Insurance Law was amended to permit the guarantee by insurers of payments under bonds and mortgages covering real property. In about 1906, the so-called "guaranteed participation certificate" was devised which allowed investors to purchase an undivided share interest in a single or pool of mortgages which were guaranteed by an insurance company. What is

interesting about this is that, within the last few years, the concept of "securitization" of a whole variety of assets generating a payment stream--auto loans, credit card receivables and the like, has generated much interest as a new and innovative financial services product. Well, it is not new and it certainly is not innovative. The complete and, I might add, tragic story of this early financial guarantee business is told by the 1934 report of the New York Moreland Commission to Governor Lehman which details the collapse of the industry and the liquidation of 18 insurance companies having outstanding and unsatisfied guarantees in excess of 1 billion 700 million dollars. Very many ordinary and innocent people lost their life savings either directly or because savings institutions into which they had deposited failed as a result of that collapse. That so-called Alger Report is a frightening document, particularly because an informed reader can easily see how the abuses, conflicts of interest, and simple errors chronicled therein could reoccur in modern times with even more widespread and devastating impact.

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Opponents of the monoline approach will answer that a monoline requirement will not create honesty when it does not now exist, and that the majority of insurance companies are honest and ethical and should not be penalized for the as-yet-unperformed transgressions of a few bad apples. That first assertion is, unfortunately, true; monoline does not equal rectitude. But a monoline requirement protects traditional insurers and the people who rely on them for their financial security from the possible disastrous consequence of the headlong rush for premium income. On the other hand, the "only a few bad apples" argument misses the point. While I absolutely believe that the vast majority of insurance people are honorable, by definition, regulation must be targeted at the lowest strata of the regulated group; in order to regulate the business it is necessary to restrict those who are honest, ethical, smart and experienced. Moreover, we worry about those who may lack any of the aforementioned characteristics

and believe it makes prudent sense to protect the traditional insurance mechanism from them.

Another reason for the imposition of the monoline requirement is that because the financial guarantee business is such a swift and potent cash generator, we believe that traditional insurers which are in financial difficulty may have an irresistible incentive to enter the business in an attempt to see themselves through tough times. It is our understanding that insurance departments in several states are liquidating companies which were in the financial guarantee business in an attempt to generate fast cash. Writing financial guarantees under these circumstances just creates a new class of victims when the guarantor folds its tent. A separate licensing requirement, such as is supported by the multi-line proponents, would help but will not solve the problem because it is simply impossible in all cases for regulators to detect an insurer's financial difficulties in the context of a licensing investigation. A monoline requirement eliminates this concern.

In an attempt at brevity, let me take a few moments to summarize some of the other reasons for Chubb's position that financial guarantees be written only by monoline insurers.

1. We do not believe that the financial guaranty business will ultimately turn out to be as loss free as everyone now thinks. The amounts of liability involved are huge and premiums are divorced from any analysis of future payout requirements. Moreover, it is extremely difficult to underwrite since the

underwriting process requires looking into the distant future and forecasting events which are essentially unknowable.

According to numbers provided by the Surety Association of America, the financial guarantee business sustained a pure loss ratio in 1986 of over 90% with net incurred losses of almost $170 million. As I'm certain you are aware, the pure loss ratio includes no expenses, so it is quite clear that in 1986, the financial guarantee business was significantly unprofitable. There are certain caveats which must be stated--not all financial guarantors report their statistics to the Surety Association and so some of the data comes from an analysis of individual insurer Annual Convention Statements. But consider the following: the foregoing numbers include municipal bond insurance figures. Most of the premium collected for financial guarantees is in the municipal bond subclass and the loss ratio for that business was somewhere in the low 30's. Simple arithmetic suggests that for the aggregate numbers to be as bad as they are, the non-municipal bond experience had to be an unmitigated disaster.

While I will be the first to admit the difficulty in drawing broad general conclusions from only one year of experience in a long-tail line like financial guarantees, the only real data we have suggests there is something fundamentally wrong with the assertion by the multi-line proponents that the business is safe.

Let me give you a real-world example of how unpredictable events impact on financial guarantees to make the business less safe or loss free than expected. Many insurers have written guarantees of notes given by investors in private placement limited partnerships. One of the principal reasons those obligations were considered good risks was that the individual limited partner's interest in the partnership had significant collateral value and could be taken over and sold to a replacement investor to reduce or eliminate the insurer's loss under its guarantee. The day President Reagan signed the new tax bill, the collateral value of most of those units dropped precipitously because of the new passive loss rules. All limited partnership guarantees are not going to go into default, for a variety of reasons, but for the guarantors, the probability of an ultimate loss on that business has dramatically and unexpectedly increased and there is nothing anyone can do about it.

On the corporate side, most credit underwriters would undoubtedly admit that, if given the opportunity five years ago to guarantee the debt obligations of a Manville or A.H. Robins, they would have done so without hesitation, and yet today such a judgment would be extremely problematical.

2. Both past and recent history shows that there is another significant potential for abuse in the financial guarantee arena through the activities of managing general agents writing business on behalf of companies which are essentially unfamiliar with the

Some parties that oppose the designated capital concept for financial guaranties have proposed "allocated" capital as an alternative. I submit that merely counting the capital and surplus resources and assigning them to specific lines of business, rather than legally segregating the capital, is a sham. There is no way that allocation of capital would have stopped Baldwin United from raiding MGIC.

Finally, I believe that failing financial guaranty companies should not be allowed to deplete state insurance guaranty funds, which were created for the protection of the small retail insurance policyholder. Such funds could become a much weaker back-stop if financial guaranty companies are able to access them. Certainly, the profile of a financial guaranty policyholder is not a "poor, little unprotected policyholder on the street"; someone who is socially entitled to guaranty fund protection.

B. Capital Adequacy

1. Contingency Reserves as a Percent of Net Bond Par Written

The concept of a contingency reserve which relates to insurance written (guaranteed par value written), rather than, as provided in current law, simply a percentage of the gross premiums, is a logical concept. Allowing for expenses, normal losses, and underwriting profits, the total of which will always equal at least 50%, FGIC believes that a municipal bond insurer cannot self-generate capital if its premium allocations to its contingency reserve with respect to its overall portfolio exceed 60%. In other words, the effect of a contingency reserve requirement based upon exposure is to penalize the municipal bond insurer who chooses to "buy" business with irresponsible rate reductions. The consequences of such rate reductions would be borne by that insurer's investore rather than its policyholders.

The need for a contingency reserve requirement based upon exposure becomes apparent in Exhibit 1. With a premium rate of .80%, a municipal bond insurer's lifetime claims paying tolerance is five claims per 100 policies; that is, for every 100 insurance policies (each with a 20-year life) written today, the premiums derived therefrom would be sufficient to pay five claims evolving over the life of that book of business. However, with a premium rate of .50%, the lifetime claims paying tolerance is cut in half--two and one-half claims per 100 policies. While two and one-half claims may be a sufficient claims tolerance in a normal economy, one must never forget that municipal bond insurance reserves are supposed to be sufficient to cover a Depression-type loss experience.

Contingency reserves, unlike case basis reserves funded in relation to specific credit problems, should not be funded and allocated with respect to particular risks. Such reserves must instead be viewed as an added overall cushion to aid the insurer in withstanding additional losses which may occur during a severe economic downturn. It is therefore necessary that the funding of such reserves be based upon the net amount of risk underwritten, rather than the net amount of risk in force at any given time. Linking reserve funding to current insurance in force will result in widely fluctuating reserves rather than a consistent buildup and maintenance of reserves at levels sufficient to protect the insurer and its policyholders in the event of multiple municipal defaults.

The Model Act's approach to the funding and maintenance of contingency reserves incorporates two important concepts. First, the Model Act recognizes the need for distinctions among different types of credit (and the varying degrees of risk associated with such credits), thus ensuring that required reserve amounts reflect the composition of the insurer's risk portfolio. FGIC and the other insurers charge premiums for municipal risks ranging from the middle 40-basis points to in excess of one percent against total exposure, depending upon the source pledged for repayment of the bonds, with general obligation bonds viewed as far less risky than health care and nuclear powered joint action agencies. The Model Act recognizes these distinctions by providing two contingency reserve requirements for municipal bonds (in addition to a third contingency reserve level for industrial development bonds).

Second, and most importantly, the Model Act avoids the risk of linking reserve funding to premium levels by requiring periodic deposits based on the principal amount of risk assumed rather than the premium charged for such risk. As noted above, this approach ensures that reserve funding will not be affected by rate reductions and may have the practical effect of discouraging overly aggressive price cutting.

Some proponents of more liberal legislation have proposed alternative approaches to the contingency reserve issue. These approaches include the lack of distinct categories to reflect different credit risks, lower overall reserve levels, a modified funding scheme which would allow reserve contributions to be adversely affected by premium rate reductions, and the use of exposure in force rather exposure written as the basis for reserve requirements. Each of these proposed modifications would adversely affect the continuous buildup of the contingency reserve to a level commensurate with its function as a buffer against pariods of catastrophic loss. FGIC therefore strongly supports the approach of the Model Act on this issue.

2. Aggregate Risk Limitations

FGIC believes in aggregate risk limitations of not more than 225 to 1, with a ratio of not more than 150 to 1 for "Triple A" rated insurers. Both Moody's and S&P seem to be moving toward similar ratios. The Model Act measures aggregate net liability as the sum of the unpaid interest and the unpaid principal due on the policies in force. Other proposed legislation, however, has computed aggregate net liability for certain non-municipal risks as the sum of the principal and the discounted present value of insured interest, resulting in an aggregate risk limitation for these risks based essentially on principal alone.

Are there features of these non-municipal risks which distinguish them from municipal risks and thus justify this different treatment? The answer we believe is no. Both municipal and non-municipal risks can typically be accelerated at the option of the insurer, resulting in the potential for a claim less than the full amount insured. Additionally, municipal entities stand a better overall chance of recovery after the initial claim, through the implementation of increased taxes or rates and charges pledged to the payment of bonds. As a result of this proposed modification to the Model Act's approach, only half of many non-municipal guaranties would be counted in determining the aggregate risk limitation. For these reasons, FGIC supports the aggregate risk limitations set forth in the Model Act.

3. Initial Entry Requirements

FGIC believes that strong capital adequacy requiremsnts are needed for entry into the capital intensive financial guaranty industry. FGIC would therefore recommend a requirement of paid-in capital of at least $15 million and paid-in surplus of at least $60 million, for a total of $75 million, as opposed to the Model Act's requirements of $10, $40 and $50 million, respectively.

IV. Conclusion

Establishing a monoline requirement and adequate capital and special reserve requirements for financial guaranty insurers will be the two most important factors in determining whether financial guaranty insurance has a viable future. The NAIC Model Act accomplishes both these objectives, whereas more liberal legislation could lead to insuficient capitalization and irresponsible price-cutting.

The long-term credibility of the municipal bond insurance industry hinges on the ability of its participants to withstand an unprecedented level of claims. While the loss experience to date has been very favorable, with only a modest number and amount of claims incurred to date, the industry has yet to be severely tested. More than $100 billion of bond par value has been insured since 1983, representing approximately 70% of total bond par value insured by the industry since its inception in 1971. Furthermore, most of the exposure is long-term with an average maturity of 15 to 20 years. No matter how well an insurer underwrites its business, losses will occur due to unforeseen economic factors, and such losses are likely to exceed the insignificant level of claims to date.

EXHIBIT 1

Capital Adequacy for Municipal Bond Insurance Measured in Terms of Lifetime Claims Tolerance

Introduction

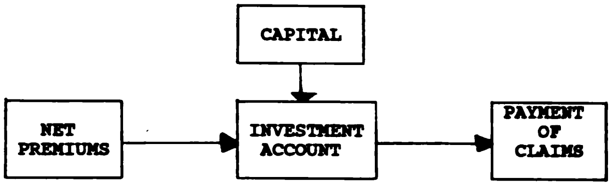
Set forth herein is FGIC's methodology for determining a municipal bond insurer's capacity to pay claims. Such claims-paying ability depends on the adequacy of both premium revenues and capital contributions.

Using a simplified business model and a conservative profile of assumed losses, we demonstrate that at a premium rate of .80% FGIC can pay 5 claims per 100 from premium revenues alone. While a premium rate of .80% is approximately FGIC's average premium rate, current rate cutting is driving premiums down towards .50% for certain categories of risk. At a premium rate of .50%, FGIC's claims paying ability from premiums alone is cut in half to 2-1/2 claims per 100.

With regard to capital, we demonstrate that by fully depleting capital we increase FGIC's claims-paying ability to 11.7 claims per 100. This conclusion is based on a 100:1 ratio of net risk to capital. At leverage ratios of 200:1 and 300:1, FGIC's claims tolerance per 100 policies drops to 8.4 and 6.3, respectively. Of course, FGIC's ability to raise capital to support incremental exposure is obviously dependent upon maintaining a quality stream of revenues (premiums), although such market access dependency is not further developed in this exhibit.

In conclusion, as a premium rate of .60% and a risk asset-to-capital ratio of 200:1 seem to be current market indicators, one final claims tolerance is offered. FGIC's claims tolerance at a premium rate of .60% and permitted leverage of 200:1 drops to 6.6 claims per 100--in sharp contrast to the 11.7 claims tolerance at former premium levels and a 100:1 ratio.

Business Model



From the perspective of the holder of an FGIC-insured municipal bond, FGIC is in business to pay claims. As depicted in the simplified business model above, claims are paid from the proceeds of an investment account. The investment account is funded with net premiums and capital. Accordingly, the ability to pay claims is directly dependent upon both capital and premiums. The capital/premiums relationship is critical to, but viewed differently by, regulators, shareholders, the "market" and reinsurers. These differences, and issues related thereto, are discussed below.

Claims Assumptions:

The credit risk analysis undertaken by FGIC and FGIC's high credit standards should be sufficient to screen out issuers likely to experience problems in the short-term. In constructing a conservative scenario for a FGIC claims profile, we assume that there are no claims for the first 5 policy-years and, thereafter, that a certain number of every 100 policies experience claims. We assume a typical claims pattern of 100% of total debt service (i.e., principal and interest payments) for policy years 6 and 7 and 25% of total debt service thereafter until maturity of the bond.(1)

Premium Cushion:

Claims-paying ability in the municipal bond business is sensitive to the fact that a bond default does not accelerate the insurer's payment guaranty. FGIC insurance only guaranties the timely and prompt payment of scheduled principal and interest. Premiums, however, are generally paid up-front and invested.

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(1) In our less simplified business model we actually employ loss profiles for each 14 risk categories of business; the claims profile scenario summarized above represents an average of these 14 profiles.

To illustrate the economics of the compounding of invested premiums to pay debt service claims, consider a typical FGIC insured issue such as the revenue bond with the debt service schedule as set forth in Table I. Assuming an insurance premium of .80% of total debt service, a premium of $524,870 is due upon issuance of the bond insurance policy. Table II shows FGIC's cash flow results assuming that 100 such policies are written and that at the assumed premium level 75% of the initial premiums are available for claim payments after payment of FGIC's marketing, credit analysis, legal and other acquisition costs. The analysis shows that FGIC is able to service five claims par 100 without tapping its capital cushion.

As seen in Table II, net premiums of $39,365,000 support claims payments of $86,024,000. This is due to the compounding of invested premiums and the deferral (based on originally scheduled bond payments) of claims.

Capital Cushion:

In addition to income from invested premiums, dedicated cash capital provides an additional cushion for the payment of claims. From our business model of 100 policies (see Table I with total par value of $3,038,000,000 and total debt service exposure of $6,560,870,000, we can determine the capital required to support the $6,560,870,000 of net risk (i.e., debt service exposure net of reinsurance). Assuming a 100 to 1 ratio of net risk to capital, FGIC is required to set aside $65,608,700 in capital.

We demonstrate in Table III that our claims tolerance increases to 11 3/4 claims per 100 from 5 claims per 100 when our investment account is increased by the full amount of the required capital.(2)

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(2) We assume in Table III that the 100 to 1 ratio is maintained until year 6 when the decision is made to retain all capital in the business. That is, as policies run-off over the first 5 years, net risk decreases and capital is remitted to shareholders to maintain the 100 to 1 ratio. In the sixth year, the decision is made to cease remitting due to the occurrence of claims for the full amount of dabt service payable in that year.

[illegible]

TABLE [illegible]

[illegible]

Principal: $30,380,000 [illegible]

Average Coupon: 9% [illegible]

Year	Principal Due	Interest Due	Total Debt Service
1	$ 741,000	$ 2,622,175	$ 3,362,175
2	780,000	2,578,515	3,358,515
3	821,000	2,531,565	3,35[illegible]
4	871,000	2,476,115	3,346,115
5	925,000	2,423,810	3,348,810
6	985,000	2,345,360	3,330,360
7	1,055,000	2,271,0[illegible]	3,325,0[illegible]
8	1,125,000	2,186,662	3,311,662
9	1,211,000	2,094,575	3,3[illegible]4,575
10	1,300,000	1,993,335	3,293,335
11	1,400,000	1,881,535	3,281,535
12	1,511,000	1,758,735	3,269,735
13	1,635,000	1,626,855	3,261,855
14	1,771,000	1,481,340	3,251,940
15	1,921,000	1,322,040	3,242,040
16	2,081,000	1,147,320	3,22[illegible],320
17	2,261,000	957,000	3,21[illegible],000
18	2,451,000	749,080	3,199,080
19	2,661,000	521,230	3,181,230
20	2,885,000	271,190	3,156,190
Total	$30,380,000	$35,228,725	$65,608,725

Gross Premium: $524,870
Premium Net of Acquisition Expense = $393,653

Note: 100 policies $3,038,000,000 principal
$6,560,870,000 debt service

TABLE II

Premium Breakeven Cash Flow Projection (a)
($000's)

Year	Premium and Net Investment Income (b)	5 Claims for Debt Service	Cumulative Cash Flow
0	39,365	-	39,365
1	3,149	-	42,514
2	3,401	-	45,915
3	3,677	-	49,589
4	3,967	-	53,556
5	4,284	-	57,840
6	4,627	(16,642)	45,816
7	3,665	(16,625)	32,856
8	2,628	(4,140)	31,344
9	2,508	(4,131)	29,721
10	2,378	(4,117)	27,981
11	2,238	(4,102)	26,118
12	2,089	(4,087)	24,120
13	1,930	(4,077)	21,973
14	1,758	(4,064)	19,667
15	1,573	(4,053)	17,187
16	1,375	(4,034)	14,528
17	1,162	(4,021)	11,669
18	934	(3,999)	8,604
19	688	(3,977)	5,315
20	425	(3,945)	1,795
		86,024	

(a) Assumes 100 policies, claims commencing after 5 years at the level of 100% of debt service for 2 years and 25% of debt service thereafter.

(b) Assumes premiums of 75% of total dabt service x premium rate (.80%) and tax-free net investment income of 8% of cumulative cash flow.

Note: Assuming the same level of expenses and lowering the premium rates, the number of claims paid from premiums alone is reduced as follows:

Premium Rate	Claims Per 100
.80%	5.0
.70%	4.2
.60%	3.3
.50%	2.5
.40%	1.7

TABLE III

Premium and Capital Breakeven Cash Flow Projection (a)
($000's)

Total	Premium and Net Investment Income (b)	Capital Account Changes (c) (d)	11 3/4 Claims for Debt Service	Cumulative Cash Flow
0	39,365	65,609	-	104,974
1	8,398	(3,362)	-	110,010
2	8,801	(3,359)	-	115,452
3	9,236	(3,351)	-	121,337
4	9,707	(3,346)	-	127,698
5	10,216	(3,339)	-	134,575
6	10,766	-	39,132	106,209
7	8,497	-	39,069	75,637
8	6,051	-	9,729	71,959
9	5,757	-	9,708	68,007
10	5,441	-	9,675	63,773
11	5,102	-	9,640	59,235
12	4,739	-	9,604	54,370
13	4,350	-	9,581	49,138
14	3,931	-	9,550	43,519
15	3,482	-	9,525	37,476
16	2,998	-	9,480	30,994
17	2,480	-	9,449	24,024
18	1,922	-	9,398	16,548
19	1,324	-	9,346	8,526
20	682	-	9,271	(63)

(a) Assumes 100 policies, claims commencing after 5 years at the level of 100% of debt service for 2 years and 25% of debt service thereafter.

(b) Assumes premiums of 75% of total debt service x premium (.80%) and tax-free net investment income of 8% of cumulative cash flow.

(c) Assumes maintenance of 100:1 risk asset-to-capital ratio until year 6 when all capital remittance ceases (see footnote on preceding page).

(d) Assumes no reinsurance.

Mr. FLORIO. Thank you very much.
Mr. Murray.

STATEMENT OF WILLIAM J. MURRAY

Mr. MURRAY. Mr. Chairman, my name is William Murray, and I am Vice President and Counsel of Chubb and Son, which is the principal employer and manager of the property/casualty insurance business of the Chubb Group of Insurance Companies.

I appreciate the invitation to speak with you today on the subject of financial guarantee insurance.

We at Chubb have been active in the ongoing debate about the regulation of the financial guarantee insurance business and have been outspoken advocates of the so-called mono-line regulatory approach under which financial guarantees would be required to be written exclusively by special purpose corporations.

There are many reasons for our position, which are set forth at length in my written statement, which you can review at your leisure.

In the 5 minutes which I have been allotted for this oral presentation, I would like to concentrate on one principal reason for our mono-line preference, which I know concerns this subcommittee, and that is insurer solvency.

When I speak of solvency in this context, I am not referring to the solvency of the entities writing financial guarantee insurance, although that obviously is a subject which could become a serious concern in the future.

Chubb's solvency concerns center around the possibility that, if financial guarantees continue to be permissibly written by multi-line property/casualty insurers, there is a possibility that a financial guarantee problem could drive the multi-line insurer into insolvency, thereby triggering massive State guarantee fund liabilities and assessments on otherwise solvent insurers which have chosen not to participate in the financial guarantee marketplace.

As you can appreciate, a multi-line insurer which becomes, as they say, embarrassed on its financial guarantees, even if financial guarantees are not covered by State insolvency funds, inevitably leaves a book of traditional property/casualty business which is covered.

You are all keenly aware of insurer worries about widespread insolvency fund assessments themselves being the cause of additional insolvencies, a kind of domino effect which could have staggering implications for our industry and our society.

Our concern here is magnified by our perception that financial guarantees represent a kind of business which is materially different than the rest of the property/casualty classes.

For one thing, guarantees are long-term credit risks of the kind which are particularly difficult to underwrite.

When I began my career at Chubb, it was as an underwriter in our surety department. I spent 8 years making what were essentially credit decisions, and I know from personal experience how difficult, if not impossible, it is to predict what the financial condition of any entity will be in 5 or 10 years. And yet that is a not uncommon financial guarantee type bet.

Another characteristic which differentiates financial guarantee insurance from traditional business is in pricing.

Unlike our normal business, in which we attempt to set rates based upon an actuarial analysis of future loss costs, however imperfect that analysis might turn out to be, in the guarantee business insurers are told how much insurance premium the deal will bear based upon some arbitrary split of the savings in interest costs brought about by the guarantee.

A lot of considerations, obviously, enter into the amount of the interest rate spread. But the necessity to accumulate capital out of which to pay losses is most emphatically not one of them.

The collection of enough money to fund the losses is the essence of the traditional insurance transaction, and all of the problems we have recently experienced in the property/casualty business have resulted from either a failure to collect enough in the past to fund present obligations or an inability to ascertain how much to charge now for future claims.

Finally, we are particularly concerned with what those of us in the insurance business call the conflagration hazard.

Traditionally, property insurers avoid writing too much fire insurance in one neighborhood or geographic area, because a serious fire could jeopardize the company's solvency.

In the financial guarantee business, the neighborhood is the economy and the fire is an economic downturn.

You have only to look at the problems being experienced now by banks, and especially savings and loans, in the Farm Belt and oil regions of our country. This is the financial conflagration hazard in small.

In financial guarantees, it appears to be an unavoidable consequence of the business, but once again strongly suggests the folly of exposing the traditional insurance mechanism to the hazards of economy-wide distress which could occur at any time and must be considered in light of the financial guarantor's complete inability to do anything to manage an economic downturn, the business being fixed and noncancellable.

That, in brief, sets forth our solvency concern, which is the principal reason why Chubb supports the mono-line approach to financial guarantee regulation.

There are other reasons, such as ease of regulation and investor evaluation.

So, I stand ready to answer your questions. Thank you for your attention.

[Testimony resumes on p. 376.]

[The prepared statement of Mr. Murray follows:]

A Statement on Behalf of

THE CHUBB GROUP OF INSURANCE COMPANIES

Mr. Chairman, members of the Subcommittee, my name is William Murray and I am Vice President and Counsel of Chubb & Son Inc. which is the principal employer and manager of the property/casualty insurance business of the Chubb Group of Insurance Companies. Our subject today, financial guarantee insurance, has been a bit of a hot topic in the insurance business on both the industry and regulatory sides and much activity has occurred with respect to the regulation of financial guarantees through the National Association of Insurance Commissioners and at the State level, particularly in New York. During the protracted and still continuing consideration of this issue, Chubb has been outspoken in its position that the financial guarantee business ought to be done only by special single purpose corporations. This is the so-called "monoline" approach and, because we are one of the very few major multi-line insurance operations which has openly supported the concept, and because we know of this Subcommittee's oft-expressed concern with the issue of insurer solvency which is a major impetus for our position, I would like to briefly expand upon our reasons for feeling the way we do.

It is surprising to some to hear that the financial guarantee business is actually quite old, dating back to at least 1904 when the New York Insurance Law was amended to permit the guarantee by insurers of payments under bonds and mortgages covering real property. In about 1906, the so-called "guaranteed participation certificate" was devised which allowed investors to purchase an undivided share interest in a single or pool of mortgages which were guaranteed by an insurance company. What is

interesting about this is that, within the last few years, the concept of "securitization" of a whole variety of assets generating a payment stream--auto loans, credit card receivables and the like, has generated much interest as a new and innovative financial services product. Well, it is not new and it certainly is not innovative. The complete and, I might add, tragic story of this early financial guarantee business is told by the 1934 report of the New York Moreland Commission to Governor Lehman which details the collapse of the industry and the liquidation of 18 insurance companies having outstanding and unsatisfied guarantees in excess of 1 billion 700 million dollars. Very many ordinary and innocent people lost their life savings either directly or because savings institutions into which they had deposited failed as a result of that collapse. That so-called Alger Report is a frightening document, particularly because an informed reader can easily see how the abuses, conflicts of interest, and simple errors chronicled therein could reoccur in modern times with even more widespread and devastating impact.

There are some unusual and thought-provoking characteristics of financial guarantees which exist today, just as they did in the early part of this century which we at Chubb believe justify complete separation of financial guarantees from more traditional insurance lines. One of the most serious is the potential for abuse in any business where the immediate rewards are as incredibly large as they are here and the costs of those rewards so unclear and possibly remote. Let's make no mistake about it, the immediate rewards in the form of premium income are quite substantial. In fact, according to A.M. Best's 1985 statistics, of the 15 largest writers of surety in the United States, measured by net premiums written, 3 of them

write only financial guarantees and 2 of those 3 wrote their first dollar of premium in 1985. In that one year, those two companies wrote more surety premium than the majority of the traditional surety companies, many of which have been in the business for 50 years or more. Statistics for 1986 on this subject are not comparable because of differences in reporting rules but there is certainly no reason to believe that the trend has changed. With that much money available so quickly, it requires extraordinary innocence to believe that there are not those who will bend or break the rules or transgress what most of us would consider ethical business practices in their rush to get a slice of the pie. The Alger Report, to which I have alluded, demonstrates that, and I suggest to you that what was true in the 20's remains equally applicable today.

Opponents of the monoline approach will answer that a monoline requirement will not create honesty when it does not now exist, and that the majority of insurance companies are honest and ethical and should not be penalized for the as-yet-unperformed transgressions of a few bad apples. That first assertion is, unfortunately, true; monoline does not equal rectitude. But a monoline requirement protects traditional insurers and the people who rely on them for their financial security from the possible disastrous consequence of the headlong rush for premium income. On the other hand, the "only a few bad apples" argument misses the point. While I absolutely believe that the vast majority of insurance people are honorable, by definition, regulation must be targeted at the lowest strata of the regulated group; in order to regulate the business it is necessary to restrict those who are honest, ethical, smart and experienced. Moreover, we worry about those who may lack any of the aforementioned characteristics

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Another reason for the imposition of the monoline requirement is that because the financial guarantee business is such a swift and potent cash generator, we believe that traditional insurers which are in financial difficulty may have an irresistible incentive to enter the business in an attempt to see themselves through tough times. It is our understanding that insurance departments in several states are liquidating companies which were in the financial guarantee business in an attempt to generate fast cash. Writing financial guarantees under those circumstances just creates a new class of victims when the guarantor folds its tent. A separate licensing requirement, such as is supported by the multi-line proponents, would help but will not solve the problem because it is simply impossible in all cases for regulators to detect an insurer's financial difficulties in the context of a licensing investigation. A monoline requirement eliminates this concern.

In an attempt at brevity, let me take a few moments to summarize some of the other reasons for Chubb's position that financial guarantees be written only by monoline insurers.

1. We do not believe that the financial guaranty business will ultimately turn out to be as loss free as everyone now thinks. The amounts of liability involved are huge and premiums are divorced from any analysis of future payout requirements. Moreover, it is extremely difficult to underwrite since the

underwriting process requires looking into the distant future and forecasting events which are essentially unknowable.

According to numbers provided by the Surety Association of America, the financial guarantee business sustained a pure loss ratio in 1986 of over 90% with net incurred losses of almost $170 million. As I'm certain you are aware, the pure loss ratio includes no expenses, so it is quite clear that in 1986, the financial guarantee business was significantly unprofitable. There are certain caveats which must be stated--not all financial guarantors report their statistics to the Surety Association and so some of the data comes from an analysis of individual insurer Annual Convention Statements. But consider the following: the foregoing numbers include municipal bond insurance figures. Most of the premium collected for financial guarantees is in the municipal bond subclass and the loss ratio for that business was somewhere in the low 30's. Simple arithmetic suggests that for the aggregate numbers to be as bad as they are, the non-municipal bond experience had to be an unmitigated disaster.

While I will be the first to admit the difficulty in drawing broad general conclusions from only one year of experience in a long-tail line like financial guarantees, the only real data we have suggests there is something fundamentally wrong with the assertion by the multi-line proponents that the business is safe.

Let me give you a real-world example of how unpredictable events impact on financial guarantees to make the business less safe or loss free than expected. Many insurers have written guarantees of notes given by investors in private placement limited partnerships. One of the principal reasons those obligations were considered good risks was that the individual limited partner's interest in the partnership had significant collateral value and could be taken over and sold to a replacement investor to reduce or eliminate the insurer's loss under its guarantee. The day President Reagan signed the new tax bill, the collateral value of most of those units dropped precipitously because of the new passive loss rules. All limited partnership guarantees are not going to go into default, for a variety of reasons, but for the guarantors, the probability of an ultimate loss on that business has dramatically and unexpectedly increased and there is nothing anyone can do about it.

On the corporate side, most credit underwriters would undoubtedly admit that, if given the opportunity five years ago to guarantee the debt obligations of a Manville or A.H. Robins, they would have done so without hesitation, and yet today such a judgment would be extremely problematical.

2. Both past and recent history shows that there is another significant potential for abuse in the financial guarantee arena through the activities of managing general agents writing business on behalf of companies which are essentially unfamiliar with the

financial guarantee class and thus unable to adequately supervise their business. This is not only true with respect to activities of agents, but also to operations in the companies themselves, managed as they are by insurance people essentially unfamiliar with the investment environment in which financial guarantors must operate.

3. The large amounts of liability are capable of driving even well-financed insurers into insolvency if significant losses are sustained. This means that if multi-line insurers are allowed to write financial guarantees, all insurers may have to respond to an insolvency through the guarantee fund mechanism even if the guarantees themselves are not covered--an insurer which becomes insolvent on its financial guarantee business will be just as insolvent on its automobile and homeowners business. The industry cannot afford to have to pick up those pieces.

4. The writing of insurance and financial guarantees are essentially two separate disciplines. Trying to mix them in one entity makes that entity extremely difficult to examine and regulate. In the interest of the protection of the public, we need to avoid that.

In explaining a number of our concerns, I keep going back to the Alger Report because history in this area has an important lesson to teach--and it is a lesson for which the unfortunate people of those times paid significant tuition. The regulatory problems involved in controlling the early financial guarantors were most clearly summarized in the report by the following excerpt--as you read it you will find the comments to be similar to those made by many people today about the whole insurance regulatory process.

> "It is perfectly obvious that salaries such as were paid the greater number of these (insurance) examiners could not attract persons to the Department capable of handling thoroughly the examination of companies as large and complex as those under consideration. Few of the examiners were certified public accountants, although the examination they were supposed to conduct was primarily an audit. It should be remembered also that the companies themselves had in their employ expensive and expert accountants and counsel."
>
> "Properly to supervise these companies required from the examining staff of the Department a high degree of skill in the study of accounts, adequate understanding of the purposes of the law and courage and independence in presenting criticism of practices found contrary to its requirements. Except in rare instances, these qualities I found missing in the work of these examiners. It is only fair to add that as a group they impressed me as a conscientious, diligent and generally over-worked body of employees."

The regulatory difficulties which we believe exist in the financial guarantee business are significant for a number of reasons. First and most obvious is that the insurance regulators will have a tough time policing compliance with whatever regulatory scheme is eventually adopted, and this will be true regardless of whether financial guarantees are written by monoline or multi-line insurers. The principal result of this inherent difficulty is that solvency regulation will be less stringent--not because the regulators will be unduly compliant, but because examinations will take longer--and therefore the available qualified examination staffs will be more thinly spread. Evaluation of compliance with risk limitations, reinsurance restrictions and other requirements will necessitate an almost transaction-by-transaction analysis in a class of business where transactions are frequently both unique and extraordinarily complicated. We therefore think it likely that the insurance regulatory system as respects financial guarantees, will be even less effective in controlling insolvencies than it has been in the traditional insurance business. Once again, this will be true regardless of the extent of the license authority granted to financial guarantors, but we believe it provides a strong reason for the monoline approach.

The second point which flows from the difficulties inherent in regulating financial guarantees is somewhat more complex and revolves around the fact that many financial guarantees seek to ameliorate investment risk for the persons holding them. As you all know, our societal approach to the regulation of investment risk has been through full disclosure with individual investors being presumed responsible for the consequences of their own investment decisions. This makes the concept of financial guarantee insurance somewhat antithetical. The very word "insurance", conjures up an image of a closely regulated, absolutely solid undertaking being overseen by a conservative regulatory bureaucracy backed by state guarantee fund protection. Some of these images can be dealt with through disclosure of the lack of guarantee fund protection and of the necessity for investor evaluation of the insurer providing a particular guarantee. That evaluation will be much simpler if the insurer is a monoline company whose condition is uncomplicated by the complexities inherent in the other insurance lines. Irvestors will know that their analysis can be purely economic without worrying about the occurrence of fires, floods, tornadoes and the like.

5. By definition, the safety of the financial guaranty business is heavily dependent upon the state of the economy. An economic downturn could trigger widespread defaults as did the depression earlier this century. Writing a large book of financial guarantees is in some ways analogous to writing too large a book of fire insurance business in the same neighborhood. Insurers don't do that because they recognize and try to manage a conflagration hazard. In the financial guarantee business, the neighborhood is the economy and the fire an economic downturn. We don't see how that hazard can be effectively managed. The separation of financial guarantees from the insurance mechanism doesn't solve this inherent problem with the class, but at least it protects the traditional insurance industry.

Much of the argument advanced by those who consider financial guarantees to be low-risk business is based upon analysis of defaults on municipal bonds during the depression. Many of the reserve requirements and risk limitations contained in all of the proposed bills are based upon economic models which, to some extent, utilize historical default experience for a variety of financial risks including the so-called "depression default scenario." What companies are doing today and will do in the future is much different than what was done in the past. For example, in the depression period, virtually all municipal bonds were general obligation instruments, unquestionably the safest form of municipal. Today G.O.'s make up only a small portion of the municipal universe; most bonds have a substantially lower level of security, so any assumptions based upon an analysis of depression defaults may be irretrievably flawed. Historical default rates on other financial obligations may not be totally relevant either because the introduction of the guarantee itself changes the nature of the risk and the incentives for performance. This is unavoidable but suggests very strongly that we not bet the viability of the traditional insurance industry on the accuracy of any of this, absent a significant period of real-world experience--the stakes are simply too high for insurers and for the people they protect.

I am quite confident that by the end of this hearing, you will all have realized that financial guarantee insurance is an incredibly complex business which will be difficult to regulate on any basis and which poses questions the answers to which cut in many different directions. Many of the arguments being made by supporters of all of the regulatory approaches are to some extent self-contradictory and will require the making of difficult decisions and the establishment of policy preferences in areas often divorced from insurance regulation. I would point out that, as a society, we got along quite well for a lot of years without the kinds of financial guarantees now being written by many insurers.

On the other hand, we must recognize that at least some products serve a useful social purpose and ought to be encouraged for that reason. But even here the situation is complex and convoluted. For example, at hearings conducted by the Insurance Committee of the New York State Senate on the subject of financial guarantee regulation, there was testimony to the effect that guarantees were being profitably employed to secure bonds providing funds to make student loans in the increasing amounts necessary to offset spiraling college tuition. The conclusion was a request for a permissive regulatory approach to encourage greater guarantee capacity. This sounds like a wonderful idea, but as something of a skeptic, as I was listening I couldn't help wondering whether that arrangement really wasn't an attempt to pass off onto the insurance industry the unhealthy consequences of our inability to control the costs of higher education. Do financial guarantees in this context really provide social utility or do they just postpone and thereby make worse the inevitable reckoning? I don't know the answer. That's not even an insurance regulatory question, but it's the kind of question I have a feeling we all ought to be thinking about. There must obviously be some finite limits on what kind and how much of society's risks the insurance mechanism can bear. Financial guarantee insurance by its very nature requires consideration of issues like that.

We at Chubb believe that extreme caution in dealing with financial guarantees is appropriate. The insurance industry holds the financial security of its customers in trust for them. Our one overriding goal must be to be there for those people who rely upon us in time of tragedy and loss. Our support of the monoline concept is, in our best judgment, the most effective way to protect the industry from an unpredictable, volatile and long-tailed business which we are a long way from completely understanding. The practitioners of the traditional insurance business have been and must continue to be extremely conservative. That's not real jazzy in these days of highly-leveraged financial deals, and I guess we come off sounding a little stuffy. We could be wrong about the dangers inherent in financial guarantee insurance. But until our industry and regulators have a lot more experience with the kinds of obligations being written today, and that's not just municipal bond or mortgage guarantee insurance, we ought to keep it insulated from the risk-spreading mechanisms which we all recognize as being of central importance to the function of our modern society.

Mr. Florio. Thank you very much.
Mr. Jacobs.

STATEMENT OF WILLIAM JACOBS

Mr. Jacobs. Thank you. Chairman Florio, my name is Bill Jacobs, and I am the Chief Operating Officer and Executive Vice President of Financial Security Assurance.

I am pleased to have the opportunity to testify at this morning's oversight hearing on the financial guarantee insurance industry.

Financial Security is a New York domiciled insurance company and the first mono-line insurance company to insure corporate backed financial guarantees, and is rated triple-A by Moody's and Standard & Poor's.

The company was formed in 1985 by The Equitable, John Hancock, New England Life, TransAmerica, Tucson Electric, The General Electric Company of Great Britain, First Interstate, Sumitomo Life, and others.

FSA is a member of the Association of Financial Guaranty Insurors, although we differ with the association in that we do favor a functionally mono-line approach to the business, and I served on the NAIC industry advisory committee on financial guarantees.

I am here today to testify to my unyielding belief in the financial guarantee industry in which I have been an active participant for over 10 years.

Through their use of our product, investors, issuers and investment bankers have acknowledged that our industry serves a real economic purpose, whether it be for the benefit of a general obligation bond issued by Camden, NJ for a Financial Security insured portfolio sale of car loans by Western Financial Savings Bank in Orange, CA, or for the $2.4 billion insured Rural Housing transaction for the Farmers Home Administration.

The industry has had a remarkable performance record since AMBAC, MBIA and Aetna Casualty wrote the first guarantees in 1974.

There are some who would say that there is no need for additional regulation based on the enviable record produced by the first-rate companies in this industry. I disagree.

I believe that, notwithstanding adequate State regulation to date, this rapidly growing industry should have evenhanded, fair and suitable State regulation in the future to assure the continuation of the superb record produced to date without stifling growth and eliminating the economic gain necessary to attract capital.

I know of these issues firsthand as I was able to raise $235 million in capital for Financial Security because, one, the investors liked the business, and two, the economic returns were sufficient to justify their investment.

There are several proposed regulations being discussed and implemented in New York, Illinois and other jurisdictions around the country. There are obviously pros and cons to each set of regulations.

We support these efforts and the functionally mono-line approach to the financial guarantee industry and applaud the thorough job done by the NAIC and those commissioners, led by New York, who participated in that process.

These proposals are a reasonable beginning of the establishment of standards for capitalization, aggregates, and underwriting standards, without unreasonably limiting the business.

We own two additional insurance companies, one domiciled in Iowa and the other in Oklahoma. These companies only write financial guarantee insurance through our intercompany pooling agreement.

We are in the process of licensing Financial Security in all 50 States.

It is my experience, being directly involved in this process, that every single State commissioner is interested in this question. And in fact, the functional equivalent of mono-line financial guarantee is clearly the recommended approach.

We believe that the mono-line structure is also well suited for the kinds of disclosure the Securities and Exchange Commission requires of third party guarantors of corporate debt offerings.

Many Wall Street Journal observers will agree that the sale of structured debt is a growth industry, maybe second in magnitude only to the sale of U.S. debt.

Indeed, as I mentioned earlier, 2 weeks ago, $2.4 billion was raised by Farmers Home Administration through the sale of debt guaranteed by Financial Security, FGIC, and MBIA, with reinsurance provided by Capital Guaranty.

There have been many statements made this morning concerning financial guarantees which I would like to briefly comment upon.

One, it is a credit business. A company, in order to perform this business, be it municipal or corporate, needs qualified credit analysts to do it.

There is no question that the business has risks. When you write your name on an insurance policy, by definition you are accepting risks.

The basis of credit and structure on these transactions is to reduce the ultimate loss to the barest minimum.

In some respects, we are, in the multi- and mono-line area, talking about an issue that is somewhat past. By and large, the business today is written by mono-line insurance companies.

All the mono-line companies monitor their liquidity requirements on exposures. We are required to pay P&I when due, generally not on an accelerated basis. We monitor the debt service timing of the obligations we insure. We structure adequate notice of potential defaults in each transaction. We monitor our investment portfolios so that there is sufficient cash to meet potential liquidity calls. And finally, we use outside liquidity sources.

It is my belief that the key to this business is that all responsible—and I underline responsible, as we have been talking about some of the horror stories by nonresponsible insurance companies—but the key is that all responsible insurance companies should be allowed in this business, as long as all of the companies in the business compete on a level playing field.

I thank you for your patience and consideration of my remarks, and I would be pleased to answer any questions you have.

[The prepared statement of Mr. Jacobs follows:]

STATEMENT OF FINANCIAL SECURITY ASSURANCE, INC.

Chairman Florio and members of the Subcommittee, my name is Bill Jacobs and I am the Chief Operating Officer and Executive Vice President of Financial Security Assurance. I am pleased to have the opportunity to testify at this morning's oversight hearing on the financial guarantee insurance industry.

Financial Security is a New York domiciled insurance company and the first mono-line insurance company to insure corporate backed financial guarantees and is rated triple-A by Moody's Investors Service Inc. and Standard & Poors Corp.

The company was formed in 1985 by The Equitable, John Hancock, New England Life, Transamerica, Tucson Electric, The General Electric Company of Great Britain, First Interstate, Sumitomo Life and others. FSA is a member of the Association of Financial Guaranty Insurors and I served on the NAIC industry advisory committee on financial guarantees.

I am here today to testify to my unyielding belief in the financial guarantee industry in which I have been an active participant for over 10 years. Through their use of our product, investors, issuers and investment bankers have acknowledged that our industry serves a real economic purpose, whether it be for the benefit of a General obligation bond issued by Camden, NJ, for a Financial Security insured portfolio sale of car loans by Western Financial Savings Bank in Orange, CA, or for the $2.4 billion insured Rural Housing transaction for the Farmers Home Administration. The industry has had a remarkable performance record since AMBAC, MBIA and Aetna Casualty wrote the first guarantees in 1974.

There are some who would say that there is no need for additional regulation based on the enviable record produced by the first-rate companies in this industry. I disagree. I believe that, notwithstanding adequate State regulation to date, this rapidly growing industry should have even-handed, fair, and suitable State regulation in the future to assure the continuation of the superb record produced to date without stifling growth and eliminating the economic gain necessary to attract capital. I know of these issues first-hand as I was able to raise $235 million in capital for Financial Security because:

(1) The investors liked the business and

(2) The economic returns were sufficient to justify their investment.

There are several proposed regulations being discussed and implemented in New York, Illinois, and other jurisdictions around the country. There are obviously pros and cons to each set of regulations. FSA supports these efforts and the functionally mono-line approach to financial guarantee insurance and applauds the thorough job done by the NAIC and those Insurance Commissioners, led by New York, who participated in that process. These proposals are a reasonable beginning of the establishment of standards for capitalization, aggregates, and underwriting standards without unreasonably limiting the business. They also provide for adequate capacity with their reinsurance regulations.

Financial Security owns two additional insurance companies, one domiciled in Iowa and the other in Oklahoma. These companies write financial guarantee insurance through an intercompany pooling agreement. We are also in the process of licensing Financial Security in all 50 States. My experience during this process has shown that all the States have raised the same issues Superintendent Corcoran has discussed on financial guarantee insurance. In fact, the functional equivalent of mono-line financial guarantee insurance is clearly the recommended approach in most of the States

FSA believes that the mono-line structure is also well-suited for the kinds of disclosure the Securities & Exchange Commission requires of third party guarantors of corporate debt offerings. Many Wall Street Journal observers would agree that the sale of structured debt is a growth industry, second in magnitude only to the sale of U.S. debt. Indeed, just 2 weeks ago, $2.4 billion was raised by the Farmers Home Administration through the sale of debt guaranteed by Financial Security, FGIC Corp., and the Municipal Bond Investors Assurance Corporation, with reinsurance provided by Capital Guaranty. Increasingly, these structured transactions are being sold to the public with third party guarantees issued by either banks or insurance companies. In these deals, the public looks to the financial condition of the guarantor and a functional mono-line structure easily accommodates the disclosure of this condition.

I thank you for your patience and consideration of my remarks. I would be pleased to answer any questions you may have either now or in the future.

Mr. FLORIO. Thank you, Mr. Jacobs and all of our witnesses. That, obviously, is a very good overview of some of the conflicting principles that we will be talking about. And obviously, there is lots that we could agree on: as you said in your concluding statement, Mr. Jacobs, we all want responsible insurers. It is the definitions that are the key things, and how we set up the systems to make those types of definitions.

Mr. Murray, I note that you are from New Jersey, and there is an interesting thing—and I was thinking in terms of Mr. Friedman's discussions about municipal bonds earlier—a hypothetical situation that I think highlights the difficulty in trying to make these responsible decisions.

In our State, for those of you who don't know it, we are currently going through a legislative debate giving the State authority to take over school systems.

Now, let's assume for a moment that we have got bonds that are issued pursuant to local school board deliberations. I suspect nobody ever evaluated the viability of the bonds on the basis of the quality of the education that is given in the school and whether, if that falls below a threshold, the State would come in and have the legislative authority to take over the State system, with a whole lot of things that flow from that.

Doesn't that tell you that we are dealing with something—and Mr. Murray, perhaps you are a little more informed about this than anybody else—doesn't that tell you that the idea of risk analysis in this area, even in terms of accepting Mr. Friedman's observation that you are not doing it in terms of traditional premium setting toward the end of anticipating risks, but we are making this determination and then we are going to allocate an appropriate—whatever that is—amount of capital to deal with the risk question. Is this something that almost defies the ability for anyone to anticipate what risks are in these areas, using this one little example of school bonds that may be issued that nobody ever anticipated this typo of development taking place?

Mr. MURRAY. Mr. Chairman, I think you have hit the nail right on the head. That incident or that hypothetical and also the Seabrook incident that is described in the papers today, if there were financial guarantees involved in those circumstances, will convert those financial guarantees into a kind of political risk insurance.

Now, we write political risk insurance as another class of business. But I must tell you that no insurer has ever even conceived of writing political risk insurance in the United States.

This has always been thought of as a place where we don't have the traditional kinds of political risks. And yet what went on in Seabrook and as it will affect the bond holders of that utility, that was very much a political decision that will have material financial consequences. And that component is now going to have to be factored in somehow into the underwriting.

But I must tell you that there is no, in my judgment, empirical way to do that. I am not convinced there is any empirical way to rate this business at all, based on historical loss exposures.

The traditional actuarial techniques that you would normally apply simply don't apply here.

Mr. FLORIO. Let me shift to Mr. Friedman, because he was the one that was advocating the idea and making the distinction, I presume, that under certain circumstances—and you seemed to be talking more in terms of mono-line than multi-line—that you seemed to be assuming that, yes, there is the capability to be making those types of risk determinations, so that at some point, if somebody knows what they are doing, they can spell out capital requirements to such a degree that we should have some assurance that the businesses can operate.

Can you elaborate on that?

Mr. FRIEDMAN. I can elaborate, and also, when I think about your previous question about premiums, which you asked while I was testifying, it relates to the same point.

Maybe I can elaborate by giving you an example of how we set a premium, which will go to the heart of your question.

Let's take health care, which is among the more risky lines of municipal bond insurance.

While you can't actuarially look back at the past, because health care is changing in America, the way we look at health care is as follows:

We say, we can underwrite a hospital, we can probably determine, if there were seven hospitals in the community, and we know some may close because of overbedding, who the strongest are for the next 3 to 5 years. We can probably make that assessment. But the bonds we are insuring are long term.

So, the judgment we make is what we call an alpha scenario. An alpha scenario is what you call a normal economy, if there is such a thing anymore. Call it everything but a depression.

We say, given 100 hospitals that we can underwrite to A quality, we want to make sure that the premium allows for a claims tolerance. That is, in a bad time you no longer make any return on your capital, but you don't invade your capital. The premium is enough to pay for 5 out of 100 losses, given 100 hospitals that you and I would insure right now with a 20 year duration.

Then we say, but there could be a beta scenario, massive changes in health care or a general depression, where you could have dramatic overbedding. And in that circumstance, we feel you could face, with the best underwriting, 13 to 14 out of 100 that could go sour.

What we do is we take alpha and beta and we mix it in our computer. In the case of health care, we happen to do it on an 80/20 basis. If we were talking about general obligation bonds, for example, which are backed by taxpayers, we would do that on a 90/10 basis, because even if there is a bad scenario, the tax base, the ability to increase taxes, gives you some comfort. Not true with health care.

We then mix this and we produce a premium. We know our cost of business. And we say to ourselves, in no event should the premium for that class of business fall below the level that we have established, even for competitive reasons, because when we begin to get below that line we are fooling around with long-term claims tolerances.

Now, Chairman, grant you, that is not an actuarial development of a premium. It is the way that the mortgage insurance industry develops substantial policyholder reserves over the years to withstand losses.

Mr. FLORIO. I am interested in somebody's observation about the premium also having factored into it the benefit to the purchaser of the reduced interest that would be paid as a result of this credit. Is that a quantifiable factor?

Mr. FRIEDMAN. Well, in terms of the example I just gave you, I didn't mention interest rate advantage because I was trying to tell you intellectually how we arrive at a premium.

However, if that was an A rate hospital—if the premium, for example, was the equivalent of a quarter of 1 percent a year, and it was an A rated hospital that could float its debt without insurance as an A rated security rather than a triple-A rated security, if the benefit of elevating itself to a triple-A security is less than a quarter of a percent, theoretically it might not use the insurance because there would be no net interest rate saving after paying the premium.

So, certainly, in order to motivate an issuer and that issuer's investment banker or financial advisor to use insurance, the net savings after paying the premium is very relevant.

Now, some insurance companies look at that spread and, frankly, gear their premium to the spread so there is always a market demand for the product. But that is not intellectually the proper way of developing a premium.

Mr. FLORIO. Just to carry your little example to its next conclusion, 55 percent of hospital revenues come from public moneys across the country, as a general average. We are now in the middle of a debate on Medicare.

The proposal is there is going to be a substantial increase in the Medicare fees to be paid by senior citizens.

Let's assume for a moment the political process works out and that they say no, we are not going to allow that. And then, of course, what you will have is hospitals shifting more costs to senior citizens.

Let's assume for a moment they don't choose to incur those costs, they don't go to the hospitals, adversely affecting the financial viability of the facility.

Is that too remote for you to try to factor in?

Mr. FRIEDMAN. Oh, no. As a matter of fact, we look at that and we try to determine which hospitals, based on their history, their management philosophy, the makeup of their board, the age of the doctors that dominate the hospital, the dispersions of risks among the doctors, the type of practices they have, who would be most likely to survive under the scenario any third party pay changes.

Mr. FLORIO. That was an interesting explanation with regard to the premium. But I thought I understood a few people to say that the premium and the pricing of the premium is not factored in to the same degree as it is in property and casualty insurance to deal with risk outcomes, but rather the capital amounts required are a much more significant way—as a matter of fact, capital to exposure is a more significant way of dealing with this.

You were talking about computers and models—do we have the same degree of capability of determining what the appropriate cap-

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Mr. FLORIO. Let me shift to Mr. Friedman, because he was the one that was advocating the idea and making the distinction, I presume, that under certain circumstances—and you seemed to be talking more in terms of mono-line than multi-line—that you seemed to be assuming that, yes, there is the capability to be making those types of risk determinations, so that at some point, if somebody knows what they are doing, they can spell out capital requirements to such a degree that we should have some assurance that the businesses can operate.

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We then mix this and we produce a premium. We know our cost of business. And we say to ourselves, in no event should the premium for that class of business fall below the level that we have established, even for competitive reasons, because when we begin to get below that line we are fooling around with long-term claims tolerances.

Now, Chairman, grant you, that is not an actuarial development of a premium. It is the way that the mortgage insurance industry develops substantial policyholder reserves over the years to withstand losses.

Mr. FLORIO. I am interested in somebody's observation about the premium also having factored into it the benefit to the purchaser of the reduced interest that would be paid as a result of this credit. Is that a quantifiable factor?

Mr. FRIEDMAN. Well, in terms of the example I just gave you, I didn't mention interest rate advantage because I was trying to tell you intellectually how we arrive at a premium.

However, if that was an A rate hospital—if the premium, for example, was the equivalent of a quarter of 1 percent a year, and it was an A rated hospital that could float its debt without insurance as an A rated security rather than a triple-A rated security, if the benefit of elevating itself to a triple-A security is less than a quarter of a percent, theoretically it might not use the insurance because there would be no net interest rate saving after paying the premium.

So, certainly, in order to motivate an issuer and that issuer's investment banker or financial advisor to use insurance, the net savings after paying the premium is very relevant.

Now, some insurance companies look at that spread and, frankly, gear their premium to the spread so there is always a market demand for the product. But that is not intellectually the proper way of developing a premium.

Mr. FLORIO. Just to carry your little example to its next conclusion, 55 percent of hospital revenues come from public moneys across the country, as a general average. We are now in the middle of a debate on Medicare.

The proposal is there is going to be a substantial increase in the Medicare fees to be paid by senior citizens.

Let's assume for a moment the political process works out and that they say no, we are not going to allow that. And then, of course, what you will have is hospitals shifting more costs to senior citizens.

Let's assume for a moment they don't choose to incur those costs, they don't go to the hospitals, adversely affecting the financial viability of the facility.

Is that too remote for you to try to factor in?

Mr. FRIEDMAN. Oh, no. As a matter of fact, we look at that and we try to determine which hospitals, based on their history, their management philosophy, the makeup of their board, the age of the doctors that dominate the hospital, the dispersions of risks among the doctors, the type of practices they have, who would be most likely to survive under the scenario any third party pay changes.

Mr. FLORIO. That was an interesting explanation with regard to the premium. But I thought I understood a few people to say that the premium and the pricing of the premium is not factored in to the same degree as it is in property and casualty insurance to deal with risk outcomes, but rather the capital amounts required are a much more significant way—as a matter of fact, capital to exposure is a more significant way of dealing with this.

You were talking about computers and models—do we have the same degree of capability of determining what the appropriate cap-

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ital exposure, the capital surplus would be to deal with reasonably projected exposures in different lines?

Mr. FRIEDMAN. Well, see, if you choose not to regulate the premium level, then the sure way of dealing with capital adequacy is dealing with the capital to exposure relationship, because if the capital can't be self generated through proper premium levels, the only way a company could maintain its viability from a regulatory standpoint or from a rating agency standpoint would be to have to raise more capital.

Now, if that fact is an established rule of the game, then the chances are that the premiums would more likely reflect levels which would self generate capital, allow the company to be ongoing.

If, on the other hand, it is a multi-line environment, you can cheat the process, depending when you want to from time to time, by doubling up in your counting.

Mr. FLORIO. Mr. Satz.

Mr. SATZ. I would like to comment on this a little bit. I was the Chief Operating Officer of AMBAC, which is a mono-line municipal bond insurance company.

One, I would like to make a quick point on your political question, the political risk question, and just note that that is, in fact, a proverbial two-edged sword.

It is very difficult to quantify the impact of political exigencies on the ability of a particular credit to make payment over a 20 year period.

However, the obverse is also true. Because, at least in the municipal bond insurance sector, generally what you are insuring has a demonstrable public purpose, there tends to be a safety net which isn't tangible and is judgmental surrounding the credits which you insure, which tend to buffer the inclination of any particular credit to default based on purely economic factors.

Actually, a good example is one of the riskier areas, which is hospitals. I agree with everything that Mr. Friedman said regarding the various factors that are taken into account in determining whether a hospital is an appropriate credit for insurance.

However, if you ever tried to close a hospital, you would find that there are very often factors that go beyond the pure enterprise efficiency of that hospital relating to its ability to remain operative and, in fact, ultimately pay its debt.

Mr. FLORIO. Are you offering that as a plus or a negative?

Mr. SATZ. That is a plus from an insurer's perspective.

Mr. FLORIO. But in terms of the overall health care delivery system, I would think it would be somewhat perverse if we are arguing that we should expend money keeping open an unneeded facility.

Mr. SATZ. I am not stating that. And, in fact, the general qualification of the original credit is premised on your best judgment that because of a variety of empirical factors you can make the judgment that it will be the survivor, to use Mr. Friedman's description.

However, if your judgment is wrong, there will be an additional basis on which that hospital can remain operative, particularly during transient periods of problem.

You may run into a situation where it is not simply a question of opening or closing, but whether a hospital can bear the brunt of an adverse circumstance.

Mr. STERN. Chairman Florio, if I may add to this also.

You raised the question as to whether or not the modeling done by the insurers and the rating agencies, and as could be done by the regulators, takes into account the different levels of risk that are contained in the different types of bonds. And very definitely, the answer to that is a resounding yes.

For example, Standard & Poor's has established a rating standard for municipal bond insurers which segregates the types of municipal bonds into 26 different categories, and based on the history of their rating downgrades over extended periods of times have established relative default rates for each of those classes. And hospitals, as an example, are in one of the highest default rates in that class, as are nuclear utilities.

And I think it would be fair to state that the example of Public Service of New Hampshire is that it did not qualify for underwriting of bond issues by financial guarantee insurers, so that it can be risk assessed. But a key is not just the aggregate capital ratios, but the fact that single risk limitations are established, so that when an isolated event such as the Public Service of New Hampshire occurs, or as occurred in WPPS, the exposure that a single bond issuer has to that issue is limited. And again, it is limited to the amounts that they have to pay at a particular point in time. The full amount of the debt is not accelerable.

Also, it is spread amongst the industry through the use of reinsurance, so that the exposure is further spread amongst participants. And, in fact, the model bill even would allow multi-line insurers to remain as reinsurers in the business, allowing them to spread the risk. In fact, that is one of the inconsistencies of the model bill.

Mr. FLORIO. Give that to me again with regard to the interaction between this and the reinsurance industry.

Mr. STERN. In particular, it is an area that is close to my heart, because I have been in the process for the last year and a half of trying to form a financial guarantee mono-line reinsurer and raising capital for it has been no easy task. We have been unsuccessful in a public offering and are in the process of a private offering stage.

The primary insurers share the risks they assume with reinsurers who participate on their entire portfolio of business through what are known as treaty agreements. That is spread not just in the United States but in international reinsurance markets.

So that the individual insurer is able to minimize his exposure to a single risk, to concentrations of risks in a geographic area, and through some mechanisms to concentrations of risks that occur in a specific type of municipal bond.

So, the ability to diversify and spread one's portfolio through reinsurance is a very important part.

Mr. FLORIO. I understand that. But are you telling me that there is a financial guarantee reinsurance industry out there? Or are we talking about the reinsurance industry there?

Mr. STERN. I am telling you there is a financial guarantee reinsurance industry in formation. There is one mono-line company in the business. There are two others, including our own, that are in the process of raising the capital necessary to enter the business, and that process has taken us over 2 years already.

Mr. FLORIO. Are these financial guarantee reinsurance companies the offshoots or subsidiaries of the traditional reinsurance companies? Or are they inclined to be independent?

Mr. STERN. The mono-line companies are, in fact, independent companies. Each of them tend to have a sponsor from one of the traditional insurance sectors that have been involved in either the primary or reinsurance sector.

Mr. FLORIO. I guess my immediate concern is that if this whole risk assessment difficulty is as complex and as difficult as it is for the actual insurers, to try to figure out the long tale or to try to figure out what the long-term obligations would be for reinsurers, who by definition are dealing with the larger amounts, that seems to me to be even that much more complicated.

Mr. STERN. Well, in fact, the reinsurers deal with the smaller amounts. They spread their risks, because of the difficulty of having the direct access to the same data that the primary companies have. They spread their risks more broadly by taking small participations of the business generated by each of the primary companies.

Mr. FLORIO. OK.

Mr. FRIEDMAN. By the way, unlike the traditional insurance business, at least 80 percent of the municipal bond business written by the industry is retained, and it is about, on average, 20 or so percent that is reinsured out.

Now, the reason that direct writers are able to retain so much of this risk without reinsuring it out is precisely because of these tremendous capital requirements that the rating agencies impose on them, controlling both single risk and aggregate risks.

Mr. FLORIO. Let me ask one last question, and quite frankly I don't think I have gotten a response, at least not one that I understood.

Let's talk about mono-line for a moment; the determination of the capability of a regulatory agency, first of all, or, if we haven't got a regulated system, a company independently, to make a determination as to how much capital surplus is regarded as safe for that company independently to make the determination that it is doing the correct thing, versus a regulatory system to make that determination.

Is there the capability now, in your opinions? And if you could just elaborate on it to get me to understand how you would be able to make those types of subjective decisions, given the absence of traditional property and casualty experience and traditional actuarial histories.

Mr. JACOBS. Mr. Chairman, let me respond to that for a moment.

I think with the various elements in the financial guarantee industry, particularly in a mono-line approach where you have companies established by very sophisticated investors—our own company being established by people like The Equitable and Hancock and TransAmerica—as well as the rating agencies looking at the business that these companies are doing prior to and on an ongoing basis, providing them with a rating—Standard & Poor's looks at every transaction that we underwrite—and also the State regulators, through the model bill, setting a standard where, in order to generate a sufficient return on the business with the capital necessary to start the business and with the ratios that the regulators, both on the insurance side and the rating agencies, allow you to write to, almost by definition means that only those companies who are willing to staff the organization with responsible credit, insurance and analytical people are able to meet the test that the body of regulation requires in this business.

Mr. FLORIO. So, with regard to the example that we talked about before, Seabrook defaulting, you are saying that if there is somebody in that business and they are good, that they would have factored in the inability to get evacuation plans approved and that they therefore would have a sufficient amount of money out there to be able to deal with their responsibilities.

Mr. JACOBS. It would be audacious of me to say that any single company would know that Seabrook was a bad risk. However——

Mr. FLORIO. But that should have been a factor in making the determination that no single company would have exposed themselves.

Mr. JACOBS. However, what Mr. Friedman explained in his underwriting, which with different words is the same as our underwriting, is that you mix, in your analysis of any individual transaction, what could be your potential worst case scenarios, and you build in those when you analyze a particular transaction. And unless it makes the cut, you don't underwrite that transaction.

The difficulty in the business and the horror stories that have been raised this morning are where there are unsophisticated companies who have entered the business without having to generate an adequate return for sophisticated investors and went into the financial guarantee business, insuring an apartment house without ever going to look at it.

That type of abuse is what happens when you have what I call the nonresponsible people in the business.

Mr. MURRAY. Mr. Chairman, if I could address that for just a second.

Mr. FLORIO. Yes, Mr. Murray.

Mr. MURRAY. You have asked what sounds like a fairly simple question and have gotten very complex answers, and maybe I can just give you our perspective on it, and I hope it is a fairly easily stated perspective.

Number one, Standard & Poor's is not charged with the responsibility for regulating the insurance industry. They do what they do for different reasons and for different perspectives. They also change their mind, as someone pointed out, with devastating consequences to the constituency that insurance regulators are designed to protect.

The second point is that you heard the witnesses on behalf of the GAO suggest that we needed more first class business school MBA types in the State insurance departments. And I think if you think about what my colleagues here have been saying this morning, that is essentially the message, that this is a very sophisticated business, and if you are going to regulate it successfully you need very sophisticated people looking over the shoulders of its practitioners.

Now, I wonder what kind of success the New York Insurance Department, which I tell you I regard as being the best in its business, had the last time they were up at the Harvard Business School recruiting graduates to serve in an insurance regulatory environment.

Our perspective is, it just ain't going to happen.

Mr. FLORIO. Mr. Foley, if you could just wrap up on this.

Mr. FOLEY. I would like to answer Mr. Friedman's question because I think it deserves an answer.

We bought UGC as a going concern, with a book of business that was adequately employing the capital involved. To put up $150 million for a mono-line company not adequately leveraging the use of that money would be a mistake on our part.

And when Mr. Corcoran had his bill in the legislature, we asked for a transitional rule that would have given us adequate time to make a decision to either get out of the business or invest the money.

Mr. FLORIO. Let me thank this panel. We have a vote that is on the House floor right now. I express my appreciation to the panel for being very, very helpful in terms of fleshing out some of these things, and we will feel free to reach back out to you, if you don't mind, to get further elaboration on some of these points.

The committee is going to have to take a recess at this point. The full committee is meeting and my presence is required there, as well.

We will take a recess until approximately 1:15 p.m., and we would hope that you would be able to get lunch. For the remaining panel, I apologize for the inconvenience. But we will recess until 1:15 p.m..

[Whereupon, at 11:44 a.m., the subcommittee was recessed, to reconvene at 1:15 p.m., this same day.]

AFTER RECESS

Mr. FLORIO. The subcommittee will kindly reconvene.

Let's conclude with our last panel and our last witness, who I would publicly like to apologize to for the disruption as a result of a lot of obligations between the full committee and the House.

But we are pleased to hear from Mr. Steven Doehler, Executive Vice President of the Mortgage Insurance Companies of America.

STATEMENT OF STEVEN P. DOEHLER, EXECUTIVE VICE PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA

Mr. DOEHLER. Thank you very much, Chairman Florio. No apology needed.

We appreciate the opportunity as a trade association to participate in these important hearings. And, of course, we have submitted this written statement for you. I will remind our timekeeper and be very brief, if I can just hit some key points that were in the written statement.

I think the subcommittee invited MICA to draw a number of parallels from the mortgage insurance industry's experience which could be related or which relate to the policy issues under review.

I think it is important from the outset to distinguish mortgage guarantee insurance from the many other forms of financial guarantee insurance that have been out there. I think it is clear it is a credit enhancement mechanism only.

Perhaps the best way to get a full picture of the differences is to look at what the NAIC has recommended over the years, especially in the development of the model act for financial guarantee that was discussed a little bit this morning. That was adopted back in December of 1986.

Mortgage guarantee insurance is exempted from that bill, and I think certainly a major element in the rationale for the NAIC has been the fact that they adopted back in June of 1976 the model mortgage guarantee insurance act, and that has been a very important element in the industry's role. A number of States have begun to adopt that and it operates very effectively.

As background, mortgage guarantee plays a very narrow role in the mortgage finance system. Simply stated, private mortgage insurance is a guarantee that protects the investor against loss if the borrower stops making his mortgage payments.

The borrower, the lender, the investor all benefit from private mortgage insurance.

For the borrower, it means he can purchase his dream house with as little as 5 percent down.

For the lender, private mortgage insurance provides a substitute for borrower equity, which enables him to originate that high loan to value ratio loan.

For the investor, private mortgage insurance makes a loan more acceptable by providing the necessary assurance that their investment yield will not be reduced by mortgage default losses.

The industry's track record since its inception in the late 1950's is available and shows the industry's response to a demand for high ratio mortgages addressing the problem of housing affordability.

The experience during the early 1980's is more meaningful to the subcommittee's current concerns. This was a period of skyrocketing interest rates, deregulation and change in the mortgage market.

There was, for example, a flood of new mortgage instrument types. Mortgage insurers insured them and set volume records for new business.

The innovations brought benefits, but these benefits were accompanied by untested risks. These new risks, combined with catastrophic loss levels resulting from economic recession in the oil patch States, provided very heavy losses for the mortgage insurance industry.

In 1986, the industry paid $1.2 billion in claims. In the first half of 1987, this level of claims has doubled.

Don't forget, however, that the flip side of claims is benefits paid, and many lenders would be in very serious shape if it were not for the substantial mortgage guarantee coverage, including a number of the FSLIC insured institutions.

Despite the industry's massive underwriting losses and claims payments during the last several years, the industry has remained viable with a positive net income, a clear sign of its staying power.

What accounts for this staying power?

Certainly, the regulatory treatment such as the mono-line rule and the contingency reserves. Members commit their capital for the long run, and that is very important.

Let me conclude with some recommendations that relate to our business.

Despite how good the underwriting experience has been or how smart we think we are, the future can't be predicted.

Therefore, there is an important role for regulations to help avoid dangers. We need innovation, but innovation and a sound regulatory framework are not mutually exclusive.

Again, the mortgage insurance industry is an example where the NAIC recommendations and mono-line rule has worked well. I am confident that our industry is totally supportive of the NAIC's efforts.

From the mortgage insurance experience, what are some lessons that might be applicable to the financial guarantee field that you are looking at?

First, I think that it is important to recognize the structure of financial guarantee must make a net economic contribution to the system. Shifting risk from one balance sheet to the next is not productive for capital formation in the economy, unless the insurer is structured to better absorb or manage the risk.

Second, coinsurance is an important concept. If risk is not shared between insurer and insured, then the insurer must be prepared.

Fraud and misrepresentation have plagued mortgage insurers and the mortgage finance market, especially in recent years. Since the security that may have a more difficult time getting investor acceptance is just the security that is most in need of financial guarantee, the financial guarantee business can invite the worst risks. This is both a management and regulatory question.

Third, we can't forget that at the heart of the financial guarantee business there is the need to perform a credit analysis. Assessing asset quality is essentially for the insurer to properly quantify and price exposures. A number of the previous witnesses have hit on that, and that is essential.

And then, of course, last, and I think this is probably one of the key ones, that is the question of capital adequacy. This is an obvious recommendation. When you buy financial guarantee, you want the candy bar, not just the wrapper. The guarantee without the reserves that demonstrate an ability to pay isn't worth very much.

I would like to just make a recommendation that I think would significantly affect the future of the financial guarantee business and the strength of our economic system, and that is the need by Congress to begin to lessen the role of the Government in all the financial markets.

The toll of the Federal involvement is high, and in far too many cases the major benefit does not go to those families to whom it was intended to go. This is true certainly of the FHA, the Federal Housing Administration, that we compete with.

Dependence upon Government guarantees reduces market discipline and has an economic consequence or cost that is very real, but is often overlooked because it is not immediate. This dependence on the Government in these areas is not consistent with our national goals.

I think we need good, sound regulations from the standpoint of solvency, but we should also think about a direction that will allow the innovation to come forth.

Thank you very much.

[The prepared statement of Mr. Doehler follows:]

Statement of Steven P. Doehler, Executive Vice President of the Mortgage Insurance Companies of America On Financial Guaranty Insurance Before the House Subcommittee on Commerce, Consumer Protection and Competitiveness

October 14, 1987

Mr. Chairman and Member of the Subcommittee:

I am Steven P. Doehler, Executive Vice President, of the Mortgage Insurance Companies of America (MICA)*. MICA is a trade association representing all the domestic private mortgage insurance companies.

MICA appreciates the opportunity to contribute to this hearing. Financial guarantee insurance is a highly complex and evolving business that is not easily defined. It operates in areas of prospective risk often lacking historical experience and while it clearly holds significant potential benefits for our financial system, it could also hold dangers.

The origins of financial guarantee insurance have often been traced to surety bonds and mortgage guaranty insurance. However,

*MICA consists of the thirteen domestic private mortgage insurance companies which represent the active firms that help loan originators and investors make funds available to homebuyers by protecting these institutions from a major portion of the risk of default. The current MICA officers are President, C. Earl Corkett of PMI, San Francisco, CA; Vice President, William Lacy of MGIC, Milwaukee, WI; Treasurer, J. Edward Carlton of Integon Mortgage Guaranty Insurance Co., Winston-Salem, NC; and Secretary, Fred Reichelt of Verex Assurance, Inc., Madison, WI. MICA also has private mortgage insurance companies members in Canada and Australia. At the end of 1986 the industry had over $267 billion of insurance in force.

mortgage guaranty insurance** is distinct from financial guarantee insurance. This line was specifically exempted in the NAIC Financial Guaranty Insurance Model Act amended and adopted by the NAIC in December 1986. A Model Act for mortgage guaranty insurance was previously accepted by the NAIC in June of 1976. While there are distinctions, there are also some very important similarities that may be of interest.

Mortgage guarantee insurance has from its modern inception in the late 1950's proven that monoline underwriting can provide adequate capacity to meet all the demand for the coverage. In 1970, the industry's new insurance written was less than $2 billion. The new insurance written by the industry in 1984 reached a high of $63.4 billion. Even during the last several years of loss, the industry has had additions to its capital.

**The sole purpose of mortgage insurance is to protect the lender in the event of a borrower defaults - stops making his payments - on his mortgage. This hazard of borrower default is not isolated to individual, random events like a fire or a bank robbery, but is broadly affected by economic conditions. Mortgage lenders face catastrophic risk which can stem from a serious national or regional economic downturns and the number of mortgage foreclosures can rise dramatically from unforeseen changes in local employment opportunities or systemic overbuilding in housing markets. When default losses occur, they tend to be clustered rather than totally random events.

Because of the inflation of home prices that has occurred in many markets in the past dozen or so years, there are many homebuyers with adequate incomes to pay the carrying cost of a home but who have not accumulated the savings for the downpayment the lender requires as a condition of obtaining a mortgage loan. Many consumers such as those buying their first home have opted for an insured conventional loan that has a high loan to value ratio. Such loans are made possible by a mortgage insurance policy that protects the lender against a portion of loss a lender may incur if the borrower were to default on the loan. The mortgage insurance substitutes for downpayment equity.

In fact, the greatest deterrent for private insurers in expanding capacity, especially in recent years, has not come from the industry's conservative regulatory and financial structure but from the usurpation of the market by the Federal government's competitive mortgage insurance programs. Although Congress has said much about the need to reduce the deficit in the Federal Budget, in 1986 Congress quietly issued an all-time record of $160 billion in subsidized loan guarantees. For the first time in a decade, the Federal Housing Administration (FHA) expanded its volume to insure more loans than the entire private mortgage insurance industry and the bulk of those loans went to upper-middle income families. This backdoor spending from loan guarantees has unfortunately not been fully understood especially as to its effect upon this nation's financial future.

We are pleased that this Subcommittee is appropriately concerned with the potential consequence to capital formation and the marketplace from poorly structured financial guarantee insurance. However, we feel Congress should pay more heed to the problems and social costs resulting from defaulted federal loans. Last year alone, Congress had to appropriate over $8 billion to pay default losses resulting from federal loan programs. If our deficit problem is truly to be solved, then it is an important objective for national policy to encourage the private sector to do more. This is clearly true in the field of financial guarantee insurance.

The private mortgage insurance industry is committed to expanding its contribution to homeownership through its sole line of business, that of providing default coverage on residential loans.

One step that will expand the contribution of the private sector in financial guarantee insurance would be the establishment of a balanced regulatory structure. The experience that is available from private mortgage insurance may help to establish some principles that can apply to the regulation of financial guarantee insurance.

Four concerns have been dealt with in the development of regulations of the mortgage insurance business. These regulations have proven themselves over time and have remained dynamic. They are especially relevant to financial guarantee insurance because there has been a trend in finance toward greater securitization of assets. Mortgage finance has been significantly affected by securitization which in turn has changed the mortgage insurance business and its operating structure.

Diversification

The first concern with financial guarantees could be described as the need to diversify risk. Insurance is typically defined as either a transfer of risk to a professional risk-bearer or the pooling of resources to better meet a common exposure to loss. In order to contribute to the financial strength of the system as a whole, the professional risk-bearer's operations or the pooling must add efficiency. If a financial guarantor operates to simply collect risk that other entities shift from their balance sheet and is not structured in a way that will permit the guarantor to absorb the "big hit" when a loss results, then no net benefit to the system results. The financial guaranty insurance must make an economic contribution to the transaction.

Real estate lending concentrates risk both geographically and in time. Because mortgage insurers can operate beyond the local or regional level they are less exposed to concentrated or catastrophic risk that could occur in a housing market that undergoes a calamity from overbuilding or other economic disruption such as a plant closing. The mortgage insurer can diversify risk at a cost or premium that for most lenders would be less than the lender's cost of maintaining capital in the form of a loss reserve. Also, because the mortgage insurer is monoline, it has committed its capital to the residential lending business and it is less inclined to either quit markets or to oversell markets because of the tendency to look at market changes over a longer term perspective. Further, the regulations of mortgage insurers consider time risk and require, for example, that mortgage insurers put $.50 out of every premium dollar into a contingency reserve for 10 years.

The ability to geographically diversify risk over time in strong and week markets adds stability to the market for high ratio loans and has benefits that favorably translate into the premiums that borrowers are charged for coverage.

Risk Sharing

A second concern that has become far more important in recent years relates to changes in the sharing of risk between the insurer and insured. For example, ten years ago in mortgage finance the primary originator of mortgages were lenders who kept the loans in their own portfolios. Because making a bad loan hurt the lender directly, mortgage lending was fairly conservative from a risk perspective. Coinsurance or the sharing of some risk between the insurance company and the loan originator/policyholder on insured loans was alive and well.

Today, due to the growth of the secondary market and the attendant economics of that market, this principle of coinsurance has declined in the eyes of many lenders. As lenders become primarily concerned with the production and sale of loans, the guarantee from a mortgage insurer can often become the determinant as to whether a loan will be originated or not. If a mortgage insurance company will guarantee the loan and the lender can sell it in the secondary market, the loan will be made. The insurer of such a loan often finds risk-sharing or a partnership in managing risk to be absent.

The decline in risk-sharing can have a harmful effect on financial guarantees unless the insurer can take steps to protect against inappropriate risks being presented for insurance. Because guarantees can affect the appearance of an asset sale, it is important that it not provide a mechanism for a party to the transaction to conceal risks that have not been underwritten. When a transaction is complex, it can become a breeding ground for fraud and misrepresentation. In the last several years, the members of MICA have had to suffer the consequences from more incidents of mortgage lending fraud than at any previous time. Lessons have been learned by mortgage insurers and measures can be taken to protect against fraud.

Financial guarantees can invite the worst risks so it is a business where management must keep both eyes open. In the absence of the discipline from risk sharing there is the need to avoid adverse selection and the practices of the unscrupulous.

Credit Analysis

The third concern is that credit analysis not be deemphasized in the system because of financial guarantees. There is a need somewhere in the finance process to examine the quality of the asset itself. The existence of a financial guarantee does not reduce this need. When a change occurs in one part of system that weakens credit analysis, a change must occur in another part of the system to compensate.

To explain this from the perspective of real estate lending, it has become generally accepted that neither the builder, realtor, mortgage originator or securities firm any longer has a major stake in the quality of the loans sold as assets in the secondary market. The primary business motivation of these parties is typically to sell; to close deals quickly and often. The incentive exists to expand volume which can operate in direct conflict with the basic underwriting goal of quality.

The entities in the secondary market with the primary interest in loan quality are the investors such as the federal credit agencies and the insurers of default risk. However, from a practical operating standpoint, neither the mortgage insurers or the secondary market agencies can be involved in the primary under- writing of the assets. They must rely upon the lender's loan underwriting representations and warranties that the loan has met specific quality guides. Thus, policies of insurers and the warranty programs of the agencies have been made explicit as to the treatment of assets presented for insurance or sale which have characteristics that are in reality not as then were represented to be.

Because the business of financial guarantees is so new, there exists the possibility that as indemnification of risks are made within complex agreements, parties to the transaction come to rely on each other's guarantees rather than on their own credit analysis of the assets. This can present some very significant dangers and regulatory attention could be needed. In a nutshell, the need to be reasonably certain as to asset quality is essential for financial guarantee insurer to properly quantify its level of exposure. Assessing asset quality must be a key managerial function structured into the business.

Capital Adequacy

The last concern involves the most essential element of financial guarantee insurance that of financial solidity and solvency. In the case of guarantees for mortgage securities, there has been a general desire by investors to depend upon the insurance or guarantee so that they can disregard the identity of the seller and the characteristics of the mortgages in the pool that ordinarily would bear upon the default risk of those mortgages. The need to perform a detailed analysis of such information by investors would prove a deterrent to the marketability of securities. Therefore, for insurance on mortgage securities to be acceptable and reduce the need for detailed analysis it must demonstrate the financial soundness and integrity of the insurer. This is likely to be true to some extent for all forms of guarantees.

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In the recent past, the cases where this has been evident have typically related to abuses that have occurred. For example, a problem that was widely reported in the press in 1985 involved huge losses reported by Bank of America when it repurchased a large volume of mortgage securities for which it acted as trustee. The insurance organizations that engaged in the mortgage securities transaction in this case were not monoline and were not licensed to underwrite mortgage guarantee. Although the Bank of America's role was limited, the insurers and those marketing the securities exploited the banks reputation to make the sale. When the securities scheme fell apart it revealed the insurance was not backed by adequate reserves to provide the meaningful protection that the investors had expected.

The success in maintaining capital adequacy for private mortgage insurance industry has been attributed to both the monoline rule and the strict capital rules that exist in the regulations of the business. It should be noted that the capital requirements have proven to be sufficiently stringent to insure safety yet permit aggressive competition for reasonable business. It has also been far easier for regulators to examine monoline firms not having to worry about the performance of other lines and how these lines might effect solvency. Because mortgage insurers are licensed to transact one line of business and must maintain a conservative 10 year contingency reserve, it has not been a field to enter into to make a "quick buck". Mortgage insurers are by design created for the long haul in the mortgage marketplace. Also it should be noted that the bond rating agencies such as Standard & Poor's and Moody's are well aware of the unique structure when they rate the claims paying ability of mortgage insurers as well as the mortgage securities carrying their guarantees. These rating agencies help set standards for the financial discipline needed in the market. Their guides could provide the Subcommittee additional reference.

In closing, the recent experience of the mortgage insurance industry should be mentioned. There have been unprecedented levels of loss that have gone way beyond the expectations and even imagination of the industry management. At the same time these losses have not delivered the disaster that some may have expected. In fact, the claim performance has helped to validate the regulatory structure established for the industry and this form of financial guarantee. The years of surplus and reserve accumulation during the strong housing market of the late 1970's effectively provided capital that insurers used to help lenders manage losses in their markets. Certainly there have been a number of FSLIC insured institutions that would not have fared as well without the billions paid to them in claims by private insurers. The recent loss experience has also identified problems and provided important lessons for management.

While this validation of the product has been positive for the industry, the industry must also point to many costly mistakes: there were too many transactions that involved fraud; there were markets that suffered heated competition with insurers accepting poor risks to retain market share; there were loan instruments and transactions structured with unreasonable levels of risk; and there were other incentives which caused insurers to neglect asset quality.

In addition, several firms in the industry also misread the danger from the concentration of risk in a program designed by "EPIC". Although the program was accepted by the most sophisticated leaders in mortgage securities market, such as Fannie Mae and Salomon Brothers, the mortgage insurers did not adequately analyze the true risks. As a result, one mortgage guaranty firm, TICOR, was necessarily put into conservatorship by the California Commissioner. Although TICOR is no longer actively writing new business, all policyholders of TICOR are having all their claims honored and this can be largely attributed to the industry's conservative regulatory treatment that has proven its value.

In sum, a balanced regulatory structure is needed in financial guarantee insurance to allow innovation and new efficiencies in risk taking while maintaining a level of safety.

MICA would be happy to provide additional information to this subcommittee in any way the association is able.

Mr. FLORIO. Thank you very much.

I suspect you probably heard some of the testimony today, and it is the question of the degree of responsibility of some of the innovation that is at issue.

Again, my own technically uninformed judgment is that when you start talking about guarantees on currency rates, that is almost by definition a capital generating instrument. But I am not sure how objective anybody can be in assessing the risks, the upside risks, the downside risks.

So, I guess that is an example of something that I have some concerns about. By definition, aren't we into a host of different areas that are almost incapable of being determined or having the risks determined for purposes of making some responsibility?

I have questions about the adequacy of the governmental regulatory systems, that even if they had all the power that they were asking for in this uniform model code or anything else, whether they would be able to make those determinations.

Let me ask of your own industry, adjustable rate mortgages are relatively new as factors. At the end of the 1970's, when we were talking about 20 percent interest rates, if we were now facing that type of an economic situation, adjustable rate mortgages, for a long period of time, ironically enough having "stagflation," a recession with escalating interest rates, which is not a difficult scenario to logistically and realistically conjure up, what is the impact upon the home mortgage guarantee industry?

Are you confident that someone has thought that through? And I assume the collateral is the basis for feeling that you have got security, but in that type of a situation you are not going to be able to liquidate any collateral. And if you did, it probably is not going to bring anything close to what the appraised value of the collateral was at the time that you took the collateral and made your decisions based upon those types of values.

Tell me, how would you respond to the question in your own relatively easy part of the guarantee insurance industry, how you feel that you have taken those things into account?

Mr. DOEHLER. The question of assessing untested risks with new mortgage instruments—and you mentioned the adjustable rate instruments—the industry does look on a prospective basis as to what the likely performance of those instruments will be. And the experience from the last several years, say from 1980 through 1985, indicates that when the industry initially began insuring those type of loans, they used the same premium rates and they used the same basic costs and assessment procedures as they had been for fixed rate loans. They were probably underpriced.

At the same time, the industry, in its efforts to keep constant available coverages out there, did go in and move into this area of new untested risks.

Now, the reason they are able to do that is because over the previous dozen or more years, as various companies were in business, they were able to build up the surplus.

The contingency reserve is one important element in the capital of mortgage guarantee companies. And the way that the regulations for mortgage guarantees are structured in this contingency reserve, is somewhat unique: 50 cents out of every premium dollar that the mortgage insurer takes in is set aside in a reserve for a period of 10 years and can't be brought into income. So, what that does is it makes an insurance company committed to be into that business.

The mono-line rule also helps. I mean, they can't be into the business and then into another line, or they can't be moving and shifting their capital.

Mr. Friedman explained very well the situation with Baldwin-United and the fact that the——

Mr. FLORIO. But Mr. Friedman also talked about not relying upon the premium as the major source, I thought, of developing your capital for purposes of risk assessment.

If I am quoting him correctly, he distinguished between property and casualty underwriting for purpose of primarily using the premium for assessing or evaluating risks, and the distinction that he advocated in this field about not doing that and really regarding set aside capital.

Now, I guess the argument can be raised that that is the source of capital, but it is not going to be the exclusive source.

Mr. DOEHLER. No. In fact, it is a combination. And I think that is the key point, is that it has to be a balance. As you are moving into prospective risks—in other words, untested risks, new risks—you have to have the reserve behind you to make that guarantee valid. And that is a key part of the regulatory structure that we have, that a 10-year period exists where that loss or that reserve can't be touched unless losses exceed a certain balance.

Mr. FLORIO. In your industry, is collateral a fairly substantial portion of your anticipated capability of paying off risks?

Mr. DOEHLER. Yes. The appraisal of real property is essential in the underwriting of the lending process for mortgage guarantees.

Now, the mortgage guarantee underwriting process is really review underwriting. We don't go out and do the appraisal. We don't sit down with the borrower, the home borrower that is coming in and applying for the loan. We rely upon the lender to do that.

So, the underwriting is really a review underwriting process. But we look at the information, and so long as that information is presented in a form that is accurate—in other words, the loan that is being insured is what it is represented to be—then those coverages are valid.

Mr. FLORIO. Where do you come in the chain of priorities? For example, we are now, some of us, looking into FADA, the Federal Asset Disposition Administration, and taking FSLIC's resources.

So, you have got a default. FSLIC takes it back. My recollection is that FADA doesn't get to it until FSLIC resolves problems.

Where does someone like your company come in the chain of capability of liquidating to satisfy a claim?

Mr. DOEHLER. Well, the policyholder for mortgage guarantee insurance is the lender. So, in a situation where the lender has failed and FSLIC has had to take over the institution, of course, they would be the policyholder in that situation. So, we would pay the claim to them in the event that there is a default of the home buyer on a property.

Mr. FLORIO. But does FSLIC have claims on the basis of its involvement? Where do their claims rank?

Mr. DOEHLER. That is where the buck stops, so to speak. I mean, when it comes right down to it, the high risk type of lending that the savings and loan industry under deregulation is permitted to get into, it was sort of a heads I win, tails the FSLIC loses.

So, the management of that industry, I think a strong element of management is there, and it is not to be critical of the savings and loans, because if you look at the record, it shows how strong some have been.

It is just that just like in the financial guarantee field, I am sure that there will be some very strong and solid companies, but what we have to think about from a regulatory standpoint is those that tend to be a little bit more on the speculative side.

Mr. FLORIO. One of the things that we have gotten out of these hearings is that theoretically a Government agency like FSLIC should be looking at the quality of, in this case, the assets.

The suggestion has been made, well, that the rating bureaus look at the quality of the assets indirectly by looking at the total package of the company. And then the suggestion is the regulators should be looking at it. And then, of course, the insurance company should be looking at it.

But conceivably, if no one looks at those things and you have got a situation like EPIC, you have got a potential problem.

Mr. DOEHLER. There is no question that somewhere within the system the credit analysis has to be done, that you have to look at the quality of the collateral. That has to be done in there, whether that is really the regulator's response or whether that is the response of those institutions.

Now, in the case of an FSLIC insured institution, you have got public funds supporting the operations of that and there should be a much stronger regulatory pressure.

In a situation where you are selling insurance coverages, as is the case the witnesses described earlier, to some quite sophisticated investors, so long as the disclosure is made and those deals are made, I think that it would be impractical to expect an insurance commissioner to be able to go through and look at those types of risks.

That is where it is important for the insurance commissioner to basically say, we want to see that you have got the financial capability, the solvency, the solidity, we want to see that capital adequacy demonstrated.

Mr. FLORIO. Let me just conclude, though, by making what I think is an obvious observation, that for the most part we are at least minimally concerned about the bad actors.

What we are concerned about is in a situation with high interest rates, you are going to find somebody coming in with as little capital as they can conceivably get away with having, out underpricing the product to get the premium, and then utilize it however they do, and at the end, when they walk away going into bankruptcy, they have probably made a lot of money, but other people will pay the price.

That seems to me to dictate the need for at least some degree of minimum uniformity across the country, because it is silly to talk about dealing with this on a State by State basis. That doesn't make any sense whatsoever.

So I am inclined to think that is what we should be at least considering doing, is spelling out those minimum standards so that you are going to at least keep the worst people out.

And theoretically, we ought to be having all the legitimate people in the business in here advocating that we have that, because if they are not advocating that degree of minimum regulation, then you are going to have them paying the price because they are going to be losing market share to the irresponsible people.

Mr. DOEHLER. I couldn't agree with you more, Mr. Chairman. I would just simply say that when you look at the debate and all the work that the NAIC has done in this financial guarantee and the development of that model bill, tremendous efforts, and certainly the concerns that you just noted were raised during that debate, I would say that there is an awfully strong body of information there and rationale for going forward in this.

We have utilized the best thinking of a lot of the best State commissioners in putting that bill together.

Mr. FLORIO. I recognize the gentleman from Utah.

Mr. NIELSON. Thank you, Mr. Chairman.

I have not had an opportunity to hear your testimony. I heard a part of it. I had other hearings and other commitments, so I wasn't able to hear the earlier witnesses.

I have some questions on your testimony on page 3, however.

You talk about the greatest deterrent for private insurers in expanding its capacity does not come from the industry's conservative regulatory financial structure but from the usurpation of the market by the Federal Government's competitive mortgage insurance programs.

Would you like to elaborate on that? Why is the Federal Government's Freddie Mac and all the other things, why has that deterred your expansion?

Mr. DOEHLER. I am specifically referring to the FHA in terms of the actual program that I would address. But the question, when you look at the role of the Federal Government in providing loan guarantees, regardless of the nature of the guarantees, I think it has to go down to there being some fundamental purpose.

Mr. NIELSON. I guess I have to ask, what do you mean by the Government's competitive mortgage insurance programs? What programs do you include?

Mr. DOEHLER. That would be the FHA.

Mr. NIELSON. What else?

Mr. DOEHLER. There is also the Veterans Administration. That is an entitlement program that is based on a serviceman's service to the country, and so that is slightly different from the standpoint of its intent and its purpose.

Mr. NIELSON. You are not talking about Ginnie Maes or Freddie Macs or any of those?

Mr. DOEHLER. We are, indirectly. I mean, that is also another aspect of the whole marketplace, these guarantees or these programs that utilize the secondary agencies going into the market for the sale of securities, where those securities are being sold as Government agency paper. That certainly has an effect on the ability of private companies to issue those.

The problem, though, identifying it in terms of how the Government's program has moved, is, initially when that program was developed, the intent was to move it to the low end of the marketplace. They had income—not income, but they had loan size caps in the range of $16,000 per loan. It was directed to those in the market who had the least options to get private alternative financing.

In the past number of years, especially as the secondary market has grown up, you have seen a shifting away from the emphasis of those programs to more of a production emphasis, and we see the average income and the average home price being directed to those in the upper middle income.

The FHA program is primarily serving now upper middle income people, and most don't recognize that in the marketplace. If you look just generally from a statistical standpoint, 1 in 20 borrowers of the FHA program have incomes below $20,000, where more than a third have incomes in the $40,000 and above range.

And what it does is it makes it very difficult for the private mortgage insurance companies, who are out and want to deal with providing private guarantees in the default coverage for the benefit of lenders, because of the obvious benefit that comes in the process to any lender who is getting a Government subsidized type of coverage.

Mr. NIELSON. If you were in our shoes, what kind of legislation would you propose to maybe limit the FHA, maybe require a lower limit on eligibility?

Mr. DOEHLER. Yes. I would retarget it and what I would do is simply retarget it based on median income in an area, median being half the people below and half above in that market. I would say that the special benefits that come in from a Federal guarantee program should be limited to those in the bottom, the middle and below. And then I would say that those above that level, if you need Government for a stimulus in certain marketplaces, then the benefit going to the individual should be more on a market basis.

Mr. FLORIO. Would the gentleman yield just on that point?

Mr. NIELSON. Yes, go ahead.

Mr. FLORIO. I understand what you are saying, but how do you deal with the question that inevitably comes and says, well, that is fine, but there is no housing out there for those that you are now making more qualified for FHA housing. And obviously, no one can argue in an egalitarian sense that you are correct. But if the perception is there is no housing for those people, you can make all the credit available to them and therefore it is of no consequence.

Mr. DOEHLER. But Lud Ashley, who was chairman of the Housing Subcommittee some years back, he made this statement, and he was talking about how limits have been constantly increasing and he was very critical of these increases.

Mr. FLORIO. Yes.

Mr. DOEHLER. And what he said basically was, what happens when you raise the ceiling is the ceiling becomes the floor.

Mr. FLORIO. Right.

Mr. DOEHLER. And what I think we have seen in a number of these marketplaces is that as the rates have gone up and more eligibility goes to higher income, because the incentives are based on loan size, you have seen the infrastructure, the mortgage banking, the whole lending industry, push toward the higher income market, and the numbers going to the lower market.

So, in effect, it is aggregated. In some marketplaces, Mr. Chairman, there is a problem of land cost, and there——

Mr. FLORIO. Not some marketplaces. It is everywhere. I don't know of anybody running out there building low income housing projects or low income housing in any substantial amount.

Mr. NIELSON. Reclaiming my time on that point, Mr. Chairman, I think with the income tax bill we passed last year there will be even less of it, because there is no longer—they have to take care of their depreciation over 18 years rather than 30 years, and I think we are going to see a real housing shortage, because private industry is not going to get involved in that business anymore. They have no tax incentive to do it, and I think we are going to have a real problem in the whole area.

Mr. FLORIO. If the gentleman would yield, the gentleman is correct. But the combination of that, as well as some other things that are taking place, are almost dictating that somebody has to start thinking about housing policy. And obviously, we are varying a little bit from our subject. But I thank the gentleman for yielding.

Mr. NIELSON. The reason I asked the question, because you made a point of the fact that FHA expanded its volume and went mainly to the higher income families. They said this is back door spending, and that has not been fairly easily understood.

Where was your industry when the FHA was given the grant to go ahead and expand their loan system? Did your industry come to us and say, you have got to put limits on FHA before they take the entire market away from us?

Mr. DOEHLER. Oh, absolutely. That has been a position of the industry for a number of years. We have said, our concept, though, is that we want a strong FHA, because there are some markets and there are some needs in certain areas, as the oil patch States certainly have demonstrated, where risks can go beyond what the private sector is capable of doing.

We want a strong FHA. But the concept is one of balance. We have to be able to have the Government role being utilized and Government guarantees and Government resources going to those—egalitarian is the best word to say—to those who need it the most. And that is all.

Now, this would be true in financial guarantees. There is no reason in the student loan area or in any of the other areas, if it were tied into the concept of good, sound regulatory structure for the financial guarantors, there is no reason the private sector couldn't come in.

Mr. NIELSON. What you are saying is, whatever funds there are available for either student loans or house loans and so on ought to go to those most in need.

Mr. DOEHLER. Exactly.

Mr. NIELSON. I think we all agree with that. Of course, we also know we can't do anything about VA. There has never been a veterans bill yet, to my knowledge—maybe Mr. Florio has more experience than I—but I have never seen a veterans bill yet that has been turned down by this administration or by any other administration, and certainly not this Congress.

So, if we give VA special privileges, FHA sort of comes along with those and takes them along with them.

Let me ask this question. On page 3 again, you talk about the fact that Congress should pay more heed to the problems and social costs resulting from defaulted Federal loans, and we had to appropriate $8 billion to pay default losses resulting from Federal loan programs.

How would you solve that problem? I am going to let you develop a bill and see how you would solve that problem. We don't like to shell out $8 billion, either.

Mr. DOEHLER. No, I think it is really the question of financial discipline. And every time that you create greater dependence upon the Government, you reduce the amount of financial discipline in the marketplace. You reduce the efficiency and thus you reduce the competitiveness.

I mean, there are enough experts out there that have been talking about ways to increase efficiency in the marketplace and increase the competitiveness that our Nation needs in its various economic sectors.

I think that would be the key thing, good regulatory structure, in this as the NAIC has mentioned, is one element of it. And I don't think we would ever expect one single bill to do the whole thing.

And I am so pleased that this subcommittee has taken this approach, because if we look at each different element and then tie in this question of, well, what is the Government doing, I think that is the way to move in the right direction.

Mr. NIELSON. One last question, and then I will turn it back to the chairman.

What, in your view, is the proper role of Government in the financial markets, the mortgage guarantee? Do we have a role or do we not?

Mr. DOEHLER. Oh, absolutely.

Mr. NIELSON. The role should be what?

Mr. DOEHLER. The role should be to assist those least able to get the financing through the private sector. Now, the Farmers Home Program, for its financial guarantees, it always said, to be eligible for the Farmers Home loan, you simply had to be denied credit, be denied the opportunity from the private, and then you were eligible.

Well, that program had been, you know, effectively utilized. And I would say that concept, although recognizing there are different markets and different needs and there has to be some obvious balance in different marketplaces, that is how I would approach it.

Mr. NIELSON. Thank you, Mr. Chairman.

Mr. FLORIO. Thank you.

Just one last point. Would you at all be concerned about the fact that if your suggestions on the FHA were carried through and my apprehensions were proved to be legitimate, that you would have a changing ineligibility and there would be nobody there to take advantage of it because there is no particular housing market? Then what you are doing is reducing the amounts.

Some—not necessarily you, but some would say, well, that is fine, that will allow for efficiency of the use of capital, and the efficiency will mean that the capital flows to more lucrative uses of the capital, which means that we don't have any housing because that would not be regarded as one of the more lucrative uses of the capital.

Therefore, the efficiency, the marketplace forces will determine what the allocation of capital is, and that means it is junk bonds or whatever, and it is not housing. It wouldn't be something that would be not regarded as the most efficient, profitable use of capital.

Is that something we should at all be concerned about?

Mr. DOEHLER. I think that you should look for efficiencies in any way we can get the efficiencies. But when you look right now in the mortgage guarantee field, the private insurance industry is serving the $20,000 and below income group as well as the Government. In fact, in a number of statistical market areas, we are doing better than the Government.

Where we are having the competition is in the higher end, in the upper middle income bracket. And so, what that seems to be suggesting is these Government guarantees—and remember, Mr. Chairman, when you look at the borrower, when he walks into that lender's shop, he is not getting an especially low rate. And when the investor buys that loan, he is not getting any better rate than he is buying from—the yield spread between Ginnie Maes and Fannie Maes is very, very small at this point.

On the other hand, there is this big bureaucracy or this big mutual mortgage insurance fund that is out there, and the argument could be made, well, why is it that we have this efficiency in the low end of the marketplace from the private sector and we have the efficiency above this, but we don't have any efficiency in this big bulk, in this section.

And I would just simply say, we look for balance. And we could do that by putting market pressures upon the higher end and giving more incentives for the lending industry and others to work at the lower end, where the Government guarantees are needed.

Mr. FLORIO. I can just anticipate the argument of the realtors.

Mr. DOEHLER. Oh, yes.

Mr. FLORIO. In saying, well, you know, higher end, lower end, that is all irrelevant when you start talking about the husband and wife with a child in college making $40,000, $50,000, and they are not higher end anymore, and therefore they are entitled to the assistance in the same way.

Mr. DOEHLER. If Congress were to go into a situation and analyze where these incentives are going, you would see by the response of the various groups participating in the programs, you would almost be able to anticipate where those incentives are going.

And it is a question of Government resources at this point in time. We have got a budget problem and we have got to think about it from the standpoint of where are we going to be when our children are getting ready for the college level or getting ready to buy the homes.

Mr. FLORIO. To a certain degree, your philosophy or the philosophy that you are espousing here has been incorporated into certain programs.

The student loan program, you would have a hard time trying to convince somebody that is making $35,000 and is trying to send a kid through college that they are wealthy and they are too wealthy to take part in the guaranteed student loan program.

I suspect you would hear something of the same type of an approach if you started talking about FHA availability to a wealthy family that is making $40,000 a year with some obligations like a few children.

Mr. DOEHLER. What you could do is recognize certain marketplaces, where in the Pennsylvania area, for example, in the Housing Bill, Congressman Ridge introduced an amendment that was passed that prohibited minimums being set and differential prices at the low end.

They were setting minimums in his area where FHA loans that were below $35,000 would not be accepted, they wouldn't offer those. It was Congressman Kleczka that offered that part of it.

Well, that is a perfect example. There are markets where a $35,000 loan for a home is fine. On the other hand, there are some areas, in New Jersey especially, because I grew up there and I know, a $35,000 house would probably be the back side of a garage someplace, you know. It just isn't available.

There have to be some adjustments, obviously, taken. But the adjustment, I think, could be made according to some kind of means test. And Congress had used that many, many times in its program design, and it is just the one industry group, I think we have to hopefully keep reminding or raising that issue.

Mr. FLORIO. Let me say that I know Mr. Nielson would also, but I would be more than interested to receive from you any kind of information, any papers you have on this last discussion point that we have been talking about.

Mr. DOEHLER. We will send you a copy of a study that we had a research firm up in—they got data from HUD. It is Temple, Barker and Sloan, and that should be out the end of next month, and it shows who is being served by the marketplace and it shows an analysis of the program.

We did that for Senator Cranston, who is going to be working on some national housing policy. But certainly we hope it has wide distribution.

Mr. FLORIO. We got a little bit off the track, but nevertheless interesting and related to what we are talking about.

Mr. NIELSON. I would like you to supply as much chapter and verse as you can on page 3. You have got some very prerogative statements there on that page. I scanned the whole testimony, but that is the one that drew my attention.

Mr. DOEHLER. All right.

Mr. NIELSON. We really don't know always what kind of Federal programs we should have. We respond to crises. We respond to pressure. That is why I said, where were you when FHA was allowed to put $160 billion into the economy and an $8 billion loan to back them up. Where were you when we were doing that? That is what I want to know. Because I was not aware of your interest in it or your concern. Perhaps the chairman was. But you need to be more visible on these issues.

Most Congressmen do not want to put $8 billion on an every year basis. We have enough trouble with the IMF, let alone all the other ones.

Mr. DOEHLER. We have been characterized as an industry as the PT boat among the battleships, and that is the realtors and the mortgage bankers and the other battleships out there. It is hard for us to get our voice heard. But at the same time——

Mr. NIELSON. I am inviting you to supply that voice.

Mr. DOEHLER. We would be happy to do it. Thank you.

Mr. FLORIO. I would just hasten to add, in light of all the current controversy with regard to committee jurisdictions and concerns that people have about the subcommittee and the full committee, that probably the reason why the gentleman was not here is that there has been some question as to whether we would play a role in these areas.

But we nevertheless are interested and we regard this as a matter of interstate and foreign commerce, and we will be happy to receive any information from you at all.

Mr. DOEHLER. Thank you.

Mr. FLORIO. If there is no further business to come before the committee, we would express our appreciation to you.

The committee stands adjourned.

[Whereupon, at 1:56 p.m., the hearing was adjourned.]

[The following letter and statements were submitted for the record:]

MARTIN M. SOLOMON
19TH DISTRICT
VICE-CHAIRMAN, MINORITY CONFERENCE
RANKING MINORITY MEMBER
INSURANCE COMMITTEE

COMMITTEES:
EDUCATION
JUDICIARY
CIVIL SERVICE & PENSIONS
CONSUMER PROTECTION
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THE SENATE
STATE OF NEW YORK

December 1, 1987

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Mr. Paul Jaffe
Subcommittee on Commerce,
Consumer Protection and Competitiveness
H2-1S1
House Office Building, Annex 2
300 "D" Street, Southwest
Washington, D.C. 20515

Dear Mr. Jaffe:

As per our previous conversation, enclosed is the report on the financial guarantee insurance industry which was compiled by the National Conference of Insurance Legislators' Task Force on Integrated Financial Services. The report was released to the public and accepted by NCOIL's Executive Committee on November 15th at the Conference's Annual Meeting in Palm Springs, California.

I hope that this report may prove informational to the Subcommittee and that you will include our conclusions and recommendations, listed on p. 90 in your comments submitted to the Subcommittee on this topic.

I would appreciate your forwarding to me any final product on this issue that the Subcommittee releases. If I can be of assistance in the future, please do not hesitate to contact me.

Very truly yours,

MARTIN M. SOLOMON
Senator
19th District

MMS:DD:lln
Enclosure

*From A Report on the Financial Guarantee Insurance Industry, Nov. 15, 1987, National Conference of Insurance Legislators, Task Force on Integrated Financial Services, Senator Martin M. Solomon, Chair.

*The full report can be found in the Subcommittee's hearing file.

CONCLUSIONS AND RECOMMENDATIONS

The task force has made a thorough review of the financial guarantee insurance industry. Based on this review, the task force has come to the following conclusions and makes the following recommendations regarding financial guarantee insurance and the regulation thereof.

The task force is cognizant of the fact that the responsibility for the role of policymaker may differ from state to state. Thus, when referring to "regulator" in the following recommendations, the reader should be aware that the term could, in fact, be referring to the regulator, the legislator, or both, and that the recommendations made may be implemented through legislation, proposed regulation or a combination of actions thereof depending on the individual's state.

CONCLUSIONS

1. Financial guarantee insurance is a socially useful product. This fact should be given serious consideration when analyzing legislative proposals designed to regulate financial guarantee insurance.

2. It has not been clearly demonstrated to the task force that the writing of financial guarantee insurance has been the sole cause of any multiline insurance company failure to date.

RECOMMENDATIONS

1. If a monoline regulatory approach to financial guarantee insurance is to be adopted, then aggregate risk limitations and single risks limitations should be considered.

2. If multiline insurers are to continue to be permitted to write financial guarantee insurance on a direct basis under a legislative proposal, then consideration should be given to (a) setting qualifying minimum capital and surplus requirement for such insurers at such a level so as to block entry of small and medium sized companies, which are more likely to jeopardize their ability to pay claims on standard property/casualty policies following a catastrophic financial guarantee insurance loss, and (b) either (i) limiting gross written premiums, including reinsurance assumed, for financial guarantee insurance to a fixed percentage gross written premiums, including reinsurance assumed, for all lines of business OR (ii) setting aggregate and single risk limits at a fixed percentage of those applicable to monoline insurers.

3. Regulators should identify which financial guarantee insurance risks are subject to higher loss ratios, whether resulting from the type or the quality of the risk being insured, and then determine the extent and the type of security that should be posted to secure this risk (i.e., security should be required for high risk guarantees). The regulator should take into consideration the social purpose of the underlying instrument

for which credit enhancement is sought in making this determination.

4. Regulators should determine which types of financial guarantee insurance may be written by a monoline insurance company and which types may be written by a multiline insurance company.

5. Regulators should determine the single risk limitation as well as aggregate risk limitations. The structure of these limits as as set forth in the NAIC Model Act is recommended, subject to the regulator's determination of appropriate ratios or percentages.

6. Regulators should promulgate regulations with regard to proper advertising wherein reference is made to financial guarantee insurance of obligations being issued. Such advertisements should be neither deceptive nor misleading to the public. (See Appendix E to this report for example thereof.)

7. Clauses providing for acceleration of the payment of principal and interest upon default of an insured obligation should be prohibited in all financial guarantee insurance contracts except at the option of the insurer upon default.

8. All financial guarantee insurance policies, other than the traditional surety type of insurance, should not be covered by state guaranty funds.

9. Regulators should set minimum capital and surplus requirements with the knowledge that the credit rating agencies (Moody's and Standard & Poor's) will determine the amount of capital and surplus necessary to obtain appropriate ratings. The credit rating agencies requirements should not be determinative of the regulator's minimum capital and surplus requirements.

10. Direct writers of financial guarantee insurance, whether monoline or multiline insurers, should be limited in the amount of direct business, per risk and in the aggregate, they can cede to one or more reinsurers. Furthermore, consideration should be given, if warranted, to different per risk and aggregate ceding limits based on the type of financial guarantee insurance being ceded.

11. If a monoline regulatory approach to financial guarantee insurance is to be adopted and regulators determine that reinsurance capacity amongst monoline insure's and monoline reinsurers is insufficient to meet both existing and anticipated growth needs of the financial guarantee insurance industry, it is recommended that regulators adopt or enact measurers which would authorize multiline insure's to both write on a direct basis and reinsure financial guarantee insurance subject to (a) appropriate capital and surplus requirements and (b) appropriate limitations on the amount of business insured.

TESTIMONY

REVEREND JOHN P. WHALEN

PRESIDENT

CONSORTIUM OF UNIVERSITIES OF THE WASHINGTON METROPOLITAN AREA

Mr. Chairman and Members of the Committee:

My name is Father John P. Whalen. I am a priest of the Diocese of Albany, N.Y., but I have been on special assignment to the higher education community of Washington, D.C. for about a hundred years. I have served in virtually every capacity you might imagine at colleges and universities, from instructor to president, and more latterly, for the past dozen years, as the President of a Consortium that works with and represents 12 colleges and universities in the Washington area. It has about 160,000 students, about 15,000 faculty members, about 48,000 employees and, as you can imagine, at least 12 of everything. I have had to learn a lot about higher education. Our institutions of higher education are intractable, ante-deluvian, irascible, fractious, inefficient, expensive institutions that our society simply could not do without. In that, they are no different from our governments or factories; the only difference is that universities express their faults with greater literacy.

But, despite all their failings, that they have been practicing to the point of perfection for some 1500 years now, they are, with the possible exception of the Church, the very best our society has to offer. The people there are bright and energetic; they are critical of mind and inventive; they devote themselves to the daily drudgery of scholarship while you and I frequent the headier atmosphere of the marketplace or the forum. They are willing to bury themselves in our traditions and to transmit them to the ignorant who, at times, are willing to hear about them only with the greatest of reluctance and grumble about it all the time. And especially, they get ideas and they invent things! They are in a position of having insights, because of their closeness to the concepts involved, that the rest of us can have only by recognizing theirs - precisely because of the distractions we have in the forum or the marketplace. We would, on occasion, like to have the outspoken professor between two slices of whole wheat bread; but we would be much the poorer without him. We need higher education and we need it just as it is. If it were made to be radically different in the interests of economy, it would die; and we would wither as a nation. Intellectual progress, and the productivity that follows after it, is more at home in an atmosphere of stale pipe smoke and wet tweed than it is in the crisp, sterile office of the efficiency expert or the accountant.

That having been said, there are a number of problems that are besetting this estimable industry. The worst of them can be boiled down into one word, money. There is never enough of it certainly for what the imaginative faculty and management of universities desire; but, more importantly, there is not enough of it to meet the costs of providing education for our people.

The usual university president in a major university spends at least 1/3 of his time trying to raise money. He is on the road a great deal. Just try to get a meeting of several college presidents together, that has not been scheduled a year in advance, and you will see what I mean. This money raising effort is aimed at either specific projects (usually capital projects) on campus or for enhancing the endowment. The conventional wisdom says that if we could get our endowment up to the point where we think it belongs, it could subsidize some of the costs of providing education for the students.

Very few of the universities in the United States have been around for more than a hundred and fifty years. Very few of them have endowments in excess of $200 million dollars.

Take one of our institutions in Washington, for example. It has a budget of about $390 million dollars a year and an endowment of about $200 million. Giving a return on that endowment of about 7% (which is good in today's market), the endowment generates income for the university of $14 million dollars per year. The trustees there require a set - aside from income to go back into capital to provide for keeping the corpus of the endowment even with inflation. Inflation is currently running at 5% so we subtract $700,000 from the income to be added to corpus which leaves $13,300,000 yield from the endowment for university purposes. The actual budget of the university is $390 million dollars a year or $1,068,493.15 per day. The total income from endowment results in being able to operate the university for 12 days and 18 hours. If there were no other source of funds, the university could open on September 1st each year at the stroke of midnight and it would close at 6 p.m. on September 13th.

Take another one of our institutions that is not among the first 35 of the United States in endowment holdings, as the first one was. This institution has a budget of $80 million dollars a year and an endowment of about thirty. Under the same conditions, this endowment would yield sufficient funds to operate the university for nine days, two and a half hours.

My point is that while our better endowed institutions are sometimes looked at askance, the yield from endowment, compared with overall costs, doesn't amount to a hill of beans.

It should be pointed out, and emphasized over and over, that the <u>costs</u> of higher education as between public and private institutions are about the same. It <u>costs</u> the University of the State of New York, for example, about the same amount to educate a student as it <u>costs</u> Cornell University, or New York University, or Fordham University, to educate the same student. The difference is not in the costs of education but in its <u>price</u> to the student. Because of the appropriations from tax money that are given to the public higher education system, not only in New York but elsewhere in the country, the <u>price</u> to a student (a subsidized price) is lower than the <u>price</u> of attending a private institution. There is already an economic incentive to attend public higher educational institutions and to flee from attending colleges and universities in the private sector. There was a point when, without question, the quality of the private sector in general was far superior to that of the public sector. This situation is no longer true. Some of the state universities at large are as good as any private university anywhere. That being the case, there is an economic drive toward attendance at the public institution and away from attendance at the private.

Moreover, everyone operates on the conventional wisdom that college means a group of students 18 to 22 years of age who spend a lot of time listening to music, going to Florida, drinking beer, and generally having a rollicking good old time. This is no longer the case in higher education. A majority of the

students who attend my institutions in Washington, and a growing majority at that, consists of people who are going either to our graduate or professional schools, usually part-time, while holding down a job of some responsibility; they are usually married and very often with a young child either on the way or already here. Very often both the husband and the wife in this marriage are pursuing education either for promotion purposes or for degree completion or for a change of career, or for a variety of reasons. They make a good combined family income but the costs of education are such that they must spread it out or they cannot afford to go. More than 50% percent of our 160,000 students are in a situation similar to the one I just described. They are serious, they are self motivated, they are not kids, they are highly responsible people usually having responsible
jobs, and they work very hard for what they get. You will find the same profile in every state in the Union. These are the very people, with motivations like that, that form the profile of what this country is going to look like in the future. They need help in every way they can get it, and they should have it.

It is not inexpensive to attend college today, no matter which sector is selected, either public or private. It is true that tuition at college has risen faster than family income in recent years. The chief reason for that is that for years colleges have been trying to keep their prices low and "eat" the difference. They are generally non-profit organizations and therefore are not required to distribute "profits." If there have been any surpluses in past years, those surpluses have gone either to tuition subsidies or to improvement of plant. Raising new capital for a non-profit organization requires holding out your hand and spending thirty percent of the CEO's time to do that. Raising capital for for-profit organization means issuing equity or a long-term debt. Raising capital for a state college or university means dealing with the legislature. Even at the costs that are now being paid by students for higher education, their tuition is subsidized by whatever resources a college has to offer.

If there were no federal and state financial aid programs, the whole higher education industry would likely come down in a heap. But there are some such programs, they are mostly inadequate, and they appear to be more or less of a teaser rather than a solution to a problem.

I shall not here get into the details of the federal financial aid programs, but I will say that they are designed to attempt to alleviate some problems for those who are least able to afford to go to college and leave the great middle class of this country unaided. There are countless people that I know of who are able to help their children go to college, or go themselves, by "scraping together" everything they have in the world and putting it into this one basket. They do not take vacations, they do not buy new cars, they live with the old refrigerator, they put a second trust on the house, they do not buy new clothes, and in general they do without many things that they have a right to enjoy so they can help their children or relatives go to school. There comes a point in the lives of some of these families when they just can't do that anymore. If there is a severe illness in the family, that's the end of it. If there is a fire, or an automobile accident, or a layoff, or anything that stands in the way of the hand-to-mouth existence that middle class people have while their children are going to school, that's the end of it. There's nothing to fall back on. We priests take the vow of poverty; but these middle class families keep it!

Giving the present state of the economy and taking into consideration all other factors, it appears to be clear that beginning with this generation and henceforth, it will be necessary for those who attend college to have three regular debts outstanding instead of the two regular debts that the American people have been accustomed to. In the usual course of events, Americans, if they are lucky enough to do so, buy a house and buy a car. Everyone is always paying a monthly payment on a mortgage (or alternatively for rent) and a monthly payment for a car. These obligations are standard and are now standard operating procedure for anybody who lives long enough to grow up.

From this generation forward, there will be a third debt added on to the other two on a regular monthly basis; and that will be a debt for previous costs of education, chiefly student loans. About a third of the American people who have gone to college or a professional school and have now graduated are already carrying these three debts. From this generation forward, everybody will be in that same boat. There will be a leveling of obligation and opportunity in the same way that the leveling occurred when we all undertook the obligations of home ownership (or rent) and automobile ownership. There will probably be no skewing of career patterns because of this additional burden any more than there was because people wanted to buy a house or own a car. The difference is that the capital investment in education must come at the front end of life while the student is in school and be paid for thereafter when it appears to be gone already. Quite the contrary is true, however. Investment in education is a capital investment that pays off over the long run so that those who have completed college by some estimates will earn $640,000 more during their lifetime on average than those who have not. For that kind of earning power in the future, it is worth the front-end capital investment and it is certainly worth borrowing for.

There are classes of people who wish to attend higher education who can not afford to borrow. They should be subsidized. There should be federal and state plans that provide for those who are unable to provide for themselves, in education, in the same way that there is in other areas of social concern. For the middle class person, if that person can qualify to borrow either for his house or for his car or for his education, he probably should do so. Just as he pays back his obligation for his house and his car, he should also pay back his obligations for a college education.

The state can make it easier on people to pay their own way in this fashion. Both the federal and state governments have done so in the past with regard to home ownership. They have permitted the interest paid on a mortgage to be fully deductible from gross income on the income tax. Since 1986 they have not given such favored treatment to automobiles unless they are used for business purposes. They should give the same treatment to education loans as to mortgages since this is a capital investment in the future of the United States, and should be fostered.

The federal and state governments also, sometimes inadvertently, put obstacles in the way of permitting people to pay their own way through college.

In some states at the moment, for example, there are bills pending in the legislatures that would put severe restrictions on multiline insurance companies, requiring them to form monoline companies to provide credit enhancement insurance for issues of securities (including those that underlie private loan programs for students, such as ours . This would severely curtail the possibility of private capital being brought to bear on the severe problems of higher education to make that capital available in the form of loans for students, parents, and others who wish to borrow to send young people through the university to improve themselves. These pending bills should clearly exempt credit enhancement insurance for student loans and more properly for higher education purposes in general, whether that involves student loans or loans necessary for college facilities upgrading and improvement. As a matter of fact, an affirmative action on the part of the states or the Federal government to guarantee private sector loans, and thereby automatically enhance their credit, could guarantee the availability of private sector capital for student loans.

Given the Federal strictures involved in financing higher education for our students and their parents, we have begun a student loan program that we have now permitted to go national. It is called ConSern: The Student Loan Program. I have brought some literature to describe that program for the committee. This program has already has been subscribed to by organizations representing well over a million people. Without credit enhancement insurance on this student loan program, the availability of outside private sector funding to provide student loans at low interest rates and long payback terms, specifically designed for the needs of the middle class person, would not be possible. We are making it possible for thousands of people to go to school who otherwise wouldn't be able to. They are willing to undertake the student loan obligations to do so. They want to stand on their own two feet, get their own educations, and become productive citizens of this country. This is the class of person that we should be helping, not with money give-aways because they are too proud for that; but rather with a close scrutiny of what incentives may be brought to bear to make it more possible for them to do what they really want to do for this nation, and certainly a scrutiny to eliminate any proposed legislation that could, even inadvertently, interfere with that. Any effort on the part of the government, Federal, state or local, to restrict the abilities of multiline insurance companies to offer credit enhancements by way of insurance or surety activities would make programs such as ours more difficult, more expensive, and perhaps impossible altogether.

There is really no risk at all to the surety that stands behind our national student loan program. We have structured an internal funded default fund that covers defaults on our loans up to 10.00%. The actual default rate on our loans will be 0.6%. What we purchase from the surety is credit enhancement, not financial risk insurance; there is no financial risk to them. But, without this credit enhancement, private sector initiatives to address pressing public purposes, such as ours, could not exist.

I would ask you not to be unmindful of the terrible consequences to our program, and perhaps to many others based on credit enhancements to attract private capital to solve public problems, of any actions of yours that would make it more difficult or financially undesirable from a business point of view for large insurers to continue in this line of business. An insurance bill, rejected last session by the New York State legislature, is an example of legislation that I believe would have an extremely adverse impact on the good work we are trying to do. I would encourage you to reject out of hand the approach of that legislation that would have required the establishment of monoline insurance companies to engage in credit enhancement activities and prevent multiline companies from doing so. It was designed to contain within one line of insurance a financial risk that, quite frankly, in our case simply does not exist.

I would like to point out one final thing. The Federal student aid programs, especially the Guaranteed Student Loan Programs, have operated over the years and have now loaned some $56 billion dollars to students in this country or their parents who can qualify for it. (To qualify these days means in effect that your family income has to be so low that the vast majority of the American people probably can't qualify for them). It has costs the federal government almost $21 billion dollars in special allowances, incentives, special insurance etc. to lend out that $56 billion dollars. This obviously is not good business. With regard to financing higher education, it is unquestionable that low interest rate, long-term student loan money is absolutely necessary for the middle class person at this point in our history. Every government effort should be bent in the direction of making that student loan money available through the private sector, as in our loan program, and at the lowest possible costs. I would recommend that every legislative initiative of this Congress be directed toward inventing ways to do that and in scrutinizing bills, from whatever other source or from whatever other committee, that could in any way interfere with the process of providing funds for people to go to school.

Thank you for your kind attention and for inviting me to come to testify.

TESTIMONY BY

KENNETH R. REEHER
EXECUTIVE DIRECTOR
PENNSYLVANIA HIGHER EDUCATION ASSISTANCE AGENCY

Mr. Chairman and members of the Committee, I am pleased to be offered the opportunity to share with you my views of the relationship of student financial assistance and financial guaranty insurance, a relationship that has a growing potential of importance to student financial assistance and the colleges, universities, college communities, and students affected by the delivery of student aid.

I have been active in student assistance for nearly 40 years, first as a teacher and counselor, then with the state scholarship program in the Pennsylvania Department of Education, and for the past 23 years as Executive Director of the Pennsylvania Higher Education Assistance Agency (PHEAA). PHEAA is a state agency, a public corporation and a national leader in the business of helping students secure their future through the acquisition of education and job preparation. PHEAA is charged with providing educational opportunity to Pennsylvanians and those who elect to study in Pennsylvania. This is accomplished through a myriad of programs, the most notable of which are loans, grants, and employment for students as well as direct grants to colleges which are independent of state control and state financial support. More than $1.5 billion has been extended to almost 900,000 students in the form of grants, $5.5 billion to about 1,300,000 students in the form of student loans and $212,000,000 in direct grants to the independent colleges and universities.

Student aid, including educational credit in the form of student loans, performs a vital role in the general economy of our Commonwealth and particularly in our efforts in the area of economic development. A study by the Pennsylvania Economy League, a respected and reputable research entity, determined that for each dollar that is expended on higher education in the community, $1.70 is generated into the local economy. We have a saying, "Without the state university at Slippery Rock, there would be no town of Slippery Rock". I'm sure that you understand my reference ---- now for my point in making such a reference to you.

Educational credit --- student loans --- now represents more than 55% of the student-oriented aid to higher education in Pennsylvania and is critical to the continued viability of the higher education economy. In my opinion, a strong financial guaranty insurance industry is equally critical to the availability of educational credit and the economy of our higher education community. Let me explain.

When educational credit was first developing, back in the late 50's, most state governments were not in a position to appropriate from state revenues the "capital" necessary to fund educational credit and opted to join hands with the private sector lenders, principally commercial banks but later savings banks, S & L's and credit unions, to make private capital available for educational credit so as to avoid direct state appropriations for this purpose. The private sector put up the capital (principal amount of the loan) and state government offered collateral for the loan in the form of a cash deposit, usually 10% of the principal advanced by the private sector banks. Some colleges functioned in a similar manner through the United Student Aid Funds, Inc. with the colleges offering 12% cash collateral on loans advanced to their students by the private sector banks. To this point the support of educational credit was a private sector bank and state government or participating college partnership.

The federal government became active in student aid support to higher education in 1958 with the enactment of the National Defense Education Act. This first step included educational credit in the form of NDSL loans capitalized by direct federal appropriations to college loan funds. The social objectives of the federal government and its need to offer educational opportunity to the disadvantaged led to a larger and larger role in support of higher education on the part of the federal government and the need for substantial increases to the availability of educational credit. This introduced, for the first time in higher education credit, insurance as a replacement for cash reserves. A partnership was formed between the private sector banks and the state and federal governments wherein the banks would advance the funds (provide the capital) for the credit necessary and the state and federal governments would provide financial guaranty insurance collateralized by cash commonly called Guaranteed Loan Reserve Fund. The federal government made payments to states in the form of loans to encourage this financial guaranty insurance concept with the first federal funds going to the states in 1967 and referred to as "seed monies". These federal seed monies were intended to strengthen and encourage state appropriations to guaranty loan reserve funds and to provide program development and expansion. Federal funds were later distributed in 1978 and were called "federal advances" and had more restrictions and controls on the part of the federal government. The federal government in 1976 also offered 100% reinsurance of state losses due to default, eventually negating the need in their opinion for cash reserves for the payment of defaulted student loans.

Many states, no longer exposed to default liability, repaid their seed monies to the federal government in the early 1980's to get relief from the federal restrictions that had been placed on state funds that had been co-mingled with those federal seed monies, and in 1986 the Congress directed that most of the seed monies and federal advances be repaid to the federal government no later than 1989. The recall of federal funds by the Congress was generally perceived as an alternative to further cuts in eligibility to educational credit rather than as a result of the conviction that the financial guaranty insurance funds were more than adequate. This recall of cash reserves placed the massive student loan program on the reliance of implied full faith and credit by the federal government which federal reinsurance suggests. All of this activity has serious implications for the private sector lenders who have been advancing capital for years to finance educational credit based upon "cash" reserves that they assumed were safe and upon the letter of credit concept which a contract with a state or federal agency suggests. Cash reserves, seriously depleted by the Higher Education Act of 1986, will cause the program for practical purposes to function solely on the "full faith and credit" of the federal government. Hardly a great assurance if you have had any experience with Gramm-Rudman, Deficit Reduction in 1984, or the Tax Reform Act of 1986.

In addition to the recall of cash advances, the federal government has retrenched extensively in other ways in its role of a credit provider. Family after family has been denied access to educational credit. The program retrenched from the lofty position of "a loan available for everyone" under the federal Middle-Income Student Assistance Act to a restriction that loans available to families above the $30,000 income level were approved only if that family could demonstrate need. More recent legislation requires that <u>all</u> loans contain a "needs test" requirement as part of the loan eligibility requirements. The referenced "needs test" is not a test of need for educational credit but rather the financial analysis to which a family has traditionally been subjected to qualify for grants and scholarships ---- non-repayable gift aid geared to the disadvantaged low-income student. This is an unrealistic test for middle-income families who have traditionally been willing to pay for their costs of education but must turn to educational credit to meet their cash flow requirement.

PHEAA, the public agency with which I am associated, has tried to move into the vacuum that federal retrenchment in educational credit has created and to make educational credit available to those thousands of deserving students and families who no longer qualify for federal benefits. To do this, and to avoid the onerous capitalization that would otherwise be required from state appropriations, PHEAA moved to the public market to seek capitalization. As a state agency, PHEAA faced both legislative and constitutional prohibitions against offering the credit or the full faith of the Commonwealth as collateral to any fund-raising effort ---- sale of bonds ---- taxable or tax-exempt. The issuance of General Obligation Bonds likewise is beyond the reach of PHEAA. As an unrated Agency PHEAA cannot secure capital without the assistance of the financial guaranty insurance industry. With the support of this industry, PHEAA has issued 106,228 student loans valued at $302 million to those who would not qualify for educational credit under the recently established stringent federal standards and to those for whom the costs of such educational credit were excessive. These funds have not been "secured" or "collateralized" by the Commonwealth of Pennsylvania but instead have the support of the issuer's (PHEAA's) capital and letters of credit or other financial undergirding by credit enhancements offered by the Student Loan Marketing Association, Mellon Bank, and Financial Guaranty Insurance Company.

These guaranty insurance agencies, fronting in the capital markets for PHEAA as an untested credit risk, perform a most vital function for this public body, a state agency, in succeeding in its basic charge --- to make educational credit available to provide educational opportunity for Pennsylvanians, provide stability to the Pennsylvania economy through the higher education economic community and participate in the economic development necessary to recover a rusting smokestack, coal, steel and rail economy.

The role of the state and federal governments in making educational credit available through the traditional process of provision of capital by the private sector banks relying on cash reserves collateralized by the state and federal governments is becoming a thing of the past. In addition, with the credit rating deterioration of many of our nations strongest banks, we are dependent on the financial guaranty insurance industry as a last resort provider of credit enhancement for agencies such as PHEAA and the middle-income families PHEAA strives to serve. The experience of the past five years would indicate that the availability of educational credit for one of the most energetic sectors of our economy, the middle-income family, is directly dependent upon the guaranty insurance industry's participation in the student educational credit function.

I beseech this Committee to do all within its power to work with the financial guaranty industry to insure that a strong industry is available to provide access to the capital markets as state agencies such as PHEAA and other non-profit agencies attempt to offer educational opportunity through direct educational credit (student loans). Again I want to thank the members of the Committee for providing me with the opportunity to offer our views on the financial guaranty insurance industry and its relationship to the fast growing business of direct loans made by public and non-profit agencies from funds raised in the capital market with the undergirding of credit enhancement from firms established in the financial guaranty insurance business.

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