AMERICAN ACADEMY of ACTUARIES

June 2, 1998

The Honorable Alfonse D'Amato, Chairman
Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C. 20510

RE: Financial Services Reform

Dear Chairman D'Amato:

As your Committee prepares to hold hearings on H.R.10, Financial Services Competition Act of 1997, the American Academy of Actuaries would like to offer some observations about the implications of this legislation. The Academy neither supports nor opposes the bill, but believes that policymakers should adequately address all of the kinds of financial risks affected. Enclosed you will find a report that clarifies the difference between insurance and investment risk.

With or without H.R.10, there are clearly trends toward blurring traditional distinctions among various kinds of financial risk, i.e., investment risk, and insurance risk. As companies and products mix elements of banking, investment, and insurance, it is important to ensure that companies provide adequately for their risk exposure, so that the companies and their customers are protected against bankruptcy.

It is especially important that solvency standards provide adequate protection to cover the insurance risk. For example, banks which underwrite insurance products, such as mortgage guarantee insurance, need to have adequate reserves to cover the risk of natural disasters. Actuarially adequate reserves should be required regardless of what the business calls itself or whether the business operates at the holding company, operating company, subsidiary, or other level. Bank failures, with the accompanying harm to the American public, may be a predictable consequence of banks underwriting insurance products for which adequate reserves and other consumer protections have not been established.

Insurance risk is particularly complex, requiring the selection and application of appropriate assumptions based on a highly-trained and experienced understanding of the universe of those being covered, and the nature of the risks involved in each product. Actuaries are uniquely qualified to deal with the measurement and management of insurance risk. The Academy urges your Committee to protect the public and the financial system by providing for the appropriate application of actuarial skills in the newly emerging financial services world. We would be happy to appear before your Committee and work with you and your staff to ensure that adequate protections are provided for the public and the financial services industry.

Sincerely,

Don Sanning, Chairperson
Task Force on Banking and Financial Services

Enclosure

cc: Members of the U.S. Senate
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1100 Seventeenth Street NW Seventh Floor Washington, DC 20036 Telephone 202 223 8196 Facsimile 202 872 1948

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Report
to the
United States Senate
Committee on Banking, Housing, and Urban Affairs
on
Financial Services Reform
by
The American Academy of Actuaries
Task Force on Banking and Financial Services

June 2, 1998

The American Academy of Actuaries (the Academy) is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to senior federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

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The American Academy of Actuaries has analyzed numerous aspects of insurance regulation, especially insurer solvency. The actuarial profession is uniquely qualified to examine the various alternatives to reform the financial services area, especially with regard to the tools used to manage insurance risk.

In this paper, we will discuss the different risks involved with the business of insurance, the role of regulation, and the actuarial implications of recent federal initiatives to relax restrictions on banks' underwriting and sale of insurance. Many of the proposals put forward in the area of financial services reform have focused on banks or their operating subsidiaries acting as agents for the sale of insurance or insurance-like products. Permitting banks to function as insurance sales agents raises a number of issues concerning consumer protection, registration and regulatory oversight. The Academy is concerned about the potential consequences if federal regulators broadly preempt state laws and regulations in this area. However in our testimony, we would like to focus on initiatives that permit banks (on their own or through holding companies or operating subsidiaries) to underwrite insurance and insurance-like products and programs. This trend raises serious actuarial concerns that have not yet been adequately addressed by the courts, regulators or Congress.

To put these remarks into context, one must first distinguish between "insurance risk" and "investment risk." To the individual consumer of financial products, the distinction between the two is sometimes unclear. Loss of any kind, whether it be loss of life, health, income, or property on the one hand, or reduction in the market value of assets on the other, is unwelcome and, if extensive, detrimental to the individual's standard of living. However, from the point of view of the financial institution to which the individual consumer turns, the management of insurance risks requires different skills from those needed to manage investment risks. For purposes of this paper, "insurance risk" is a risk of personal loss to the insured party, which can take the form of loss of life, loss of health, loss of income due to disability, or loss through damage to or destruction of property such as a home or automobile. Thus, the risk that the value of a home will decline because a rise in interest rates makes the home less marketable is an investment risk. The risk that the same home will be destroyed by fire or flood is an insurance risk.

It is relatively easy to determine whether the major risk associated with some financial instruments is investment risk or insurance risk. A certificate of deposit involves investment risk; a term life insurance policy involves insurance risk. However, there are an increasing number of instruments available to the consumer that involve both insurance risk and financial risk. One example of such instruments is a fixed interest annuity, which involves both insurance risk (depending on the death benefit provisions and the factors used to convert the values to an annuity income) and investment risk (because the interest rate on the annuity varies with the financial market).

The Supreme Court recognized the investment risk associated with annuities in its *NationsBank v. VALIC* decision, when it ruled that national banks could sell annuities as investment instruments without reference to whether annuities are also "insurance" for purposes of state regulation. However, the Academy argued to the Court in an *amicus curiae* brief in that case, and continues to believe, that the insurance risk associated with annuities is significant, and needs to be more thoroughly considered.

Insurance risk is different from investment risk and requires different management and regulatory oversight. The risk associated with many insurance products can be of a catastrophic nature and large enough to threaten the solvency of banks that underwrite such products. For example, banks may want to offer mortgage guaranty insurance on homes for which they issued mortgages that would cover the mortgage in the event of damage to the property. (The kind of catastrophic risk involved in natural disasters such as hurricanes would be attached to mortgage reinsurance.) Significant harm might be done to a bank's overall solvency if an unexpected environmental disaster struck a large number of homes for which the bank had issued both mortgages and reinsurance. Indeed, many property-casualty insurers that were more experienced than banks in projecting and managing insurance risk than banks failed or were pushed to the brink of failure as a consequence of the losses generated by natural disasters like Hurricane Andrew. Current state laws and regulatory oversight are intended to protect consumers from the possible losses and failures in the insurance industry by providing necessary safeguards to the public.

Insurance risk is often tremendously volatile, particularly if the insured pool for a particular product has not been adequately analyzed or properly selected. This potential for catastrophic loss associated with natural disasters is why these coverages are often provided by governments. Individual companies would need to be well-reserved to pay the claims that might arise from flooding, for example. This raises the issue of whether financial services entities providing such insurance coverages should be required to establish the necessary reserves or if these entities would voluntarily establish reserves at the proper level if there was no regulatory requirement to do so.

Dealing with the volatility of investment risk has long been part of the "business of banking" as that term has been defined under the Glass-Steagall Act. However, banks are inexperienced with the analysis and management of the risks involved with insurance. The insurer must project a range of loss factors in anticipation of claims, and must be certain that adequate reserves are available to pay claims as they are made. The projection and management of insurance risk is a complicated science, involving the selection and application of appropriate assumptions based on an educated and experienced understanding of the insured pool and the nature of the risks involved in each insurance product.

Insurers are required by state law and regulation to maintain reserves against insurance risk, and to undergo periodic actuarial and regulatory review and oversight of the risks of loss

associated with insurance products. The National Association of Insurance Commissioners, which develops the model laws and regulations upon which state laws and regulations are based, has the experience to help in establishing appropriate reserving.

It is important to keep in mind that solvency laws and regulations are primarily in place to protect the public from the consequences of an insolvency. Therefore, the Academy's work generally assumes that risk to the public should drive solvency regulation. If Congress intends to protect the public from comparable solvency risks, it should establish reserving requirements and other solvency standards for banks similar to those established for insurers on those products with a significant element of insurance risk. Absent such reserves, the banks may be unable to pay policyholders' claims. Alternatively, the solvency of banks may be threatened if they are required to pay claims for which they have not established adequate reserves. Bank failures, with the accompanying harm to the American public, may be a predictable consequence of banks underwriting insurance products for which adequate reserves and other consumer protections have not been established.

It is not clear if the Office of the Comptroller of the Currency (OCC) has fully considered the need for reserving requirements. It is also not clear whether the OCC is planning to establish reserving requirements when it authorizes banks' operating subsidiaries to issue mortgage reinsurance. Similarly, when the OCC proposed allowing banks to issue "debt cancellation contracts" that were, for all intents and purposes, credit insurance, the OCC merely permitted, but did not require, banks to establish some unspecified level of reserve to support those debt cancellation contracts. There was no guidance offered as to the size or nature of those reserves, or how they should be managed. Some Congressional proposals simply require banks or their operating subsidiaries to meet "appropriate state laws" when they offer or sell insurance, without specifically articulating which state laws are meant. This is an important distinction.

In addition, it may be appropriate to consider if current laws restricting banks' insurance activities will still be applicable after the "reforms" are made. Although current laws may put restrictions on entities, such as banks, that underwrite insurance products, current laws may not be applicable under future federal reforms.

It is also important to understand the impact of having different solvency or reserve standards for different entities engaging in the same business. Different standards may create artificial competitive advantages for certain risk-takers. Whenever banks or their operating subsidiaries develop and market products or services that involve a significant level of insurance risk, Congress should consider whether their activities should be subject to appropriate regulation by governmental entities that have a thorough understanding of insurance. If the intent of Congress is to create a level playing field for all entities selling insurance, then functional regulation of banks' insurance activities should be based on the significance of the level of insurance risk attached to the product or service being offered, and

not to what that product or service is called. If a "debt cancellation contract" is contingent upon the death, disability, or loss of employment of the debtor, that contract is essentially credit insurance and should be regulated as such.

The state insurance departments are one possible choice to provide regulatory oversight to banks that underwrite insurance. Insurance departments are experienced in overseeing insurance activities, and well-equipped to assist banks to underwrite with appropriate concern for solvency. Alternatively, it might be possible to establish some federal entity to perform this function. In either case, in order to protect the public, Congress should encourage uniform, adequate, and consistent solvency standards for these entities taking on risk.

Actuaries are professionals experienced in the management of insurance risk. Actuarial opinions and certifications that are currently required by state law and regulation are valuable tools to manage insurance risk. Therefore, we strongly suggest that any regulation of banks' underwriting activities should make provisions for appropriate actuarial involvement in the projection and management of banks' insurance risk. In addition, actuaries can offer the banking industry expert assistance in dealing with investment risk, and appropriate recognition of the profession's expertise in this area should be included in governing laws and regulations.

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