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Regulation of the Financial Guarantee Industry

Statement of
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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 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.

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:

-- <u>Credit Enhancement</u>: 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.

-- <u>Risk Insurance</u>: 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 requirements 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.

<u>Adequacy of Oversight</u>

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 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. 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.