S. HRG. 109–1067

PERSPECTIVES ON INSURANCE REGULATION

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

ON

EXAMINING THE INSURANCE MARKET AND MODERNIZING INSURANCE REGULATION

JULY 18, 2006

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

50–119 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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PERSPECTIVES ON INSURANCE REGULATION

TUESDAY, JULY 18, 2006

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:05 p.m., in room SD–538, Dirksen Senate Office Building, Senator Wayne Allard, presiding.

OPENING STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. The Committee will come to order.

Today, the Committee will examine perspectives on insurance regulation, a topic which will likely be one of our biggest issues for the coming year. Insurance has helps millions of people during some of the most vulnerable times in their lives. Insurance has served many people well. Even for those who do not personally own an insurance policy, every American has a vested interest in a robust, well-regulated insurance market.

Well-regulated insurance markets help families and businesses manage risk. If private insurance were to fail in this function it would likely fall to the Government to provide assistance. Because insurance is so important, it is critical to maintain healthy insurance markets through good regulation. Therefore, we cannot take reform of insurance regulation lightly. It is important that we understand the implications for States, and especially for consumers.

Before coming to Washington, D.C., I served in the Colorado State Senate. My service as a State legislator gave me a particular appreciation for States' rights. However, I understand the insurance markets have evolved, and so market regulation must also evolve to keep pace.

Before we can make decisions about the future of the insurance industry we must understand the present state of the industry. Quite simply, we need to understand and define the problem to be solved before we start discussing solutions. This hearing will be an important step in that effort.

Today, the Committee will continue its examination of insurance regulation by hearing the perspectives of three experts on financial regulation.

I would like to welcome back to the Committee Under Secretary Quarles, who has a unique background in financial regulation having served in a variety of positions with responsibilities for financial regulation at the Treasury Department during the current and prior Bush Administrations. In addition, he served as co-head of the financial institutions group at the law firm of Davis, Polk and Wardwell.

I am also pleased to welcome to the Committee Dr. Scott Harrington and Dr. Robert Klein, two of the country's leading experts on insurance regulation.

Before we enact any insurance regulation reforms, especially any of the comprehensive reforms that have been proposed, it is crucial that all of the economic and legal consequences of such reform be fully understood. Accordingly, I look forward to hearing the experts' insights of our distinguished witnesses. I want to thank all of the witnesses for being here today. Their testimony will be very helpful.

At this time I would like to submit an opening statement by Chairman Shelby for the record. If the Chairman shows up this afternoon—he might—then we will give him an opportunity to make some comments.

Senator SUNUNU. I do not have an opening statement, Mr. Chairman. I am ready to go right to the witness.

Senator ALLARD. Very good.

Then as other members show up that may have statements, we will give them an opportunity to present those statements.

We will start with the first panel. Secretary Quarles, welcome to the Committee, Under Secretary of Domestic Finance, Department of the Treasury. We look forward to hearing your comments.

STATEMENT OF RANDAL K. QUARLES, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. QUARLES. Thank you. Thank you, Mr. Chairman, members of the Committee. It is a very welcome opportunity to appear here today to discuss both the role of insurance in our economy and the need to modernize the regulation of insurance.

As you noted in your opening comments, in the first instance, the issues surrounding insurance regulation are significant because the insurance industry is a significant part of the U.S. financial sector. It has assets of over $5.6 trillion at the end of 2005.

But even more importantly, insurance, like other financial services, has significant ripple effects through our entire economy. The ability of individuals and businesses to insure against risk adds certainty to their planning. That contributes to greater economic activity, enhanced economic growth. And insurance is also, like other financial services, in that its cost and its safety and its ability to innovate and compete are heavily affected by both the substance and the structure of its system of regulation.

So, as a result, not only of the industry's importance considered simply as a separate line of economic activity, but even more as a result of its consequences for commerce and economic growth more broadly, we should seek to ensure that the regulatory system for the insurance industry is consistent with the efficient and cost-effective delivery of its services, and with continuing innovation in the design of its products.

Now in that regard there seems to be virtually no disagreement that the current insurance regulatory system is in need of modernization. As you know, unlike the banking and securities sectors, insurance is solely regulated at the State level. While this multiplicity of regulators can provide certain benefits in the form of local expertise and control, it does raise a number of issues that deserve further consideration. In our view, those issues fall into three main categories.

One, potential economic inefficiency. That results both from the substance of regulation, especially, and form control, but also from the structure of regulation, the inevitable duplication in cost that is associated with multiple, non-uniform regulatory regimes.

Second, our international impediments.

Both questions of comity, facilitating international firms' operations in the United States which benefits U.S. consumers, and competitiveness, facilitating U.S. firms' operations abroad, which provides growth opportunities for those firms, helps diversify their risk exposures.

And third, systemic blind spots. The inability of the official sector to understand and respond to the insurance industry's evolving contribution to risk that affect the financial system as a whole.

So, at the most fundamental level, the question in each of these areas is whether the benefits from regulatory competition that are fostered by our existing multiple regulatory structure or could be fostered by other multiple regulatory structures, are outweighed by the costs of regulatory fragmentation, which are significant in a 50-State system. And in light of that consideration, where needed, what can be done to address those issues.

Now, I discuss each of those three categories of issues in detail in my written testimony, but let me just provide a brief overview of them here.

First, with respect to economic inefficiency. One aspect of modernization has been a focus on the lack of uniformity in State regulation. While the NAIC has achieved some success over the past 135 years in fostering more uniformity among the States, many of its model laws and regulations have not been enacted, and differing State insurance regulatory treatment can lead to inefficiencies and to undue regulatory burden. In turn, that can directly limit the ability of insurers to compete across State boundaries, and reduced competition can diminish the quality of services, it diminishes consumer choice, and ultimately leads to higher prices.

Now among the areas of potential inefficiency from non-uniform regulation are licensing, and form approval requirements. I describe those in some detail, again, in my written testimony. But perhaps the greatest potential for inefficiency in the current system is with price controls. Insurance is maybe the last major market in the United States with direct price controls. And the term price controls is frequently used to describe the State regulation of rates that are used by property and casualty insurers that are licensed or admitted in a State.

One of the fundamental principles that we are all familiar with is that price controls result in inefficient outcomes. If the mandated price is set above the market clearing price, the result will be surpluses. If the mandated price is set below the market-clearing price, the result will be shortages.

The latter outcome is what we generally observe in insurance markets with strict price controls. When insurers are not able to charge what they feel is an adequate rate for their product, they generally tighten their underwriting standards in order to limit their writings to preferred risks that are less likely to suffer an insured loss. This obviously leads to shortages in the voluntary market and increases demand on what is referred to as the residual markets, which are State-sponsored mechanisms that provide consumers with another way to obtain automobile, property, or workers' compensation insurance coverage.

Insurers that operate in a State and provide insurance in the voluntary market in the State are generally required to participate in these residual markets. But as the size of the residual market grows, in light of the price control, it is likely that fewer and fewer insurers would be willing to do business in that line of insurance in the State in question.

That puts further pressure on the residual market mechanism. States usually respond by adjusting prices to preserve the viability of that particular market. As a result, States with a less restrictive regulatory environment are generally characterized by lower and less volatile loss ratios, smaller residual markets, and insurance expenditures that are below the national average.

Next, let us turn to the international impediments. U.S. firms and firms from abroad in insurance and in banking and in the securities sector compete around the globe, around the clock. Clearly, foreign sources of capital are important if we are going to have a robust U.S. insurance market.

But as noted above, the lack of uniformity in our State-based insurance system has the potential to lead to inefficiency, undue regulatory burden. And while that burden and inefficiency affects all insurance companies that are licensed to operate in the United States, foreign firms are likely to find adapting to such standards more difficult.

In my prior role as the Assistant Secretary for International Affairs at the Treasury I led our financial regulatory dialogue with the European Union and with other of our bilateral partners. Among the issues that were stressed, again, both in our E.U. dialogue and in others of our financial regulatory discussions with foreign officials were rate and form approvals, capital adequacy standards, guaranty fund membership, and most fundamentally, that our insurance market has at least 50 different regulators, and the insurance companies have no single regulator to coordinate with on insurance matters.

Navigating the existing regulatory structure is daunting for a new foreign company that is seeking to do business in the United States. And it has certainly impeded the flow of capital into the United States to some degree.

Finally, there is the question of systemic blind spots. As previously noted, the insurance sector is a critical part of the broader U.S. economy, and in terms of size alone is a key participant in the U.S. financial sector. In comparison to other financial institutions, it could be argued that financial problems at an insurer pose less potential to generate broad economic problems as opposed to systemic risk to the financial system.

But nonetheless, there remains some potential for disruptions in the insurance market to affect economic activity in financial markets. And most importantly, these potential risks, whatever the degree of them may be, may not be well understood at the State or the Federal level in our current structure.

For example, there has been a considerable amount attention paid to the expanding credit derivatives market. While in that area there are a number of issues that might warrant attention, as with many other derivative contracts, a credit derivative is very similar to an insurance policy that pays off when certain credit events occur. So given the close correlation to insurance, insurance companies appear to be taking a more active role in this market.

From an overall perspective of market stability, do we fully understand what risk insurance companies are undertaking, or how their activity could affect the credit derivatives in other financial markets?

While the State-based system has made improvements in solvency and holding company regulation, under a structure with over 50 different regulators it may be somewhat difficult for individual State regulators to get a firm handle on the risks that large, complex insurance companies pose to our Nation's insurance system. Add into that mix that the Federal Government has little to no role in the current regulatory system and we are left with what could be a large blind spot in evaluating risks that are posed to the general economy and to financial markets.

So, to sum up, it is clear to us, we think it is to most observers, that our current system of insurance regulation requires modernization to meet our current challenges. The existing system of regulation has the potential to lead to inefficient economic outcomes. That raises the costs and reduces the supply of insurance products to consumers. It deters international participation in our domestic markets. Again, that raises costs and limits consumer choice. It creates obstacles to our own insurance firms' international expansion, and it limits the ability of any one regulator to have an overview of risk in the insurance sector and its contribution to risk in the financial system more broadly.

These are issues of importance not just to the insurance industry or even to the larger financial services industry, but to the economy as a whole because of the essential role that the mitigation of risk through insurance has in promoting commercial activity and enhancing economic growth.

We have been monitoring the developments with respect to insurance regulation closely, and while we are still evaluating what approach we believe to be the most appropriate, it is clear that all of the approaches that are on the table should be assessed in light of the fundamental principles we have discussed today, and we are looking forward to continuing this discussion.

Thank you, Mr. Chairman.

Senator ALLARD. Thank you very much for your testimony.

We will now proceed to the first round of questions. We will set aside 5 minutes for each member to ask questions.

I would like to start this off by asking a few questions. First of all, while the role of insurance at the Federal level has been rather limited, there has been a Federal role, and it has been dispersed among several agencies. Should an optional Federal charter be created? Do you believe that the new regulator should be independent or should they be part of an existing agency? What are your thoughts about that?

Mr. QUARLES. Well, that is an issue that I think requires further consideration. We at the Treasury Department would not have a final view on that. Both regulatory structures exist currently and are shown to work. The banking regulatory bureaus that are part of the Department of the Treasury, the OCC, and the OTS, the depository insurance regulatory bureaus, obviously work well and have for a long time. So that is a model that certainly can work.

The independent regulatory model is also one that has been shown to work over time. In the very near term it would be the case that if the choice were made to stand up a new Federal regulator, in the transition period that would be easier to do within an existing bureaucracy and with the support of an existing bureaucracy than to immediately stand up a new regulator. That could ease the time to implementation.

But for a final view, we do not have a final view at this time.

Senator ALLARD. And if we were to go to an independent regulator, would you think that would need to be supported by fees provided by the insurance industry?

Mr. QUARLES. That has, in general, become a principle of an independent regulator, is that its administrative expenses are generally provided by fees on the regulated industry. But again, I think that is an issue that needs to be considered in light of all of the full range of issues that are relevant to both the type of regulator that would be put in place and to the best structure of regulation that would ultimately address the issues that I outlined in my testimony.

Senator ALLARD. Now, if it went into an agency, would you expect that agency to absorb those costs, or do you expect the industry to pay for it?

Mr. QUARLES. Again, that is not a question on which we have a final view. But again, the usual structure of an independent regulatory agency is that it assesses fees in order to cover its costs.

Senator ALLARD. Now, Mr. Secretary, in your written testimony you noted that the European Union has undertaken reforms to forge one insurance market for all 25 of its member states in the E.U. If the Europeans are successful in establishing a unified insurance market do you visualize any adverse consequences for the U.S. insurance market and/or the competitiveness of U.S. insurance companies?

Mr. QUARLES. Well, I do think that the structure of regulation, particularly for financial services companies has a significant impact on the competitiveness of the regulated industry. So as the regulation of an industry in another jurisdiction becomes more streamlined and efficient, one would expect that to result in increased competitiveness for the affected industry, and at the margin result in a competitive advantage for that industry versus the United States.

Senator ALLARD. Now, we have a decentralized regulatory regime right now basically right now with the States. Is there an adverse impact, from your point of view, on the global market and how the insurance companies can compete?

Mr. QUARLES. The existing issues largely result from questions of reciprocity when a domestic insurer wants to operate abroad, and frequently the regulatory structure abroad requires the jurisdiction in which they want to operate to have a point of contact, to have confidence in a single, regulatory interlocutor in the home jurisdiction of the financial services company, in this case an insurance company that would be operating abroad. So, that is a current issue.

More broadly, I think there is a concern that if, over time, insurance companies that become used to operating under more streamlined regulatory jurisdictions abroad come to view our current regulatory structure as too much of a barrier to trade, that further barriers could be imposed on our financial services companies wanting to operate in their jurisdictions.

Senator ALLARD. OK. My time is expired.

First individual in on the opposite side is Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Well, thank you, Mr. Chairman. I regret that I was delayed. As you know, this hearing is overlapping caucuses and it complicated some things, but I appreciate—what I thought I would do is, I want to make a statement and then I want to ask Under Secretary Quarles a question at the conclusion of that.

I do appreciate holding this hearing on a continuing effort to examine the issue of insurance regulatory reform. Last week we heard from 10 witnesses representing various segments of the insurance industry, and the general sentiment expressed was that it is time for the Federal Government to act. And I agree.

Senator Sununu and I have done just that. We have crafted a comprehensive legislative proposal that would give insurers a choice of charter.

Insurance is the last sector of the financial services industry for which there is no concurrent State and Federal regulation, but it appears that the climate is changing. With the proliferation of the Internet, the world is becoming smaller and smaller while the national and global marketplaces are becoming larger. Consumers today have more information available to them than ever before. Virtually instant access to information, allowing them to comparison shop for products and services all over the world.

Businesses have to be able to meet consumer needs and expectations. Insurance is no exception. It is a large, complex and diverse industry and its growth should not be hindered by a regulatory structure that has failed to adequately adapt to the evolving business environment and consumer demands. This process is about reforming a system of regulation that has failed to keep pace.

What was once a sector of the economy that was marked by a local geographic focus, the financial services industry has taken on a national, and even a global focus. And as a part of that industry, insurance cannot and should not be left behind. Not everyone is convinced that we need to create a dual system of regulation like we have for the securities industry or the banking industry. Some argue that consumers will be confused by having to deal with more than one regulator.

I have to echo the sentiments expressed by my colleague, Senator Sununu, last week. Consumers are not dumb. And quite frankly, many consumers right now hold policies that are governed by more than one regulator, as do many Members of Congress who maintain residences in different States.

Under an optional Federal charter, my local agent in South Dakota, who wrote the policy on the home my wife, Barbara, and I own, could obtain a national license and also be able to take care of my insurance needs here in Washington.

As a consumer, it has never occurred to me that I have insurance policies that are governed by the laws of different States, and I have never had a reason to call Merle Scheiber, South Dakota's Director of Insurance because of an issue that my agent or insurance company could not assist me with.

What has occurred to me is that because I own property in different States, I have to do business with different agents licensed in those different States. And for that I have no choice.

However, S. 2509, the National Insurance Act, would give me that choice as a consumer, and would give my agent a choice, as well.

I am also disappointed that opponents of Federal legislation have suggested that the Federal Government is incapable of protecting the interests of consumers, and that Washington is full of inexperienced, insensitive and unresponsive bureaucrats who would make a mess of insurance regulation and consumer protection. I just could not disagree more.

We have created systems of Federal regulation here in Washington that are widely referred to as world class. A Federal insurance regulator would be no less. I expect the commissioner of national insurance to be an expert on the issues facing the industry and develop strong consumer protections and regulations that are applied and enforced in a fair and impartial manner.

I want to be clear. A Federal regulatory agency should not be expected to be a close friend of the industry, nor should the industry or agents expect to have its ear. That would be a recipe for disaster.

Mr. Chairman, I look forward to hearing from our witnesses today. I have appreciated the testimony of Under Secretary Quarles. These witnesses are highly credentialed experts, and I appreciate their willingness to appear before us today.

To Under Secretary Quarles, some people believe that the Federal Government does a pretty bad job of protecting consumers or responding to their needs. How would you respond to the contention that a Federal regulator would be distant and that a State-based regulation of insurance assures a level of responsiveness that simply cannot be matched at the Federal level?

Mr. QUARLES. Well, I think that whether a regulator is going to be responsive or not is not a function of the level of our governmental structure that we place that regulator at, but the charge that we give that regulator and resources and attitude of that regulator.

We have certainly seen that the Federal Government can do a very good job of consumer protection. So I do not think that it is inherent in the nature of the Federal/State dichotomy that the Federal Government cannot do a good job of consumer protection.

Senator JOHNSON. Do you believe the presence of a Federal insurance regulator would threaten the survival or effectiveness of the State system?

Mr. QUARLES. I do not think that would be a necessary consequence. In answering this question, I do want to underscore that as we look at the various proposals on the table at the Treasury Department we have not yet come to a view as to what we think is the right approach. But it is definitely not an inevitable consequence of creating a Federal option that saps the vitality of the State system.

I mean, that is the attractiveness of one regulatory system versus another, is going to be a function, again, of the attitudes of the State regulators and their approach to their regulatory responsibilities.

Senator JOHNSON. I realize my time is about expired. Let me ask just one last point here.

Do you see evidence of competitive inequities between banks, security firms, and insurance companies because of their differences of regulation?

Mr. QUARLES. As bank securities firms and insurance companies do increasingly become competitors in areas of—in offering certain financial products, I think that it is the case that the current fragmented regulatory system does create some obstacles for insurance companies in the time to market of new products. And it is in the new products area that this competition would largely be occurring.

So while I do not want to overstate the importance of that differential for the insurance industry, the burden that that places, I think that it is undeniable that there is a greater time to market for a new product in the insurance industry than in banking and securities.

Senator JOHNSON. Thank you, Mr. Secretary, and I yield back.

Senator ALLARD. Let me now call on the Senator from New Hampshire.

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Secretary, you talked a little bit about price controls in your testimony and I think you indicated that you felt that was perhaps the greatest factor or contributor to inefficiency in the current State-based system.

Roughly how many States still have some form of rate regulation or price controls?

Mr. QUARLES. It is a very significant majority. I think it is about 43.

Senator SUNUNU. Do you believe that consumers fare better in States or under a system that does not regulate rates?

And if so, how so?

Mr. QUARLES. No. I think that the, you begin with the fact that—just look at average insurance expenditures in the States that have less regulation. The States with less price regulation do not have insurance expenditures that are any higher than the States with more price regulation. In fact, the States with the least price regulation actually have insurance expenditures that are below the national average.

So, what would the reasons——

Senator SUNUNU. And that is something that has been correlated?

Mr. QUARLES. Yes. Absolutely. And when you look at what would be the reasons for that, a State like Illinois, that has relatively little rate regulation would, in fact, have relatively low insurance expenditures.

And that is because of the operation of these residual markets and the effect of price controls on the availability of insurance that I described in my testimony.

When there is a price control that sets the price below what would be the clearing price, then the insurer is going to withdraw the supply of that product in that State. As it withdraws the supply, the residual market mechanism would require all insurers who were offering that line of insurance in the State to participate in the residual market.

Senator SUNUNU. I want you to explain that in a little bit more detailed fashion, how those residual markets work and why it is problematic for price controls, why it is problematic for their usage to be increased in the price control situation you described.

Mr. QUARLES. Sure. Absolutely. So, given the recognition of the fact that if you require an insurance company to provide its product at a certain price, it will choose not to provide that to certain customers because it will judge the risk too great for the price that it is allowed to charge.

Most States that have these price controls then have a residual market in which the insurers are required to participate for individuals who would seek automobile insurance or worker's comp insurance that they would otherwise be unable to obtain in the admitted market or in the voluntary market.

And if you offer a particular line of insurance in the voluntary market, you are generally required to participate in this residual market.

But while, in theory, you could come to the same effect by pricing the residual market appropriately, in order to compensate the participants in the residual market for the extra risk they are taking for insuring these greater risks, that is very, very difficult to do as a matter of practice.

So what you will almost, therefore, always see is that the residual market risk is underpriced. And if it is significantly enough underpriced, you will have insurers saying well, if I offer this line of insurance at all in this State, even in the voluntary market, I am going to have to lose money in the residual market. And so I need to withdraw from that line entirely in that State.

In order to prevent that from happening, the rate regulators will then seek to adjust the price that is allowed in these two markets, increase the price in order to make this a continuing attractive economic proposition for the insurance companies. But the effect of that is to result in average prices that are either higher because of the inefficiency of trying to set prices this way, or certainly no lower than would be created simply by allowing the market to operate.

Senator SUNUNU. You suggest that the residual markets are, more often than not, they are not self-sufficient. So where does the money come from required to cover their operating costs?

Mr. QUARLES. Insurance companies are assessed to cover the deficiencies of the residual market, which is another reason that there is an economic disincentive for them to continue in the activity that requires them to participate in that residual market.

Senator SUNUNU. What is the long-term effect on price controls on volatility, price volatility?

Mr. QUARLES. Well, as I mentioned, when a rate regulator sees that this effect is happening, it will attempt to adjust the rates in order to make the market attractive. But because this is not being set by the market because it is being set in a centrally planned environment, those rate changes, when they happen, are likely to be significant swings.

And therefore, the volatility of rates, it is not just the level of rates that is lower in the less regulated States, but the volatility is significantly lower in the less regulated States.

Senator SUNUNU. One more question about price controls, and then I will come back, because my time is up.

I read a description of—I think it was referred to as price trapping in the market that suggests that another unintended consequence of a price control is it makes insurers less likely to lower their rate, even if their costs go down, because of the fear—and I guess it is a natural fear, human behavior—that they would not be able to raise them because they are in a regulated environment. That for political reasons, although it is hard to imagine any regulator ever operating in a political way—and we have had some very good ones testify in front of this Committee. But maybe for political reasons people would be reluctant to approve a later rate increase.

And so they would therefore not want to lower the prices even if their own cost profile showed that they could do that and still make money.

Is that real or did I just make it up?

Mr. QUARLES. I do not have statistics for you today as to how common an effect that is, but inevitably that disincentive is there because rate regulation, in any environment, whether we are talking about insurance or financial services more broadly, or other areas where there is rate regulation, rate regulation is also often very sticky on the upside.

Senator SUNUNU. Thank you very much. Thank you, Mr. Chairman.

Senator ALLARD. I will now call on the Senator from Rhode Island.

Senator REED. Thank you very much, Mr. Chairman. Thank you, Mr. Secretary.

Let me follow up on the line of questions Senator Sununu raised about residual markets. Looking ahead, if there was a Federal charter, then a company could go in under their Federal charter into a State and not participate in the residual market, which is mandated in the State law. Is that a fair assumption?

Mr. QUARLES. Well, it would depend on the specific structure that was created, but in general that would likely be the case with the Federal charter.

Senator REED. And there could be then either an unintended incentive to get out of the residual market, which you described, some complications or problems with the Federal charter, leaving the residual market diminished consistently, causing those that stayed to pay increasingly higher prices to cover the risk.

And the point of the residual market is to provide protections to consumers that cannot get it in the voluntary market. Is that correct?

Mr. QUARLES. Yes. That is right. That would be a logical consequence.

Senator REED. But that would be, in some respects, a very unfortunate consequence because you would diminish opportunities to purchase insurance or you would shift the burden onto those companies for one reason or another who cannot get out of the State regime; is that correct?

Mr. QUARLES. I think that—I mean, the issues that you are describing are definitely issues that would need to be considered, the incentives that would be created for movement between regulatory regimes. I do not think that movement between regulatory regimes, whatever the incentives that were created, would be particularly rapid because of just the legal and technological obstacles there are to move between regulatory regimes.

But the issues that you are describing would definitely have to be considered.

Senator REED. This raises a general question. I wonder if Treasury has looked ahead at some modeling or projecting the dynamics of what would take place with these two charters. Have you done that, Mr. Secretary?

Mr. QUARLES. No. We have not.

Senator REED. Would you consider that to be a useful exercise?

Mr. QUARLES. Absolutely. I mean, as this dialogue continues, it is the sort of thing that we would need to look at.

Senator REED. One of the areas for concern, and I think you addressed this in the context of the European experience versus the United States is they are trying to streamline their procedures, streamline costs, become more efficient. Some of those costs, though, go to consumer protections.

And there is a fear, I think again, if we look ahead, that if you have a very stripped down Federal approach, without some of the protections that you have at the State level, that it is inherently more attractive from a profit and loss standpoint, you will get people moving over there and you will have consumer protections that are weakened.

Is that a concern we should have?

Mr. QUARLES. I think that should be less of a concern when you are considering the options of a Federal charter or not. Again, without wanting to take a view here at all, because we think that all of the various structures that have been proposed approach these issues in different ways and merit consideration.

But I do not think that there would be, in any—I neither think that it is inherently necessary nor likely that a Federal regulator, even if it was streamlining the costs of consumer protection, would do a worse job of consumer protection.

Senator REED. Well, one would hope that you are right. And it is our responsibility to make sure of that if we go down this path.

Again your comment, it would seem to me then that if we assume that consumer protections will be adequate and similar to the

States, we still have the issue of the residual market. But the great attractiveness of this approach is avoiding the registration costs and the—supervisory costs, rather, in 50-plus jurisdictions versus one. Is that the biggest?

Mr. QUARLES. The registration costs, as well as form approval burdens. I mean, the general multiple administrative burden. On the economic inefficiency, regulatory burden side, I think that is important, although I do not think that the regulatory burden on the industry is the most important reason for considering the modernization of our current regulatory structure.

I think issues like the international impediments and the systemic blind spots that I have described are at least as important as the regulatory burden.

Senator REED. Thank you. Thank you, Mr. Chairman.

Senator ALLARD. OK, we have finished the first round of questioning.

Senator SUNUNU. Can I just ask a couple of more questions of the Secretary?

Senator ALLARD. That is what I am going to propose to the Committee. I think we have got time to do a second round if we limit it to 3 minutes. Is that satisfactory to the members? OK, we will go to the second round and we will limit it to 3 minutes per person.

On regulating financial entities, it requires a great deal of resources and expertise. And a successful regulator must be able to attract and retain top caliber employees. And, in some situations, it has been difficult for Federal financial regulators to get adequate human capital.

In fact, nearly all Federal regulators are able to pay above the general Government pay scale because of the demand out there in the labor market.

Do you believe that States have the resources and experts necessary to carry out the necessary level of oversight of these large and highly complex entities?

Mr. QUARLES. Well, I certainly do not want to characterize all States or any particular State, but it would obviously be true that there is significant variation in the resources that States devote, and are able to devote, to insurance regulation.

Some States, obviously, devote a lot of resources and relatively sophisticated resources to it. They are able to do that. But others are not. And I think that is an issue, the significant variability of the resources.

Senator ALLARD. In insurance, we have companies that may specialize in certain areas. You may have casualty and property companies. You may have life insurance companies. You may have automobile insurance, title insurance, medical liability, medical insurance.

What area do you think most necessitates a Federal regulator?

Mr. QUARLES. As we look at the issues, I do not think that I would prioritize across lines at this moment. I mean, the broad categories of issues that I described at the outset of my testimony, whether it is regulatory burden, international impediments, systemic overview, are applicable really across each of those lines to one degree or another.

So as we think about the issues right now, we have not prioritized which are most in need of regulatory reform. We think that it is applicable, really, across them all.

Senator ALLARD. In my State of Colorado, in some insurance, we get put into a regional pool. So the insurance company just does not look at the State, but also looks at other States that might be part of this pool. For example, in some, we are a part of California, which we accuse that of creating a high-premium rate for people in Colorado.

Do you think that a Federal regulator would have an impact on these regional pools?

Mr. QUARLES. I think it is certainly easier for a Federal regulator to consider issues across State boundaries. Issues that effect State-to-State relationships.

Senator ALLARD. My time is expired. I might want to pursue that a little further later on.

The Senator from South Dakota.

Senator JOHNSON. Mr. Secretary, is there anything especially unique about the business of insurance, of the insurance industry, that would make an optional Federal charter or concurrent State and Federal regulation inappropriate or inoperable?

Mr. QUARLES. No. I do not think so. I think that, while there are, obviously, a number of unique aspects of the insurance industry versus other elements of the financial services industry. I do not think that any of them relate as to whether a Federal regulator would affect the question—whether a Federal regulator is appropriate.

I think whether or not one concludes that that is the right way to address the issues we have described here will depend on other considerations and not on the special nature of insurance.

Senator JOHNSON. Given the fact that Congress has been confronted with a number of insurance issues over the past few years that have been national in scope, such as TRIA, and large scale devastation, such as we experienced with Hurricane Katrina, do you believe that a Federal regulatory presence of some sort on some insurance matters is needed?

Mr. QUARLES. I think that has been a weakness in the overall Federal Government regulatory structure. And again, without wanting to describe how one should address it, we do find that there is a weakness in our ability to analyze and address insurance issues, generally.

Senator JOHNSON. I yield back.

Senator ALLARD. Senator from New Hampshire.

Senator SUNUNU. You indicated, in your testimony, that foreign capital is important to the insurance market, and that, to some degree, perhaps the State regulatory structure can impede that flow. Could you describe a little bit the role that the foreign capital plays in our domestic insurance markets? And in what ways in particular could the regulatory system be improved to help sustain a better flow of foreign capital?

Mr. QUARLES. Well, the role that foreign capital plays in our insurance markets—which is beneficial—is the role that it plays in our economy generally, but particularly in financial services.

There are very sophisticated foreign financial services firms that are capable of providing useful competition in the industry as a whole, which is always beneficial to consumers.

They can provide additional product innovation. There are a number of ways in which foreign financial firms, particularly from other developed countries—I am thinking particularly of Europe—can bring benefits to our financial services sector through participation.

But it is not nearly anecdotal. I mean, we hear a lot of anecdotes from foreign insurance firms that they find our insurance regulatory system enough of a barrier that, at the margin, they are less likely to make investments in our insurance industry and to operate in our direct insurance industry in the United States, which is the most heavily regulated.

And you can see that simply by looking at just the general level in foreign participation in different financial services. In the banking area, for example, over a very long period, foreign participation in the banking industry has been 20 to 25 percent of the industry as a whole. In direct insurance in the United States, it is significantly less, maybe about 15 percent of premiums for direct insurance in 2005 were written by foreign-controlled firms.

Senator SUNUNU. Assuming for the sake of discussion that Senator Johnson and I have persuaded 98 of our colleagues to support our legislation, and 435 members of the House of Representatives and it is on the verge of becoming law because the President is prepared to sign the legislation, having received that recommendation from his top policy advisors at Treasury, would you suggest or prefer that a regulatory agency for life and property and casualty be independent with Treasury or an entity that stood by itself outside of Treasury?

Mr. QUARLES. That is interesting. So, the question that you are asking is it better for a regulatory agency to be independent within Treasury, as opposed to just within Treasury.

Senator SUNUNU. Yes. I think we can assume that is going to be an independent thinking regulatory body, but should it be within Treasury or outside?

Mr. QUARLES. Well, that is an interesting question. I do not want to give you a final view on the specific question with respect to insurance today, because it is not one that we have completely formulated?

Senator SUNUNU. So you are refusing to answer my question?

[Laughter.]

Senator SUNUNU. It has happened before.

Mr. QUARLES. I promised that I would never do that. But, as a general rule, I do think that, just as a general matter of organizational behavior, if you will, it is something of an issue when an entity is within an organization that, in fact, has no control over it, but then is expected to have some responsibility for it.

And I do not know, again, that that structure is, in fact, is necessary for the efficient operation of a regulator. But those would be, I think, some of the principles that we would have in mind as we looked at that proposal.

Senator SUNUNU. Thank you.

Senator ALLARD. Thank you, Senator Sununu. I did not realize that you were such an idealist that first question implied.

Senator SUNUNU. Well, it is all hypothetical.

Senator ALLARD. Well, we have completed the first round. I would just remind the members of the Committee that the Committee asked for questions to be submitted within the week, and then we ask the participants on the panel to respond back in 10 days. I hope that, Mr. Secretary, you would be willing to do that. And thank you for coming and testifying before the Committee.

Mr. QUARLES. Thank you, sir.

Senator ALLARD. We will now go to our second panel. And on our second panel, we have Dr. Scott Harrington, who is the Alan B. Miller professor at the Wharton School, University of Pennsylvania.

He is joined by Dr. Robert Klein, Director of the Center for Risk Management and Insurance Research at Georgia State University.

And when you gentlemen get settled, we will start off with testimony first from Dr. Harrington, and then we will go to you, Dr. Klein. And you are familiar with the rules, I think, that ask for 5-minute testimony. We will not be real strict on that enforcement, but at least reasonably close, if you would, please.

STATEMENT OF SCOTT HARRINGTON, Ph.D., ALAN B. MILLER PROFESSOR, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. HARRINGTON. Good afternoon, Mr. Chairman, and members of the Committee.

Much of my research over the past 30 years, for better or for worse, has focused on the economics of insurance markets and insurance regulation.

A number of my publications have dealt specifically with whether problems in insurance markets and insurance regulation justified some form of optional Federal chartering. And, at the time, given my assessment, I concluded "no."

In February of this year, I prepared an issues paper on possible Federal chartering of insurance companies and other Federal intervention for the Networks Financial Institute.

Despite some reforms, I highlighted that regulations of rate classification and policy forms remain dysfunctional in many States. With no end in sight, and with burdens on interstate commerce, cross-sector competition, and cross-national competition, I concluded that some form of Federal intervention was necessary to modernize insurance regulation.

When not impeded by misguided regulation, most modern insurance markets are highly competitive. Regulations should focus on reducing the extent to which some insurers might misrepresent or fail to keep their promises. It should do this through appropriate monitoring of insurance solvency and some oversight of sales and claims practices.

The main features of State regulation and solvency are entirely sensible. The system of limited *ex post* assessment of solvent insurers to pay a portion of failed insurers' obligations is appropriate economically, and it works reasonably well, especially under some circumstances. Limits on State-guaranteed protection reduce their adverse effects on policyholders incentives to deal with safe insurers.

Compared with pre-funding, such as occurs under deposit insurance, *ex post* assessment likely increases financially strong insurers' incentives to be vigilant in pressing for effective solvency regulation.

But other aspects of State regulation fail to pass a cost benefit test. Lack of uniformity, unnecessary or excessively burdensome processes for form approval represent a major problem. They disadvantage insurers compared with federally regulated financial institutions and something really needs to be done to help speed to market.

Price controls are truly problematic. State requirements that regulators approve rates before use for many types of insurance are unnecessary and counterproductive.

Prior approval regulation of insurance rates produces significant administration and compliance costs borne by consumers.

It cannot and does not affect insurance company profits in the long run. It impedes timely adjustments of rates to new information. It produces fewer but larger rate changes, greater swings in coverage availability in residual market size, and it increases insurers' risk.

Quite a bit of my research over the years has documented these effects. In addition, some States significantly restrict underwriting and rate classification, including caps on residual market rates.

Some of these policies provide some benefit. But, in general, they create cross-subsidies from lower-risk buyers of insurance to higher-risk buyers. They push up average premium rates in a State to a more high-risk insurer and fewer to low-risk insurers, or they buy less coverage.

And these types of subsidies to high risk reduce higher-risk buyers' incentives to take action to mitigate risk.

In some cases they require costly State re-insurance or risk adjustment mechanisms to insure stable markets with all sorts of distorting influences.

Appropriately designed, optional Federal chartering and regulation of insurance has the potential to achieve the essential goals of regulatory modernization, to increase uniformity, to provide national certification or approval of policy forms, to have rates and rate classes determined by competition, rather than rate regulation, and streamline or lower the cost of monitoring market conduct.

And it can do this all, with luck, while preserving or even enhancing private market incentives for safe and sound insurance markets. It will motivate States to further modernize and it could promote beneficial regulatory competition over the long run.

Requiring federally charted insurers to participate in the State guarantee fund system, perhaps with minimum standards, is a sensible approach in any optional Federal chartering.

It should be recognized, however, the guarantees of insurers' obligations under Federal chartering could evolve toward nationalization over time, with uniform coverage. And with some Federal oversight of State-chartered insurer's insolvency, as is true in the dual banking system.

Any optional Federal chartering system will entail some risk that the scope of Government guarantees of insurers' obligations will ultimately increase, including being backed by the full faith and credit of the United States, reducing private incentives for safety and soundness.

A fundamental goal should be to avoid expanding guaranteed fund protection under any optional Federal chartering system, and impossible to intelligently narrow the scope of guarantees to encourage private incentives for safety.

A pre-funded Federal guarantee system should likewise be avoided. Federal-chartered insurers' rates should not be subject to prior approval regulation. In turn, that would help discipline regulation of State-chartered insurers' rates. There are, again, inherent uncertainties, both about the specifics in any legislation that could ultimately be adopted, and whether any initial exemptions for freedom for price controls would persist over time.

With regard to residual markets, it is not part of any unnecessary optional Federal chartering plan that Federal-chartered insurers' would not have to participate in residual market.

But what is important is that if they participate in residual markets that there are some sort of safeguards, at least written safeguards, that would discourage extensive cost subsidies at the State level through the residual market mechanism.

Optional Federal chartering could be an effective engine for modernization. There are risks, and it would involve the cost of creating a new Federal regulator. Unintended consequences or mistaken policies would have national repercussions.

There are other approaches. One would be narrow and carefully targeted preemption of certain State regulations that do not meet minimum standards.

And a second would authorize insurers to choose a primary State for regulation and operate nationwide, in large part, under the rules of that State. I think both of those types of approaches are also worthy of serious consideration.

Thank you.

Senator ALLARD. Dr. Klein.

STATEMENT OF ROBERT W. KLEIN, Ph.D., DIRECTOR OF THE CENTER FOR RISK MANAGEMENT AND INSURANCE RESEARCH, GEORGIA STATE UNIVERSITY

Mr. KLEIN. Good afternoon, members of the Committee that are left, or will be here. I appreciate the opportunity to speak to you today about insurance regulation.

I am going to try to keep my comments relatively short, but obviously, I am going to be open to questions. My views on the issue of what kind of regulatory reforms are needed are probably pretty close to Scott Harrington's. My views on the institutional route to those reforms lie somewhere between the optional Federal chartering proponents and the optional chartering opponents.

So, at the end of my testimony, I am likely to have made more enemies and less friends, and probably just about everybody will hate me. But that is not untypical for me to do.

Senator ALLARD. Welcome to the academic world.

Mr. KLEIN. I am sorry?

Senator ALLARD. Welcome to the academic world.

Mr. KLEIN. Right. I will just briefly mention, in 30 years I have been an insurance regulator, and I have worked for insurance regulators. And, during the last 10 years, I have been an academic studying insurance regulators. So, that is what I have been doing.

I am going to quote a bit from my written testimony, and then I am going to do a little ad hoc summarization.

In my opinion, the States have come a long way in improving their regulation of insurance, but further reforms are needed, both in terms of the States' structures and processes, as well as their policies.

I think the preferred institutional route to this goal is strong Federal standards for and oversight of States' regulation of insurance that will move their structures and policies to where they need to be.

In essence, the States need to appropriately and efficiently regulate things that need to be regulated, and not regulate things that do not need to be regulated.

However, if this cannot be achieved under the institutional arrangement that I would prefer, then an optional Federal charter approach may be necessary to achieve the objectives the States would be either unwilling or unable to achieve.

The specific reforms that I propose reflect four basic themes or characteristics.

One, the elimination of regulation where it is not needed.

Two, uniform and appropriate and efficient regulation where it is needed, to the extent that uniformity is possible, given differences in State laws that cannot be changed.

Three, singular institutions and processes for insurers' filings and applications that would be approved for all States.

And four, full rationalization and coordination of all State enforcement and compliance activities.

In the regulatory system that I envision, the States would efficiently enforce a uniform set of regulations, to the extent that uniformity is legally feasible in their respective jurisdictions and the inefficiencies and costs of unnecessary State differences and redundant regulatory processes would be minimized.

I have prepared a list of 11 reforms which I will list or summarize.

First of all, there should be a uniform set of requirements for insurance products sold to persons, small businesses, and for mandated insurance coverages, to the extent that the uniformity is legally feasible.

So, we would have requirements, but they would be uniform among all States.

Regulatory restrictions or mandates on insurance products sold to medium and large businesses should be eliminated, except where Government requirements or significant externalities compel such regulation.

Prospective price regulation should be eliminated in all lines of insurance except those lines where market failures and abuses have been demonstrated, such as title insurance and credit insurance.

Some residual authority to intervene in pricing should be retained should competition and market forces fail to ensure fair and competitive rates.

A process should be established that would allow an insurer to make one product filing that could be approved for sale in multiple States, as well as one licensing application that could apply to multiple States.

A rigorous set of uniform financial standards should be established, maintained and properly enforced. We are almost there but we have more ground to cover.

Also, the laws and process for administering insurance company receiverships need to be further rationalized and made uniform among the States.

There should be streamlined and appropriate State enforcement of all insurance regulations that are retained or instituted, including single, national, financial and market conduct examinations that would serve all States.

Efforts to streamline and nationalize the licensing and regulation of insurance producers should continue to their maximum possible fulfillment.

I will just briefly summarize the rest of my points.

We do need to look at systems for the reporting of various insurers' data, beyond that which you would call financial data. That is an area we need to look at.

I would basically do away with elected insurance commissioners. I would have them all appointed.

I do think that there should be a further strengthened program of consumer public education and information. I think that, despite all of the efforts that we have to get consumers more informed, there is a huge amount of ignorance out there, which is a problem. So we need to be more aggressive and proactive in that area.

And finally, if we establish the type of institutional framework that I described, we are going to need some kind of comprehensive and continuing evaluation of that structure. So that, basically, we have a certain amount of Federal monitoring and oversight to make sure that the States are doing what they are supposed to be doing, and that the system that has been established and designed functions as it is supposed to function.

So, those are essentially my recommendations, and I will leave it at that. And I will be happy to answer any of the questions that you may have.

Senator ALLARD. Let me start off a question for the panel. I would like to have your view on insurance that operates in smaller States—I am talking population-wise—as opposed to larger States.

And insurance companies face certain compliance and market-entry costs in order to do business in a State. And does this leave the smaller States, potentially, at a disadvantage? I would like to have your comment on that.

Mr. KLEIN. That is a good question. I think that probably smaller States, perhaps, do present a little more of a challenge for insurers in terms of entry. I mean, basically, if you were to look at the number of insurers operating in a small market versus a large market, a small market is going to have fewer insurers. They are going to be less likely to make the expenditures necessary in order to operate within that State.

So, I think a small State, to a certain extent, probably does suffer a bit in terms of entry costs or compliance requirements relative to the volume of business that a company could do in that State.

Senator ALLARD. So, if they sign off on agreement that they are going to have a certain regulatory agreement, it might work out fine for the larger State, but on the smaller State, it would not work out so well because you have such a small market.

Yes. Dr. Harrington.

Mr. HARRINGTON. I would say that if the regulatory environment is conducive to making insurance companies feel that they can market their products at rates that will cover their costs, it is really not a material issue on our modern markets.

As an example, in South Carolina, where I lived for 16 years, when they relaxed some pernicious automobile insurance regulation, the number of auto insurance writers went from 100 to up to the high 100's within 12 months.

So, at some point, smallness is a problem, but I do not think it is really an issue in our modern world unless the State does things to make it hard for companies to operate.

Senator ALLARD. Yes.

Yes. Dr. Klein.

Mr. KLEIN. Yes. I would tend to agree with Scott. I think that if we had a system that worked the way that I would conceive of, and I think that the way that Scott would conceive of, where essentially, whether it is through an optional charter or it is through uniform requirements in all States, entry barriers in small States would not be significant. So, basically, an insurer creates one product and is able to sell it in all States, then you basically remove that cost and entry barrier.

So, they can sell it in South Dakota. They can sell it in New York. A State's market size does not matter too much, other than maybe some issues relative to distribution.

Senator ALLARD. If you had, with the insurance company, when we talk about the optional charter, you can either go Federal or State, are you thinking in your mind, that an insurer might select several States that he might get licensed in to sell insurance? And a Federal charter that would encompass that would encompass all, or are you thinking in terms of just one State, which might be his headquarters, and he insures in there, or he goes to a Federal charter?

See what I am trying to get at? Some insurance companies may be able to cherry pick the market if they can pick the best States that have the best markets and go with those, as opposed to a Federal charter. And that might be 10 States as opposed to a Federal charter. I would like to have your comment on that option that might be available.

Mr. HARRINGTON. I would presume that an optional Federal chartering system would require an entity to pick. You either have a Federal charter and you operate nationally subject to that charter, or you maintain the current requirements to get licenses in every State where you write business.

Now, I certainly think that companies will make that decision strategically and in the interest of their owners. And that is one of the possible advantages of moving in that direction. And that it will then encourage regulatory environments that could help to lead to entry in robust insurance markets.

Senator ALLARD. It seems to me, maybe, more of a competitive market, where it would at least, as far as the Federal charter is concerned, might be a force that would hold down, you know, Federal charter rate costs. You know, what the insurance company would get charged for a Federal charter. Mr. Harrington. I think, in general, that there are advantages that could reduce costs associated with regulatory competition.

Senator ALLARD. Yes.

Mr. HARRINGTON. To be sure, we do not know, yet, what might happen in insurance if we have optional Federal chartering. I am not sure that it will be that easy for insurers that choose the Federal charter, for example, to switch later on if they had to go back and get licensed in 46 States or 49 States.

So, that could detract a little bit from the competitive results.

Senator ALLARD. Yes.

Dr. Klein, do you have any comment on that?

Mr. KLEIN. Yes. A little bit. I think I tend to agree with Scott. I think that my sense would be that most of the national companies that operate in a large number of States would basically opt for the Federal charter, and that really should be the regulatory regime if we are going to have that kind of system.

And presumably they will stay with that as long as the regulator and the Republicans are in the majority. But there could be a time—I do not necessarily want to show any disrespect—we could have a Democratic President and a Democratic regulator appointed and Federal regulation, at that point in time, might not look so good to certain companies. And so there would be a question if they would switch or could switch. And that could be an issue.

But my sense is that, basically, if we went to this optional system, we would have a large number of national companies that would, basically, go for the Federal charter and keep their fingers crossed that the regulatory regime would stay reasonable.

And you would have a withering of State insurers and you would have a few insurers that would just specialize in certain State or certain niches. And that is probably a market segmentation that would result.

Senator ALLARD. Personally, I like to hold down the regulatory environment, but sometimes I do not know how much company I have on that effort.

Senator Johnson.

Senator JOHNSON. Well, thank you. I would only observe that our friends in the banking industry do not seem to be going back and forth between Federal and State charters depending on which party is in the White House. I think that the regulatory balance has been fairly stable there.

Let me just ask a couple questions to each of you. One of the early on debates that we have had relative to a Federal regulator is whether that regulator is more appropriate for life insurance than it is for property and casualty, or whether we ought to stick to a more comprehensive approach, and that there is no necessary advantage or disadvantage either way.

Would either of you care to comment? Is there one element of the insurance industry that is significantly where a Federal regulator more justifiable than another?

Mr. HARRINGTON. That is a very interesting question. I have not reached a final conclusion.

But seriously, at times I think that the speed to market issue and the competition of life insurance companies with other financial institutional and the accumulation of management business creates an additional edge which makes it very, very important for them to get more uniformity and more rapid speed to market.

But when I go down that route, I start thinking about prior approval rate regulation or property casualty insurance, residual market rate caps, and all of those things, as well as the fact that in the modern world, many of the larger entities, of course, have life insurance and property casualty insurance.

So, things really are not that simple across product lines.

Mr. KLEIN. And my response would be that to a certain extent, I think you have got a point. I think for life insurance and annuity products we would not expect there to be significant differences between States in terms of what people need, other than income levels might be different. So that does kind of lend itself, perhaps, to greater uniformity and that is probably one of the reasons why the NAIC has adopted uniform standards in that area more readily.

But the other side of this is that I do feel, and I agree with Scott, that there does need to be a lot of reform on the property-casualty side. There is a lot of regulation there that simply, in my view, is not necessary, or potentially harmful. And the States need to make further, major moves in that area.

And if they would be willing to do that with the type of institutional structure I described, that would be terrific. If not, then I think maybe optional chartering would have to be the alternative. But, one way or another, I think those changes need to occur, and so we have got to get there somehow.

Senator JOHNSON. And Dr. Harrington, some of your publications in the early 1990s, you concluded that Federal regulation of insurance and the possible optional Federal charter would not have been an appropriate response and not justified at that time. But since then, you have concluded that States' regulation of rates, rate classification and policy forms remain dysfunctional in many States and with no obvious end in sight.

Can you elaborate just a bit on what has led you to decide that now is the time to start considering Federal regulation or possibly an optional Federal charter? Were there situations and specific organizations and States that led you to the conclusion that States can no longer do an adequate job of insurance regulation.

Mr. HARRINGTON. Senator Johnson, that is an excellent question. I have had to really think long and hard about that issue.

I think in the past 3 or 4 years I became even more distressed by what I observed in terms of the politics of State regulation. And I also became more knowledgeable and aware and concerned about international insurance, international insurance competition, and the competition between insurance companies and other financial institutional than I had been previously.

My earlier writings, to some extent, more focused on insolvency problems that had arisen and arguments for Federal chartering that related to alleged defects in State oversight of insolvency. And I felt that the States had taken actions and done some things that had redressed those problems.

But it is really an evolution of the modern economy, as well as seeing State regulation in action, in some cases, up close and personal, and I found it to be very distressing.

Senator JOHNSON. Let me close with just one last question to Dr. Klein.

In your testimony, you stated that you had a concern that you had with adequacy of State regulation of agents and brokers and noted some instances of fraud.

Is this a symptom of the patchwork of State laws and regulations in this area, or do you think a Federal regulator would be more effective in educating and regulating agents and brokers in enforcing stringent standards of conduct?

Mr. KLEIN. That is an interesting question. I think it does have something to do with a patchwork. I mean, there is a lot of variation and some States, I think, do a much better job of regulating and ensuring the competency of agents than others.

It is possible that a Federal regulator, if it really focused on it properly, could do a better job of making sure that agents were competent and did not commit fraud or abuses.

But, on the other hand, a good State regulator that is very focused, that has very good standards, is very hands-on, can be effective; but there is a potential for problems in States that have not handled that well.

And I am sure there are a lot of instances like that.

Senator JOHNSON. There is a great deal of variability. So, that is where the recommendation that I would make is that I would have uniform standards, but I would make them rigorous.

Mr. KLEIN. Yes. There is a great deal of variability.

Some of this has to do with incompetence and some of it has to do with outright fraud. The fraud is a problem that deserves a different type of enforcement approach. But the incompetence thing is also an issue and that really is a matter of not only having high competency requirements, but making sure that the agents continue to maintain that level of competence.

Senator JOHNSON. Having some kind of Federal standard or Federal regulator may, in fact, be on the side of consumer protection.

Mr. KLEIN. In that respect, it could be. Yes.

Senator ALLARD. Senator from New Hampshire.

Senator SUNUNU. Thank you.

Dr. Harrington, Under Secretary Quarles spoke about what he perceived to be the problems with rate and price controls. I take it that you generally agree with his assessment.

Is there a particular aspect of price controls, or a particular effect that price controls have on insurance markets that your research has shown to be particularly problematic?

Mr. HARRINGTON. The two most problematic aspects are the tendency for some States, occasionally, not to allow rates to go up on average commensurate with the growth and claim costs.

It creates availability problems and increases residual markets. It also tends to lead to changes that bump around more than what they probably need to.

Senator SUNUNU. Greater volatility.

Mr. HARRINGTON. Right.

And then the other thing is very State specific, it is when there are decisions made, really, to hold down rates for certain segments of the population in ways that produce substantial deficits in residual markets.

And, over time, they require greater rates for the voluntary market. So you end up in those mechanisms by trying to lower rates to some, you end up raising rates to others. I think that is negative sum.

Senator SUNUNU. He noted that over 40 States still have some kind of rate and price regulation. What is the international experience? Do our counterparts in Europe, for example, still regulate prices in insurance?

Mr. HARRINGTON. I do not have detailed information in all countries, but in Europe, in general, the movement has been in the past 15 years, away from price regulation and toward reliance on competition, with some very narrow exceptions related to public health insurance programs.

Senator SUNUNU. How would residual markets operate in an environment without price controls? How can Government, broadly speaking, a Federal regulator in this particular case, ensure that the main objective of residual markets continues to be met in a world where we do not have price limits, price caps, price controls?

Mr. HARRINGTON. Senator Sununu, that is an important question and a difficult one. In principle, I think that it is easy to say that with Federal chartering, federally chartered insurers should participate in State residual markets, but those markets must be designed so that the rates that are charged are self-sustaining.

The question is, how do you actually get to that result and practice?

For the types of insurance that we are generally concerned with, and ignoring catastrophe coverage, which can be troublesome, it is possible for reasonable——

Senator SUNUNU. I am sorry. When you say catastrophe coverage, what are you talking about.

Mr. HARRINGTON. I think certain types of—the hurricane risk——

Senator SUNUNU. You are talking about specialty insurance, not general property casualty, auto insurance.

Mr. HARRINGTON. For Worker's Compensation insurance, automobile insurance, it is quite possible to get a handle on what rate adequacy should be for the market of last resort.

Many States have done this for decades and, as you know, their residual markets for automobile insurance have been very tiny, because the rates for the residual market do not crowd out the private sector.

Senator SUNUNU. Are there any residual markets for hurricane insurance or earthquake insurance?

Mr. HARRINGTON. Yes. There are. We have the special State systems in some States. I do not know if they would fall under the rubric specifically of residual market.

And we also have beach and windstorm plans in a number of the coastal States.

Senator SUNUNU. But you are suggesting that there are some markets where insurers are forced to offer and sell hurricane insurance?

Mr. HARRINGTON. In a number of the States for many years, there have been regions on the coast that have been designated as eligible for coverage through a beach State—beach and windstorm plan—which is, in essence, a residual market.

When those plants have performed well, the rates have helped affordability, but they have not produced large cross-subsidies and assessments.

Senator SUNUNU. But is insurers participation in those plans compulsory?

Mr. HARRINGTON. I believe it is in some States. I cannot be certain on all the States.

Senator SUNUNU. Excellent. Thank you. You talk about it being ideal to narrow the scope of the guarantee funds.

What does that mean?

Mr. HARRINGTON. Let me give an example. In some of the States, have no guarantee firm protection for large commercial insurance buyers that have net worth in excess of some threshold.

Large entities with resources do not need to be protected against the consequence of their insurers' default. They can manage that risk and they have the wherewithal to identify safe insurers to keep that from happening.

So, there is not a strong public policy reason to rope in large corporations as an example and give them protection. It is similar to banking, where you have uninsured depositors.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

Senator ALLARD. I would like to follow up on the guarantee fund question that Senator Sununu was pursuing. On an optional Federal charter system, should the guarantee funds be administered at the national or the State level? And what are the implications of each type of administration?

Mr. HARRINGTON. I have not thought through what should happen. My thinking has been more on what I guess is likely to happen. I think once you have Federal-chartered insurers and State-chartered insurers, I think it makes perfect sense to have the beginning of the system be participation in the State guarantees by Federal-chartered insurers.

I think there will be pressures over time that would tend to move toward having some nationalization of that system.

In terms of the specific administration of a national system, I have not thought about it.

Mr. KLEIN. Yes. I would just add to that. I agree with Scott about the short-term. I think over the long term there is a problem when the administrator of the guaranty fund, so to speak, or you have a situation where States regulation of insurers that come under its purview for financial purposes could potentially draw or impose costs on insurers that are, say, nationally regulated.

When you get, basically, a disconnect between a regulation and the payers, or the guarantors, you have got a problem. Now, you actually have that problem right now, under the State system. And that could be potentially worsened with federally chartered insurers still contributing to State guaranty funds.

So, I think over time that kind of conflict would need to be resolved. Actually, what exists, I think, in banking right now seems to me to make a lot of sense.

Because, as I understand it, the FDIC guarantees both the Federal banks and some of the State banks. And, basically, their rules ultimately determine the financial standards, to a great degree, for those institutions.

So, whoever the guarantor is, their standards and their rules ought to apply over the entities that are being covered so that you do not have this disconnect between the responsibility of guarantees and the control over financial risk.

Senator ALLARD. And another question along the same lines, what are the implications of the funding guarantee funds through assessments after insolvency, as is currently done by States other than New York, as compared to a system that collects annual assessments regardless of insolvency, such as under the FDIC.

Mr. HARRINGTON. I like the way *ex post* assessment has worked in general in insurance markets, because, with some exceptions, insolvency assessments have been very minor.

The historical risk associated with those assessments is the type of thing that can readily borne on an *ex post* basis. And there are mechanisms when assessments increase and they may hit limits for making sure that the claims get paid.

Ex post assessments for many companies, but not all companies, create, I believe, additional incentives for them to pay attention to what regulators are doing and how effective solvency regulation is and how effective liquidation of insolvent companies is.

It gives them, I believe, possibly, more skin in the game, than if they put money into a pot that accumulates over time which they view as gone once it leaves their coffers. And I think that is another useful reason to have *ex post* assessments.

And another thing, the major advantage of charging insurance companies in advance would be, if you could, in principle, have risk-tailored premium for guaranteed protections, so that an insurer would have more insolvency risk would face a higher *ex ante* premium, which, in turn, would give them an incentive to reduce their insolvency risk.

But I doubt that, in practice, we will ever get to the point where we have reasonably accurate risk-based premiums for guarantees for insurers. And my reason for that is understanding some of the politics and having observed bank regulation.

Senator ALLARD. Do you agree, Dr. Klein?

Mr. KLEIN. Pretty much. I mean, I also would like to see risk-based assessments, whether post or pre, and I think actually, you could have a risk-based post assessment, as well as a risk-based pre-assessment.

But I also agree that it would be a highly politically charged process. Even though, theoretically, if Scott and I were running the system, we could probably develop good risk-based charges, but the people that would be actually in that situation would be under a lot of pressure.

So, I am not sure that you would get the result that you would, ideally, like to have.

Senator ALLARD. Let me get back to what I was trying to get at in an earlier question. I am going to put this in a little different format.

Let me direct this to you, Dr. Klein. Someone suggested that life insurance and property casualty insurance are fundamentally different products. Life insurance is a more national product, and therefore creating an optional Federal charter for life insurance companies is more appropriate than for property and casualty insurance companies.

What is your view, and does an optional Federal charter make more sense for life insurers than for property casualty insurers?

Mr. KLEIN. Well, as I indicated before, perhaps to an extent, there is more commonality among life insurance products and less of a State variation issue there.

So, one could make that argument, but I would not take that too far because the argument that the conditions for property-casualty insurance in the various States vary so much that uniform requirements, whether done through an interstate compact or done through optional chartering, or whatever, would not work because States are so different in terms of their situations is not valid in my view.

I put in my written testimony, that I do not really buy that. There are some differences, but, basically, if you look at the property-casualty insurance products that are typically sold in various States, other than needing to meet different State laws, they are pretty similar.

And so, I do not see variations among States being an argument against uniformity in product regulation in the property-casualty arena. And, in fact, I would advocate it for both, both life and property-casualty. Understanding that maybe in life insurance, there would be a little less of an issue or concern about State variation.

Senator ALLARD. Dr. Harrington, do you have a comment?

Mr. HARRINGTON. Yes. I do. The local nature of torte liability law and Worker's Compensation law, I believe, at the margin, makes the property casualty insurance business more local than the life insurance business.

But on the other hand, some of the inefficiencies associated with misguided regulation are particularly pronounced for property casualty insurance and, in particular, what we have been discussing in terms of rate regulation and residual markets.

So, I do not have a strong opinion that one deserves more than the other. I think that in property casualty insurance, there are things that State regulators do that can have spillover effects on insurance buyers on other States. And at the margin that justifies some sort of national response.

Senator ALLARD. Some have said that the reason we have put in place rate regulation is to prevent a race to the cheapest policy.

And then, by doing that, they under-price their policies based on competition of the market. Is rate regulation still justified to prevent a race to the bottom as some suggest? And could solvency regulation take the place of rate regulation in making sure insurance companies maintain adequate reserves to pay future claims?

Mr. KLEIN. OK. I will answer that first, and let Scott give his opinion. It is an interesting question that a lot of people have asked me. And, based on my research, rarely, if ever, have I seen a regulator disapprove a rate cut, no matter how severe.

And a good case in point, I guess, is what Reliance was doing in Pennsylvania, or the other States in which it was operating. I mean, I am not aware of any regulators who said Reliance, you should not cut rates so far and keep spending so much money.

I mean, for political reasons, and this basically happens in commercial lines, a regulator is not going to oppose a rate decrease. So, the only kind of situation that probably one could contemplate, although I do not know that this has ever really occurred is that if an insurer got to a point where its rate cuts were so severe relative to its expected losses that it did threaten its solvency—and admittedly, I think Reliance was such a case—one could make an argument that there should have been some earlier intervention by regulators. But for whatever reason, reasons I would like to know myself, that did not occur.

Basically, my response is that I do not think that rate regulation can deal with the under-pricing phenomenon. I think experience has shown that.

Potentially, a more active or proactive solvency type of approach could deal with the companies that cut prices so far that their solvency is threatened, which tends to have a depressing effect on the rest of the market.

Senator ALLARD. Any comments, Dr. Harrington, on that question.

Mr. HARRINGTON. I agree with Dr. Klein and I think regulators can pay more attention to companies that they think might be under-pricing in the sense of taking a closer look at their solvency.

But I just agree with Dr. Klein.

Senator ALLARD. Let me go to something more local, as far as my State is concerned. Now, I understand that the NAIC is attempting to address one of the industry's most pressing concerns, and that is slow product approval through the use of an interstate compact.

In Colorado, they brag about the fact that they are the first State to adopt the compact. Now, what are your thoughts on this initiative—and it seems to be moving ahead successively. So, is it necessary for Congress to consider an optional Federal charter? And, if so, why is an interstate compact insufficient, and what are the problems with it?

Mr. KLEIN. Well, I have done a little bit of reading about this, but I have to admit I have not really had an opportunity yet to really thoroughly access how well it is working and what the companies think about it.

It sounds promising, but I, at least, have a couple of issues. One is, will other States join this? And two, I would be interested in knowing what the companies who go through this process, what their assessment of it is, and whether they feel that it does satisfy their need for streamlined and uniform approval of products.

So, it sounds like it is a good idea and it may be accomplishing quite a bit of progress, but I have not really been able to assess it.

Senator ALLARD. As I understand it, this compact just has four general areas, life, annuity, disability, and long-term care insurance.

Mr. KLEIN. Right.

Senator ALLARD. Yes.

Dr. Harrington, did you have a comment?

Mr. HARRINGTON. I regard it as a very positive development in general, but it will forever be incomplete and it is a slow process.

Senator ALLARD. OK. I am going to draw the Committee hearing to a close.

Again, I would remind this panel as well as the other panel that Committee members have a week with which to submit questions, and then we would ask that when you receive the questions, you get it back to the Committee within 10 days, if you would, please.

I would like to thank Under Secretary Quarles, Dr. Harrington, and Dr. Klein for their testimony before the Banking Committee. Insurance regulation is a highly complex topic, and their testimony has aided our understanding of the issue. In particular, their responses during the question and answer period will be invaluable as we continue to explore the appropriate regulatory reforms.

Just like Chairman Shelby, there are many members with other commitments this afternoon, and I am sure that many of them would like to take advantage of our witnesses' expertise by submitting those questions for the record. Therefore, we will hold the record open until the end of the week, should they wish to submit any questions.

Witnesses, this is an important topic for the Committee, so we would appreciate your prompt response to the questions.

Thank you all for being here today. This hearing is adjourned.

[Whereupon, at 3:42 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF RANDAL K. QUARLES

UNDER SECRETARY FOR DOMESTIC FINANCE
DEPARTMENT OF THE TREASURY

JULY 18, 2006

Good afternoon Chairman Shelby, Ranking Member Sarbanes and Members of the Committee. Thank you for the opportunity to appear before you today to discuss the role of insurance in our economy and the need to modernize the regulation of insurance. This is an important topic, one that affects not only the efficiency and competitiveness of a significant U.S. industry and a central function of the U.S. financial system, but one that has broad consequences as well for the ability of our economy as a whole to innovate and to grow.

INTRODUCTION

In the first instance, the issues surrounding insurance regulation are significant because the U.S. financial services industry is one of our country's most important areas of economic activity, and the insurance industry is a large part of the U.S. financial sector. According to the Federal Reserve, at the end of 2005, total assets held by U.S. insurance companies totaled $5.6 trillion, as compared with $11.82 trillion for the banking sector, and $10.5 trillion for the securities sector.

In addition to the size and importance of the insurance industry considered solely in itself, however, insurance—like other financial services—has substantial ripple effects through the economy as a whole. Insurance performs an essential function in our overall economy by providing a mechanism for businesses and the general population to safeguard their assets from a wide variety of risks. The ability of businesses to insure against risk adds a degree of certainty to their planning and thus contributes to greater economic activity and enhanced economic growth. The general population also benefits from being able to purchase protection for various types of losses that would be difficult for individuals to absorb on their own. Insurance companies are in the business of managing these risks. They specialize in evaluating the potential for losses and perform an important function by spreading that risk widely across various segments of our economy and population.

Insurance is also like other financial services in that its cost, safety and ability to innovate and compete are heavily affected by both the substance and the structure of its system of regulation. As a result, then, both of the industry's importance considered simply as a separate line of economic activity as well as its consequences for commerce and economic growth more broadly, we should seek to ensure that the regulatory system for the insurance industry is consistent with the efficient and cost-effective provision of its services and with continuing evolution and innovation in the design and distribution of its products.

In that regard, there appears to be virtually no disagreement that the current State-based insurance regulatory system could benefit from further modernization. There have been a variety of approaches that have been considered: State-driven efforts at reform, total Federal preemption of the State-based system, the setting of Federal standards for States to administer, and the creation of a dual chartering structure that would allow insurers to opt for either State or Federal regulation.

Unlike the banking and securities sectors, insurance is solely regulated at the State level, and while this multiplicity of regulators can provide certain benefits in the form of local expertise and control, it does raise a number of issues that deserve further consideration. In our view, those issues fall into three main categories:

- Potential inefficiency, resulting both from the substance of regulation (especially price and form control) but also from its structure (the inevitable duplication and cost associated with multiple non-uniform regulatory regimes);
- International impediments, both questions of comity (facilitating international firms' operations in the United States, which benefits U.S. consumers) and competitiveness (facilitating U.S. firms' operations abroad, which provides growth opportunities for U.S. industry and helps diversify their risk exposures);
- Systemic "blind spots", the inability of the official sector to understand and respond to the insurance sector's evolving contribution to risks affecting the financial system as a whole.

At the most fundamental level, the question posed in each of these areas is whether our current system of insurance regulation is up to the task of meeting the challenges of insurance regulation in today's evolving and increasingly global insurance market. More broadly, we should evaluate whether the benefits of regulatory competition (which are fostered by our existing structure or other multiple-regulator structures) are outweighed by the costs of regulatory fragmentation (which are significant in a 50-State system).

BACKGROUND

The current structure of insurance regulation in the United States is the result of a long history. In 1868, the U.S. Supreme Court concluded that the issuance of an insurance policy was not interstate commerce, and therefore outside the constitutionally permitted scope of the Federal Government's legislative and regulatory authority *(Paul* v. *Virginia).* In 1944, some 76 years later, the Court reversed itself holding that insurance was indeed subject to Federal regulation and Federal antitrust law *(United States* v. *South-Eastern Underwriters Association).* In 1945, before any assumption of Federal regulatory authority over insurance, Congress passed the McCarran-Ferguson Act, which "returned" the regulatory jurisdiction over the business of insurance back to the States, and generally exempted the business of insurance from most Federal laws provided such activities were regulated by State law.

Under the current State-based regulatory system, each State has a chief insurance regulator, generally referred to as "commissioner," who is charged with administering State insurance laws, promulgating regulations, and other duties pertaining to the supervision of the business of insurance. In most States the insurance commissioner is appointed by the Governor. In 11 States, including California, the commissioner is elected. Each State commissioner is a member of the National Association of Insurance Commissioners (NAIC) that was founded in 1871. The NAIC is the primary vehicle through which State insurance regulators exchange information and coordinate activities to enhance the effectiveness of insurance regulation.

State insurance regulation can be divided into two broad categories:

- Solvency or financial regulation aimed at preventing insurer insolvencies and mitigating consumer losses should insolvencies occur; and
- Consumer protection and market regulation focused on potential anti-consumer practices.

Each State enacts State-specific insurance laws. The NAIC has developed model laws and regulations covering various aspects of the insurance business in an effort to achieve greater uniformity. In the solvency and financial regulation area these range from accounting and investments to solvency/market examinations, holding companies, insider trading and proxies, and reinsurance. In the consumer protection area these model rules cover matters ranging from privacy protection, deceptive advertising, unfair policy terms, and discriminatory or unfair treatment of policyholders. Many model laws must be approved by State legislatures before they can be implemented, while some States may have the authority to adopt model regulations in certain areas without legislative action. The adoption of model laws and regulations has been spotty at best. It is a cumbersome process that, in many cases, can take a number of years. It also allows for variation in implementation across States.

The State-based insurance regulatory system was subject to significant criticism in the 1980s after several major insurance companies became financially impaired. At that time, there were calls for regulatory reform, including a proposal for a preemptive Federal regulator. State insurance regulators, sensing that the State-based system was in jeopardy, made some impressive strides in undertaking initiatives to reform State solvency regulation. They established an NAIC Accreditation Program requiring the adoption of designated model laws and regulations, and a review of the insurance regulatory agency of each State by an independent review team to assess compliance with the required standards. As a result, today there is a relatively uniform solvency regime that has been implemented across the States. However, in other areas of regulation, the States appear to be much more reluctant to adopt uniform standards.

Another important aspect of the State-based insurance regulatory system is its system of guaranty funds. Unlike the system that is in place for federally insured depository institutions, there is not a Federal guarantee ensuring that policyholder claims are paid. Each State operates its own guaranty fund, and typically separate funds are maintained for property/casualty insurance (mostly personal lines) and life/health insurance. If an insurer becomes insolvent, the State insurance regulator typically is appointed as the liquidator. As liquidator, the regulator appoints a receiver to manage the liquidation. The guaranty fund then works with the receiver and assumes responsibility for the payment of a specified portion of the claims that would otherwise have been paid by the insurer. The State-based guarantee system is funded primarily on a post-assessment basis, with all insurers that write particular types of business being subject to an assessment to fund losses.

KEY ISSUES IN CONSIDERING INSURANCE REGULATORY MODERNIZATION

An important part of this debate is what should be the role, if any, of the Federal Government in insurance regulation. While the State-based system has a number of potential merits—such as local knowledge of insurance market conditions and preserving local decisionmaking over key aspects of activity within a particular State—it does raise a number of issues that need to be considered as financial markets evolve in this country and abroad. The key issues I will focus on today are: potential inefficiencies associated with the State-based system—most prominently undue regulatory burden and price controls; international implications for free markets and competitiveness; and fully understanding the impact of the insurance sector on financial sector soundness.

Potential Inefficiencies of the State-based System

As I indicated, there is virtually no dispute over the fact that there is a general need for modernization of the current State-based system. One aspect of modernization has been a focus on the lack of uniformity in State regulation. Even though the NAIC has achieved some success over the past 135 years in fostering more uniformity among the States, many of its model laws and regulations have not been enacted by the States. States interpret these model laws differently, and craft individualized exceptions to them. This should not be a surprise given that the general nature of State legislatures and regulators to preserve authority in areas where it is perceived to be warranted.

Nonetheless, differing State insurance regulatory treatment can lead to inefficiencies and undue regulatory burden. This can directly limit the ability of insurers to compete across State boundaries. Reduced competition can diminish the quality of services, consumer choice, and ultimately lead to higher prices.

At the most basic level, States have individual requirements that insurers and producers (*i.e.,* agents and brokers) must meet to operate in each State. For example, all insurers must receive a license from each State in which they plan to do business. While the NAIC has tried to simplify this procedure, the filing requirements for licenses can vary significantly from State to State and companies must still ascertain and comply with those requirements.

All States also require a license from those who wish to sell insurance, and the licensing process also varies from State to State. The multi-State licensing of insurance producers has been somewhat streamlined in recent years thanks to the provisions of the Gramm-Leach-Bliley Act, which provided for a Federal preemptive producer licensing system (the National Association of Registered Agents and Brokers) that served as a threat to the States to develop a more unified system. The States responded and established a system that established the required reciprocity arrangements. Reciprocity arrangements have somewhat streamlined the process; however, agents must still obtain a license in each State in which they do business.

Another area of potential inefficiency is form approval regulation. Form approval is the system or process by which State insurance regulators review and approve (or disapprove) policy forms insurers wish to use in a State. There are at least seven categories of State policy form approval systems, including the use of State required forms, strict prior approval of forms, "file and use," "use and file"—to no form filing required. State form approvals can be based on any number of factors. For example, some States require certain disclosures and descriptions of coverage, some even specify the proper typeface sizes and the color of ink, as well as specifying that the disclosure has to be on the first page of the policy—a requirement that can make an insurer have to have State-specific cover pages for their policies. Some States also require special disclosures for particular products such as small face amount life insurance policies, or special "buyer's guides" or policy endorsements for certain products. Requirements for descriptions of coverage can also vary from State to State, with some States requiring the language text itself to be based on specific readability standards, such as a minimum score of 40 on the Flesch reading ease test or compliance with some other test approved by the commissioner.

The NAIC made efforts to achieve a higher degree of uniformity in product approvals by launching such programs as CARFRA (Coordinated Advertising, Rate and Form Review Authority) and SERFF (System for Electronic Rate and Form Filing). In addition, just last month some 27 States entered into an Interstate Insurance Product Regulation Compact that would provide for uniform national product standards for the products sold by life insurers (life insurance, annuities, disability income insurance, and long-term care insurance). While these efforts may lead to some degree of greater uniformity, it is still up to each State to interpret and enforce such standards.

States justify form approval as a necessary tool for consumer protection. However, there should be a careful analysis of the cost and benefits of these requirements at the individual State level. In addition, having multiple technical State requirements makes it very difficult, and very costly, for an insurer to roll-out a new product on a nation-wide basis.

Perhaps the greatest potential for inefficiency in the current State-based system is with price controls. Insurance is perhaps the last major market in the United States with direct price controls. The term "price controls" is frequently used to describe State regulation of rates used by property/casualty insurers licensed or admitted in a State (referred to as the "licensed/admitted market"). This market includes such personal lines of insurance as automobile and homeowners, as well as a substantial portion of the commercial lines of insurance such as fire, burglary, theft, workers compensation, and commercial automobile. The basic legal standard for rates in all States is that they not be "inadequate, excessive, or unfairly discriminatory." In the early years of State insurance regulation, the emphasis was more on whether rates were adequate, and thus would prevent solvency problems. However, more recently it seems as though most of the controversy over price controls has concerned efforts of State regulators to hold down prices for their constituents by denying rate increases on grounds that they are excessive.

States address rate regulation in a number of different ways. For example, as to rates on most lines of commercial property/casualty insurance; 5 States have no filing requirements (No File); 2 require informational rate filings only (Information Only); 9 allow rates to be used without pre-filing, but they must be subsequently filed (Use and File); 13 require filing before they are used (File and Use); and 19 require rates to be filed and approved before they are used (Prior Approval). Of the 43 States with some degree of rate control, many also provide for the exemption of rate approval requirements on certain large commercial property/casualty policies based on the amount of the premium charge or size of the policyholder.

One of the fundamental principles of economics is that price controls result in inefficient outcomes. If the mandated price is set above the market clearing price, the result will be surpluses; if the mandated price is set below the market clearing price, the result will be shortages. The latter outcome is what we generally observe in insurance markets with strict price controls. When insurers are unable to charge what they feel is an adequate rate for their product, they generally tighten their underwriting standards in order to limit their writings to "preferred" risks that are less likely to suffer an insured loss. Not being able to charge an adequate rate also limits insurers' abilities to price on the basis of measurable differences. To the extent that prices do not accurately reflect differences in risk, low-risk consumers are effectively forced to subsidize high-risk consumers. This obviously leads to shortages in the voluntary market, or a "tightening market," and increases demand on what is referred to as the residual markets. Residual markets, known also as "shared" or "involuntary" markets or "markets of last resort," are State-sponsored mechanisms that provide consumers with another way to obtain automobile, property, or workers compensation insurance coverage.

For example, where a driver with a history of multiple accidents applies for insurance, an insurer might be willing to write the coverage if it could charge a rate commensurate with the risk. However, if that rate was more than the State regulator allowed it to charge, then the insurer would likely refuse to write the policy. If no other insurer in the voluntary market were willing to issue coverage at an approved rate, then the driver could apply to the State's residual market (sometimes referred to as the "assigned risk pool.")

All licensed insurers in a State are generally required to participate in that State's residual markets, typically by assuming a fair share of the residual market's operating results. Residual market programs are rarely self-sufficient, and where the premiums received are insufficient to support the program's operation, insurers are generally assessed to cover the resulting deficits.

The residual market mechanism is the way that States address the shortages that are caused by price controls. While it is theoretically possible for the price control/residual market mechanism structure to duplicate the result that would occur in the absence of price controls, that outcome seems highly unlikely. At the most basic level, given that the residual market mechanism structure requires all insurers to share in the fortunes of the residual market mechanism, as the size of the residual market grows, it would be likely that fewer and fewer insurers would be willing to do business in that line of insurance. As insurers pull back from that line of insurance, further pressure is placed upon the residual market mechanism. So in a broad sense, one potential outcome of the price control/residual market mechanism structure is that it artificially restricts the number of insurance suppliers in a particular market. States typically respond to this outcome by adjusting prices to preserve the viability of that particular market.

Most evidence indicates that there is a strong correlation between the size of residual markets and price controls: the larger the residual market you find in a State, you will also generally find a tighter market and a higher degree of rate inadequacy—often the result of price controls. In other words, price controls generally result in elevated residual market populations when the permitted rates are lower than indicated by market forces.

Automobile insurance is often cited as an example of problems with State price controls. In 2004, the average nationwide percentage of private passenger cars insured through residual market mechanisms was 1.5 percent. However, in States with more restrictive price controls, such as North Carolina and Massachusetts, the percentage of private passenger cars insured through the residual market was, respectively, 24.2 percent and 6.5 percent. In general, States with a less restrictive regulatory environment (*e.g.,* Illinois and South Carolina) are generally characterized by lower and less volatile loss ratios, smaller residual markets, and insurance expenditures below the national average.

Another example is workers' compensation insurance, which is often pointed to as the line of insurance with the greatest degree of rate regulation. In the last few years, the percentage of workers' compensation premiums in residual markets has been on the increase. Among those States that report through the National Council on Compensation Insurance (25) the residual markets' share has increased from 3.2 percent in 1999 to 11.5 percent in 2005, and was even as high as 12.7 percent in 2004. There is also wide variation among individual States, with 2005 market shares ranging from 1.1 percent in Idaho to highs of 22.7 percent in New Jersey and 20.5 percent in Massachusetts.

International Issues

U.S. firms and firms from abroad in insurance, banking, and securities compete across the globe and around the clock. Clearly foreign sources of insurance capital are important for a robust U.S. insurance market.

As noted above, the lack of uniformity in our State-based insurance system has the potential to lead to inefficiency and undue regulatory burden. While all insurance companies that are licensed to operate in the United States are subject to same regulatory standards, foreign firms likely find adapting to such standards more difficult. From the international perspective, issues that have been raised in bilateral financial regulatory discussions with foreign officials are that our insurance market has at least 50 different regulators, and they or their insurance companies have no single regulator to coordinate with on insurance matters. Navigating the State-based insurance regulatory structure is likely a challenge for a new foreign company seeking to do business in the United States and has likely impeded the flow of capital into the United States to some degree. Issues that have been brought to our attention include: rate and form approvals; capital adequacy standards; and guarantee fund membership.

The U.S. insurance market, in particular the global nature of insurance, is vastly different than it was six decades ago when McCarran-Ferguson was enacted. To give an example of the sort of efforts underway internationally, the European Union (EU) is continuing its work on its Solvency II project focused on insolvency risk for insurers in preparation for its scheduled introduction on an EU-wide basis in 2010. Solvency II is an important undertaking for it encompasses quantitative capital requirements, a supervisory review process expected to harmonize the procedure in Europe, and it will conform to disclosure requirements with those of the international accounting standard-setters. This is all part of the effort to forge one insurance market for the twenty-five member States in the EU. Reflecting the growing international nature of the markets, the NAIC is working closely with international regulators on a number of projects, such as Solvency II in the EU, on international accounting standards, and others. The NAIC itself is not a regulator but facilitates communications among the States on international regulatory issues. To that end, it engages in regulatory cooperation with international insurance regulators and through Memoranda of Understanding (MOUs), and supports individual members by providing technical assistance to regulatory agencies. The NAIC also coordinates closely with Office of the U.S. Trade Representative in international financial services negotiations, and it participates in Treasury's financial markets regulatory dialogues with various countries, including China, Japan, and the EU.

To sum up, there is significant work underway in international insurance regulation to reflect the changes taking place in the United States and global insurance markets. In evaluating proposals to modernize our system of insurance regulation, we, too, need to consider what will best serve us in maintaining an insurance marketplace that attracts capital and does not set up artificial and costly barriers. A number of countries are pushing forward with regulatory systems seeking more uniform, efficient and stronger insurance sectors, in order to underpin more and better products for their consumers with less risk to the financial system.

Lack of Federal Understanding of Risk in the Insurance Market

As previously noted, the insurance sector is a critical part of the broader U.S. economy and in terms of size alone a key participant in the U.S. financial sector. In comparison to other financial institutions, it could be argued that financial problems at an insurer or reinsurer pose less potential to generate broad economic problems or pose systemic risk in the financial system. The immediate financial problems from the failure of a large insurer or reinsurer could be limited given the nature of insurance contracts (*e.g.,* delayed payments, dispersed risks, and timing of in force coverage) and the general funding strategies of many insurers (*e.g.,* a focus on meeting potential near term liquidity needs to pay claims). Nonetheless, there remains some potential for disruptions in the insurance market to impact economic activity and financial markets. And importantly, these potential risks may not be well understood at either the State or Federal level.

At the most basic level, the failure of a large insurer or reinsurer could place stress on State guarantee funds and to policyholders that do not have guarantee fund protection (mostly large commercial organizations). This could in turn have a negative impact on the broader economy, which could also impact other financial institutions. While market participants should perform their own due diligence when they enter into insurance contracts, given the magnitude of potential consequences of a large insurer insolvency the Federal Government should have a better understanding of the nature and potential for such an event.

Given that the insurance sector is also a direct participant in a number of financial markets, either through direct credit exposures or through derivative counterparty relationships, financial problems at insurers could be transmitted throughout the broader economy. For example, there has been a considerable amount of attention paid to the expanding credit derivatives market. While there are a number of issues that might warrant attention, as with many other derivative contracts, a credit derivative is very similar to an insurance policy that pays off when certain credit events occur. Given the close correlation to insurance, insurance companies appear to be taking a more active role in this market. From an overall perspective of market stability, do we fully understand what risks insurance companies are undertaking, or how their activity could impact the credit derivatives and other financial markets?

In addition to broad areas of financial sector stability, there has been a convergence across some product lines that are offered by banking, securities, and insurance firms. This is particularly true in regard to wealth management products. Many wealth management products serve a similar purpose (*e.g.,* variable rate annuities and mutual funds), but are offered by firms with different charters and underlying regulatory structures. Any underlying economic reason for treating like products differently for regulatory purposes has blurred over time. Much like the State-based insurance system, differing regulatory treatment for like products adds complexity and creates potential problems for the free flow of capital. Given the general efficiency of capital markets, differences in regulation (whether through capital standards, product approval standards, or otherwise) and differences in tax treatment can direct capital flows away from their most efficient uses. These are all areas where the Federal Government should have a better understanding of potential implications.

What should be apparent is that the insurance industry is extremely complex. While the State-based system has made improvements in solvency and holding company regulation, under a structure with over 50 different regulators it may even be somewhat difficult for individual State regulators to get a firm handle on the risks that large complex insurance companies pose to our Nation's insurance system. Add into that mix that the Federal Government has little to no role in the State-based insurance regulatory system, and we are left with what could be a large blind spot in evaluating risks that are posed to the general economy and financial markets.

CONCLUSION

To sum up, it is clear to us—as we think it is to most observers—that our current system of insurance regulation requires modernization to meet the challenges facing the insurance industry, and financial services, generally, in the 21st century. Our existing system of regulation has the potential to lead to inefficient economic outcomes (raising the cost and reducing the supply of many insurance products), deters international participation in our domestic markets (again raising costs and limiting consumer choice), creates obstacles to our own insurance firms' international expansion, and limits the ability of any one regulator to have an overview of risk in the insurance sector and its contribution to risk in the financial system more broadly. These are issues of importance not just to the insurance industry, or even the larger financial services industry, but to the economy as a whole, because of the essential role that the mitigation of risk through insurance has in promoting commercial activity and enhancing economic growth.

Treasury has been closely monitoring the developments of the various approaches to modernizing insurance regulation—ranging from the self-initiated approaches of the State regulators, and establishing Federal standards for the harmonization of State insurance rules, to the concept of an optional Federal charter now being considered by this Committee. While we are still evaluating what approach we believe to be the most appropriate, what is clear is that each of them should be evaluated in light of the fundamental issues we have discussed today. Again, thank you for addressing the issue of insurance regulatory modernization and for giving me the opportunity to express the Treasury's views. We look forward to continuing this dialogue.

STATEMENT OF SCOTT E. HARRINGTON, Ph.D.

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JULY 18, 2006

Good afternoon Mr. Chairman and members of the Committee. My name is Scott Harrington, and I am pleased to provide my perspectives on insurance regulation. During my 28-year career in academia, much of my research has focused on the economics of insurance markets and insurance regulation. Many of my publications have dealt specifically with insurance rate regulation, with solvency regulation, with the performance of State regulation, and with possible Federal intervention in insurance regulation.

In the early 1990s I published two papers dealing, respectively, with insolvency problems in the property/casualty and life/health insurance sectors. I concluded that Federal regulation of insurance would not be an appropriate response to those problems. In 2002 I wrote a monograph for the Alliance of American Insurers on possible optional Federal chartering and regulation of property/casualty insurance companies. I concluded that optional Federal chartering was not justified at that time.

Earlier this year, I prepared an issues paper on possible Federal intervention in insurance regulation for the Networks Financial Institute, on which much of this statement is based. Despite a number of positive and incremental reforms in State insurance regulation during the past decade, I highlighted that several key aspects of State insurance regulation, including regulation of rates, rate classification, and policy forms, remain substantially dysfunctional in many States—with no end in sight and with significant burdens on interstate commerce. I concluded that a transformation of insurance regulation was necessary to promote healthy price and product competition and to eliminate regulatory micromanagement of price and product decisions, and that such transformation could not be achieved without Federal intervention.

In the remainder of my statement I will first elaborate on the key shortcomings in State insurance regulation. I will then turn to potential benefits, risks, and design issues for optional Federal chartering. I will also briefly discuss alternative modes of Federal intervention that might redress State regulation's problems without creating a Federal regulator.

State Regulation's Performance

The economic rationale for government regulation of business activity is to protect the public interest by efficiently mitigating market failures. Regulation should only be undertaken if there is a demonstrable market failure compared to the standard of a reasonably competitive market and there is substantial evidence that the benefits of regulation will exceed its direct and indirect costs. Economically efficient regulation also requires matching the appropriate regulatory tool to the specific market failure.

Given the competitive structure of most modern insurance markets, the main economic rationale for regulation of the insurance business is to cost-effectively reduce the extent to which insurance companies or intermediaries misrepresent what is being promised at the time of sale, or fail to keep their promises through insolvency or deficient claims settlement. Achieving that objective requires regulatory oversight of insurance company solvency. It also favors some regulatory oversight of sales and claim practices to supplement competitive market discipline and contractual and tort liability remedies for fraud, misrepresentation, and breach of contract.

In contrast to the early 1970s and early 1990s, the current debate over insurance regulation has relatively little to do with solvency regulation. The main characteristics of State solvency regulation—regulatory monitoring, controls on insurer risk taking, risk-based capital requirements, and limited guaranty fund protection—are sensible given the economic rationales for regulating solvency and for partially protecting consumers against the consequences of insurer default. Having regulators in an insurer's State of domicile play a lead role in solvency regulation reduces duplication in effort and cost. A significant degree of coordination and uniformity among the States has been achieved through the National Association of Insurance Commissioners (NAIC), including through its promulgation of financial reporting requirements and its solvency regulation certification program.

The State guaranty system of limited, *ex post* assessments to pay a portion of insolvent insurers' obligations is appropriate and has worked reasonably well, despite a large increase in required assessments this decade. Systemic risk (the possibility that failure of one insurer or rumors of trouble could produce a run that would adversely affect otherwise solvent insurers) is significantly smaller for insurers, especially property/casualty insurers, than for commercial banks, thus reducing the need for comprehensive guarantees. Limited guaranty protection helps reduce the moral hazard problem, whereby guarantees reduce policyholders' incentives to buy coverage from safe insurers. *Ex post* assessments avoid the accumulation of funds that could be appropriated by legislatures for non-insurance purposes. Compared with pre-funding, the responsibility for assessments also could increase incentives for financially strong insurers to press for effective solvency surveillance and efficient liquidation of insolvent insurers.

There are two broad problems, however, with other aspects of State insurance regulation. First, too much time and money are wasted on administering and complying with diverse regulations across the States, which often are either unnecessary or deal with activities that are amenable to less oversight, less bureaucracy, and much more uniformity across jurisdictions. Second, insurance regulation is often used for political ends to redistribute income among insurance buyers. These redistributive activities generally are economically inefficient, and they typically are opaque to the public.

There are four specific issues with State regulation's performance:

1. Costs and delays associated with regulatory approval of policy forms in 51 different jurisdictions.
2. Costs, delays, and possible short-run suppression of rates below costs associated with regulatory approval of insurers' rate changes.
3. Restrictions on insurers' underwriting (risk selection) decisions and risk classification systems.
4. State mandates that insurance policies provide coverage for certain types of benefits or losses.

The saliency of these issues varies across States and types of insurance.

Prior Approval of Forms

The NAIC and many State regulators and legislatures have taken some steps to streamline and homogenize the form approval process for life insurance and annuities, including creation of an interstate compact for approval of some forms. However, the continued patchwork process by which life insurers have to obtain approval for their products under State regulation and the associated costs, delays, and refusals place life insurers at a competitive disadvantage with federally regulated competitors in the asset accumulation and management business. The form approval issue is also important for property/casualty insurers and to a lesser extent (apart from the mandated benefits issue) for health insurers. Except for States that have substantially eliminated prior approval of policy forms for "large" commercial risks, property/casualty insurance policy forms are subject to regulatory approval in all States, with associated direct costs, compliance costs, and delays. Prior regulatory approval of policy forms is unnecessary and counter-productive for commercial lines of property/casualty insurance, except perhaps for very small businesses.

Prior Approval of Rate Changes

Market structure and entry conditions are highly conducive to competition in most types of insurance. Modern insurance markets that are relatively free from regulatory constraints on prices and risk classification generally exhibit strong evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting, and service.

Competition creates strong incentives for insurers to forecast costs accurately and to price and underwrite so as to avoid adverse selection, thus producing highly and increasingly refined systems of rate classification. Prices vary across insurers in relation to rate classification systems and underwriting standards. Substantial evidence, including small "residual markets" in States with little or no regulatory intervention in pricing, indicates that competition in pricing and risk selection promotes the availability of coverage if rates are sufficient to cover expected costs and provide insurers with a reasonable expected profit.

Prior approval rate regulation cannot be justified as a response to monopoly or oligopoly pricing in insurance markets, nor can it be justified as necessary to prevent collusion, or to protect consumers from inadvertently purchasing coverage from high price insurers. Prior approval regulation produces significant administration and compliance costs, which are ultimately borne by consumers. The rate approval process has sometimes been contentious and biased toward rate suppression that distorts the supply of coverage.

Prior approval regulation generally cannot be expected to affect insurer profits in the long run. Insurers must expect a reasonable profit over time in order to continue to supply coverage. Even when prior approval rate regulation allows adequate rates on average, the rate filing and approval process impedes timely adjustments of rates to new information about expected costs. This regulatory lag tends to produce fewer but larger rate changes and greater swings in availability of coverage and insurer profitability. Uncertainty about approval of proposed rate changes increases insurers' risk, with possible adverse effects on insurance buyers in other States. Regulatory suppression of rates in some States during some time periods reduces voluntary market sales by current insurers, increases residual market size, reduces entry by new insurers, and reduces incentives for insurers to provide valuable services and to invest in product distribution and service.

Progress has been made among the States in reducing the scope of prior approval regulation. It is virtually certain, however, that a significant number of States, including some of the largest, will retain such policies unless motivated to change through Federal action. The reasons are basically political. State legislators and regulators benefit when they claim to save consumers money. Some consumers are deeply suspicious of insurers and resent having to pay significant amounts of their income for insurance. Some consumer organizations, with ready access to major media, continue to press for rate regulation and to condemn "deregulation," claiming that "true" competition does not exist. Perhaps more important, the regulatory staffs in some States appear wedded to the mistaken notion that price controls protect consumers and serve a useful social purpose.

Classification and Issue Restrictions

Some States directly and significantly restrict insurance underwriting and rate classification for health insurance (*e.g.,* "community rating") and/or some types of property/casualty insurance (*e.g.,* restrictions on rate variation across geographic regions within a State). These restrictions generally lower premium rates for high-risk buyers and raise rates for low-risk buyers. In order to ensure that high-risk buyers can obtain coverage at rates that insurers recognize as lower than expected costs, insurers are required to offer coverage to virtually all applicants under "guaranteed issue" or "take-all-comers" requirements.

Guaranteed issue and rating restrictions may allow some high-risk buyers to purchase coverage who otherwise might find it difficult to locate a willing health or property/casualty insurer. But their predominant motivation and function is to lower premium rates for buyers with relatively high expected claim costs by charging above-market premium rates for buyers with relatively low expected claim costs. In the case of health insurance, in principle this might help higher-risk persons afford coverage, receive the types and quality of medical care that flow to insured persons, and cut down on both costly emergency care and bad debts for hospitals and providers. In the case of auto liability insurance, it may encourage more drivers to comply with compulsory insurance requirements, thus reducing the number of uninsured motorists and costs borne by other parties.

However, significant restrictions on rating and risk selection and guaranteed issue requirements have serious drawbacks, including:

1. Average premium rates tend to go up as more high risks insure and some low risks reduce or drop coverage.
2. Competitive rating and risk classification provide some incentive for higher-risk buyers to take actions to control losses and thus qualify for lower pre-

miums and/or have lower uninsured losses (*e.g.,* by forgoing construction or employing damage resistant construction in disaster prone areas, by purchasing crash-resistant vehicles, by installing security systems in homes or businesses, and so on). Restrictions on classification dull those incentives, increasing losses and premiums over time for the insured population.

3. When insurers are forced to accept applicants at regulated rates that are below expected costs for some buyers and above expected costs for others, it is very likely that the relative proportions of under- and over-priced buyers will vary across insurers. Some State reinsurance or risk-adjustment mechanism generally is needed to ensure a stable market. Such mechanisms involve significant administrative and compliance costs, and they can distort insurers' incentives for cost-effective monitoring and settlement of claims.

These problems help explain why many States have eschewed such policies. In the case of automobile insurance, the bulk of the States use residual market mechanisms (mostly assigned risk plans) to narrowly target intervention to ensure availability of coverage to the relatively few buyers who might find it hard to locate a willing insurer. On the other hand, some States have used voluntary market rate caps and residual markets as an alternative method of holding down rates for high-risk buyers in automobile or workers' compensation insurance. The result has been large residual market deficits and the need for voluntary market insureds to pay higher rates to subsidize those deficits. In the case of health insurance, over 30 States have established high-risk pools to guaranty coverage to persons with chronic health conditions at subsidized rates, including all jurisdictions without any other guaranteed issue requirements. The pools generally are designed to provide subsidized coverage to a relatively narrow, high-cost segment of the public.

Mandated Benefits

A complex web of "mandated benefit" requirements, which require that if a certain type of insurance is purchased, then it must cover specified losses, characterizes the State-based system of insurance legislation and regulation. Benefit mandates are most prevalent and debated for health insurance. Many observers argue that health insurance mandates produce significant increases in the cost of health coverage in some States, and significant reductions in the number of people covered by private health insurance.

Mandates for other types of insurance in many States include requirements that homeowners and/or auto insurance policies cover tort liability claims brought by one family member for injuries caused by another; requirements that auto insurance buyers buy coverage for losses caused by uninsured motorists, including pain and suffering; and mandates (mooted by the Terrorism Risk and Insurance Act and its extension) that property insurance policies cover fire losses caused by terrorism and in some States prohibit any terrorism exclusions. Many States also significantly limit allowable deductibles and co-payments, which can significantly drive up the cost of coverage.

Many mandates are argued to serve some consumer protection function. In reality, and when they are not simply redundant (*i.e.,* mandating what a large majority of buyers would willingly insure), mandates often simply force people or businesses to purchase and pay for insurance coverage of losses they would not willingly insure. In contrast to the cases of compulsory liability insurance laws and compulsory workers' compensation insurance laws, there would be little or no spillover on other parties without such mandates.

Optional Federal Chartering

The American Bankers Insurance Association, the American Council of Life Insurers, and the American Insurance Association agree on a number of principles for optional Federal chartering to encompass life and property/casualty insurers:

1. Creation of a Federal regulator to license insurers choosing a Federal charter and regulate solvency, market conduct, and accounting of federally chartered entities.
2. Exemption of federally chartered insurers from prior approval rate regulation and burdensome form approval requirements.
3. Preemption of State rules to help ensure a single set of Federal rules for federally chartered insurers.
4. Participation of federally chartered insurers in the State guaranty fund system, subject to Federal minimum standards.
5. Repeal of the McCarran-Ferguson limited antitrust exemption for federally chartered insurers.

6. Payment of State premium taxes by federally chartered insurers.

The National Insurance Act of 2006 (S. 2509), introduced by Senators Sununu and Johnson, incorporates most, if not all, of these principles.

Optional Federal chartering along these basic lines would streamline, modernize, and homogenize regulatory requirements for federally chartered insurers. It would almost certainly achieve efficiencies in oversight and regulation of policy forms. The results would include helping to level the playing field between insurers and federally regulated financial institutions. Very importantly, federally chartered insurers would be substantially freed from antiquated and counter-productive prior approval rate regulation.

Participation in State Residual Markets and Guaranty Funds

If federally chartered property/casualty insurers could be exempted from participation in State residual markets, residual market rate regulation could not be used to produce sustainable cross-subsidies among insurance buyers. States that wanted to cap rates for higher-risk buyers would have to finance rate subsidies some other way. Exemption, however, seems unlikely in view of legitimate State interests in ensuring the availability of mandatory coverages. In order to reduce the ability of States to use residual markets to cap property/casualty insurance rates (*e.g.,* in automobile and workers' compensation insurance), the best approach (incorporated in S. 2509) is probably to make participation of federally chartered insurers in property/casualty residual markets contingent on rates being set at self-sustaining levels. To be sure, disputes as to whether that type of criterion is being met in some States are likely inevitable.

A Federal guaranty system for federally chartered insurers would destabilize and eventually completely crowd out the State system. Requiring federally chartered insurers to participate in the State guaranty fund system, perhaps subject to some minimum standards, is sensible. S. 2509 would require federally chartered insurers to participate in "qualified" State guaranty associations and establish a national guaranty fund, with *ex post* assessments, for obligations of insurers doing business in any non-qualified States.

The guaranty system under Federal chartering, however, would likely evolve toward nationalization or quasi-nationalization with uniform coverage. Insolvency of a multistate federally chartered insurer with different coverage limits in different States would very likely create strong pressure for uniform, national coverage. Insolvency of a number of State-chartered insurers would likely create similar pressure. Such an evolution very likely would be accompanied by some Federal oversight of the insolvency risk of State-chartered insurers (as is true for State-chartered banks with Federal deposit insurance).

As I have emphasized in a number of my publications, any move toward optional Federal chartering involves a risk that the scope of government guarantees of insurers' obligations will ultimately increase, thus increasing moral hazard and producing pressure for stricter solvency standards. A fundamental goal of the guaranty system with optional Federal chartering should be to maintain reasonable coverage limits overall and to include significant restrictions on coverage for commercial insurance, at least for buyers with substantial net worth. The creation of a pre-funded, Federal system for all insurers should be avoided. It is highly unlikely that meaningfully risk-based charges for guaranty fund coverage would accompany pre-funding, and pre-funding could dull some insurers' incentives to press for effective solvency regulation and standards.

Regulatory Competition

Optional Federal chartering would presumably provide additional and immediate motivation for State regulators to modernize their systems. More generally, it could promote beneficial regulatory competition over time if insurers are able to switch charters and regulators at relatively low cost. Dual chartering of banks appears to have resulted in a certain degree of beneficial regulatory competition. However, the cost to multistate, federally chartered insurers to switch back to a State charter and return to State regulation in multiple States might be larger than in banking. If so, there is a greater risk that Federal chartering could become dominant and entrenched for larger, multistate insurers, reducing the scope of regulatory competition.

Substantial Elimination of Rate Regulation

The substantial elimination of prior approval rate regulation should be the *sine qua non* for optional Federal chartering of property/casualty insurers. Elimination of prior approval rate regulation for federally chartered property/casualty insurers would be very likely to constrain substantially prior approval of rates for State-chartered insurers as well. Again, however, there are inherent uncertainties, including the scope of federally chartered insurers' exemption from rate regulation that will be included in any bill that might be passed, and regarding whether any exemptions will persist. It is also uncertain whether Federal regulation would persistently resist temptation to redistribute wealth through restrictions on rate classification, guaranteed issue, and mandates. State regulation is largely unable to achieve cross-subsidies between States (or between lines of business within a State). While Federal regulators may be more resistant to local pressures that produce within-State cross subsidies, they may face similar pressures on a national level and significant pressure over time for adopting or endorsing policies that promote cross-subsidies within and between States.

Other Approaches to Spurring Regulatory Modernization

The case for insurance regulatory modernization through increased uniformity and substantial deregulation of rates and forms is overwhelming. Optional Federal chartering might go a long way toward achieving this result. But there are risks, and it would require substantial investment and costs in creating and maintaining a Federal regulatory agency. Potential unintended consequences, or mistaken policies in response to political pressure, would have national effects. Two alternatives to improve insurance regulation without creating a Federal regulator and which might entail less risk are: (1) Federal preemption of State regulations that do not meet minimum standards, and (2) allowing insurers to choose a State for primary regulation with authorization to operate nationwide primarily under the rules of that State.

Minimum Standards and Preemption

The enactment of minimum Federal standards for and preemption of certain forms of regulation could help modernize insurance regulation without creating a true Federal regulator and associated bureaucracy. The potential effectiveness of this approach as a means to remedy the key problems of rate and form regulation is not clear. Prohibiting prior approval rate regulation, for example, by itself would not prevent regulators in some States from challenging rates based on allegations that they are excessive or unfairly discriminatory. The threat of such actions could contribute to a *de facto* prior approval environment. More generally, any "minimum standards" approach faces the difficulty of monitoring compliance. States that did not wish to comply would attempt to circumvent or evade the requirements.

A draft proposal, The State Modernization and Regulatory Transparency Act (SMART), released by Representatives Oxley and Baker, would establish minimum and uniform Federal standards for numerous activities of State regulation, with Federal preemption of State laws and rules failing to meet such standards after specified periods. The complex proposal deals with regulation of insurer and producer licensing, market conduct, policy forms, rates, surplus lines, reinsurance, fraud, solvency oversight, receivership of insolvent insurers, and the viatical market. A "State-National Insurance Coordination Partnership" would be created to oversee rules, changes, and compliance.

The proposal contains provisions designed to promote uniformity and provide for one-stop approval of policy forms, and to eliminate prior approval rate regulation for commercial property/casualty insurance (excepting medical malpractice insurance). The proposal's breadth and complexity increases the difficulty of enforcement and the likelihood of unintended consequences. A narrower and simpler standards/preemption approach would focus on policy forms, rates, and possibly mandates.

Primary State Regulation

Another approach to spurring modernization without Federal regulation would be for the Congress to enact legislation that would allow insurers to choose a "primary State" for the purpose of rate, form, and possibly a number of other types of regulation and allow them to operate in all other States where they are licensed ("secondary States") without having to meet the corresponding requirements in those States. The general concept has its roots in corporate law, where corporations choose a State in which to be chartered, with that State's laws governing the rights of management and shareholders throughout the country. The concept is to some extent reflected in Federal authorization of risk retention groups for certain types of property/casualty insurance.

The Health Care Choice Act, proposed by Representative Shadegg and Senator DeMint, adopts this approach for individual health insurance. Insurers would be subject primarily to regulation by the primary State, but they could operate in secondary States subject to primary State rules. The proposal includes a number of safeguards and minimum standards for primary State regulation regarding, for example, solvency regulation, guaranteed renewability of contracts, and independent review of disputed claims. The bill requires clear disclosure and warning to consumers that primary State regulation applies and that various secondary State regulations do not. The main purpose is to allow consumers in States with mandated benefits, guaranteed issue, and/or community rating rules that drive up the cost of individual health insurance coverage to have the opportunity to buy coverage not subject to those constraints. Many consumers would likely be able to obtain less costly coverage that is more closely related to their needs and ability to pay.

More generally, the primary regulator approach could be an effective means of achieving substantial homogenization and streamlining of policy form regulation for all types of insurance—and of significantly constraining prior approval rate regulation—with relatively little Federal involvement. A common argument against this general approach is that it could lead to a "race to the bottom." That risk is reduced significantly by would-be primary States' concerns with their own citizens' welfare and by buyers (and agents/brokers) concerns with their own welfare. I believe that this risk could be managed with well-designed minimum standards and clear disclosure. It also, for example, would not be necessary to rely mainly on the primary State for solvency oversight and/or market conduct regulation.

Conclusion

Despite the existence of economically appropriate regulatory regimes in many States, certain aspects of State regulation—in particular the regulation of rates, rate classification, and policy forms in many States—appear beyond repair at the State level. Some form of Federal intervention is necessary for fundamental change.

The central goals of regulatory modernization should be to provide one-stop approval or certification of policy forms, to have virtually all rates, rate classes, and covered benefits determined by competition rather than regulation, and to preserve and enhance private market incentives for safe and sound insurance. The key policy question is what form of Federal intervention has the best potential for achieving these goals given short- and long-run political dynamics and the risks of unintended consequences.

Optional Federal chartering and regulation of insurers offers the potential to achieve more streamlined, less duplicative, and pro-competitive regulation. A well-designed optional Federal chartering system would have a number of potential advantages. It would also entail the creation of a new Federal bureaucracy and inherent risks. The alternative of allowing insurers to designate a "primary State" and to operate nationwide subject in large part to the regulations of that State might have the potential to improve significantly the performance of insurance regulation with relative simplicity, less risk, and without creating a Federal regulator. A narrowly targeted program of minimum Federal standards that would preempt nonconforming State regulation also has the potential to improve insurance regulation without creating a Federal regulator, and perhaps also with less risk than Federal chartering.

PREPARED STATEMENT OF ROBERT W. KLEIN, Ph.D.

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JULY 18, 2006

Introduction and Summary

Chairman Shelby and Members of the Committee, good afternoon and thank you for the opportunity to testify before the Committee on the topic of insurance regulation.

My name is Robert Klein. I am currently the Director of the Center for Risk Management and Insurance and an Associate Professor of Risk Management and Insurance at Georgia State University. In my 30-year career I have been both an insurance regulator and an economist who has studied insurance regulation. From 1979 to 1988, I served as an economist for the Michigan Insurance Bureau and the Michigan Senate. From 1988 to 1996, I was the Chief Economist and Director of Research for the National Association of Insurance Commissioners. I joined the faculty and assumed my current positions at Georgia State University in 1996. I have performed a number of studies and written numerous publications on topics in insurance regulation—a list of some of these publications appear as "Selected References" at the end of my written testimony.

In my opinion, the States have come a long way in improving their regulation of insurance but further reforms are needed, both in terms of the States' structures/processes as well as their policies. I think the preferred institutional route to this goal is strong Federal standards for and oversight of the States' regulation of insurance that will move their structures and policies to where they need to be. In essence, the States need to appropriately and efficiently regulate things that need to be regulated and not regulate things that do not need to be regulated. If this cannot be achieved under the institutional arrangement I favor, then an optional Federal charter approach may be necessary to achieve the objectives that the States would be unwilling or unable to achieve.

The specific reforms that I propose reflect four basic themes or characteristics:

1. The elimination of regulation where it is not needed;
2. uniform, appropriate and efficient regulation where it is needed to the extent uniformity is possible given differences in State laws that cannot be changed;
3. singular institutions and processes for insurer filings and applications that would be approved for all States; and
4. full "rationalization" and coordination of all State enforcement and compliance activities.

The urgency and need for insurance regulatory reform is increasing for several reasons. One, risk and choice regarding health insurance and retirement funding is increasingly being shifted from employers to employees. Two, as the baby boom generation moves into retirement, their purchase of or choices regarding health insurance and retirement funding vehicles will affect a large segment of the population. Privatization of some portion of social security accounts could further increase the importance of this area. Third, environmental and political changes appear to be increasing the risk of natural and man-made "disasters" so it is important that individuals and firms purchase sufficient insurance coverage at risk-based prices. Fourth, insurance companies continue to improve their financial risk management but this remains a continuing challenge because of mega or catastrophe risks, macroeconomic volatility, and the use of more complex and novel risk hedging/diversification instruments. Fifth, international trade in insurance is increasing and this has implications for the regulation of insurers entering U.S. markets as well as U.S. insurers that are seeking to enter foreign markets. Regulators need to keep pace with these developments and update their standards and enforcement activities accordingly. Regulators' resources will be stressed so they need to use their resources efficiently and shift their efforts to areas where regulation is most needed and away from areas where it is not needed.

A key factor underlying my recommendations is the highly competitive nature of most insurance markets, despite widespread consumer ignorance about insurance. Enough consumers shop for the best price and pay some attention to quality of service that most insurers in most markets behave as if every consumer was well informed and shopped intensively. The main problem that arises and requires regulatory attention is the ability of insurers with "improper intentions" to take advantage of many consumers' ignorance or inability to understand what they are buying and to correctly determine the solidity and integrity of the insurers they are buying from. There is also a problem with certain specific lines of insurance, such as title insurance and credit insurance, where the nature of the sales process and relationships between lenders and insurers lead to "reverse" competition problems. Hence, these specific lines require greater regulatory supervision than lines such as auto, home and life insurance.

Further, in disputes between insurers and insureds over claims and benefits, insurers tend to have more bargaining power because of their substantial legal resources and ability to outlast an insured who is facing a financial crunch and has small reserves to draw from. Even nationally prominent insurers with strong brand names may seek to "push the envelope" in certain situations or have particular employees who fail to act correctly. Hence, regulators can improve market performance in these areas by preventing insurers and personnel with bad intentions from taking unfair advantage of consumers either in the sale of insurance or in the payment of claims. Some of my colleagues may take issue with this opinion but there are literally thousands if not millions of examples of where market forces have failed to prevent abuses.[1] Moreover, by going after the "bad actors", regulators make it easier for the "good actors" to do the right things and maintain a higher quality of service.

In the regulatory system I envision, the States would efficiently enforce a uniform set of regulations (to the extent uniformity is legally feasible) in their respective jurisdictions and the inefficiencies and costs of unnecessary State differences and redundant regulatory processes would be minimized. I recognize that the design and

[1] The admitted misbehavior of several prominent life insurers and their agents in the 1980s involving the sale of universal life insurance products is just one of many of these examples.

implementation of such a system would require substantial analysis and discussion to resolve a number of issues associated with combining collective and individual State enforcement of uniform regulations in the context of our Federal system of government in which the States retain certain prerogatives. Some form of Interstate Compact would probably be needed as one of the vehicles to create and implement the system as well as some sort of arrangement to monitor and audit States' enforcement activities. Such a system would also require a "Plan B" for States which chose not to join such a system. In the remainder of my testimony, I explain the nature and rationale for my proposed system and reforms in greater detail and address certain issues that might be raised and criticisms that might be made with respect to what I propose.

I have one last partially self-serving observation to offer in this introduction. The ability of academics like me (at institutions that are not overwhelmed with donations and endowments from wealthy people and firms) to offer informed opinions on topics involving public policy and other matters dealing with risk and insurance is directly affected by public and private funding for "basic" research on the industry and its regulation. Unfortunately, both public and private funding of such research is almost non-existent and there are indications that it may totally evaporate. Further, academics' access to data and information resources, beyond publicly filed financial statement data, is becoming increasingly restricted and/or costly. The Congress and Administration could be of great help in taking steps to help with the funding problem and possibly with the data and information problem—there would a relatively high return on the investment of a relatively small amount of funds (*e.g.,* less than $1 million per year).

Summary of Proposed Reforms

Among the specific reforms I would advocate are:

1. A uniform set of requirements should be adopted for insurance products sold to persons, small businesses and for government-mandated insurance coverages (*e.g.,* workers' compensation) to the extent that uniformity is legally feasible.
2. Regulatory restrictions or mandates on the insurance products sold to medium and large businesses should be eliminated except where government requirements or significant externalities compel such regulation.
3. Prospective price regulation should be eliminated in all lines of insurance, except those lines where market failures and abuses have been demonstrated such as in title insurance and credit insurance. Some residual regulatory authority to intervene in pricing should be retained should competition and market forces fail to ensure fair and competitive rates.
4. A process should be established that would allow an insurer to make one product filing that could be approved for sale in multiple States as well as one licensing application that could apply to multiple States.
5. A rigorous set of uniform financial standards should be established, maintained and properly enforced—we are almost there but have more ground to cover. Also, the laws and process for administering insurance company receiverships should be further rationalized and made uniform among the States.
6. There should be streamlined and appropriate State enforcement of all insurance regulations that are retained or instituted, including single, national financial and market conduct examinations that would serve all States.
7. Efforts to streamline and nationalize the licensing and regulation of insurance producers should continue to their maximum possible fulfillment.
8. A comprehensive effort should be made to develop common and uniform systems for reporting of various insurers data that would minimize the cost of such reporting and maximize the value of and access to the information reported with appropriate protection of information that would be considered unsuitable for public access.
9. Competent and qualified State insurance commissioners should be *appointed—not elected.* No one would propose that Federal bank regulators be elected and the same principles should apply to State regulatory officials.
10. There should be a comprehensive and strengthened program of consumer and public education and information regarding the risks they must manage and related insurance products and coverages—the high level of consumer and public ignorance and misconceptions regarding insurance frustrates efforts to improve insurance regulation.

11. There should be a comprehensive and continuing evaluation of regulatory attention to chronic and emerging problems and the effectiveness and efficiency of regulatory monitoring and enforcement activities. An independent, national Insurance Regulation Oversight Commission could be established to perform this function and advise the Congress, working cooperatively with the National Association of Insurance Commissioners and other national organizations of State officials and legislators.

This is a long list of ideas but it is not exhaustive nor is it uncontroversial. There may be legitimate differences of opinion about their merits and feasibility. The list is intended to promote the kind of thought and discussion that will be needed to ultimately develop an optimal and feasible program of reforms. It is relatively easy to propose reforms; crafting a workable system within the web of States' rights and laws is another matter. Achieving sufficient political consensus and support and overcoming antagonistic special interests presents an additional challenge.

I also recognize that the NAIC has initiatives in many of the areas of reform I have identified above. In some areas, these initiatives may eventually come close to achieving certain of the objectives I have advocated. However, for reasons I will explain below, in many areas the NAIC is not going as far as I would advocate or can only encourage but not force the States to make the necessary changes.

Alternative Institutional Structures: Federal and State Roles

This leads me to comment further on the Federal versus State institutional debate since this is an issue that weighs heavily in peoples' minds even if this hearing is intended to address a broader set of issues. Further, the institutional structure that is employed has implications for the nature of the reforms that can be instituted. I prefer to discuss and dispense with this issue here so that I can move on to detailed discussion of the reforms I advocate.

I will acknowledge that sweeping reforms could be accomplished through the complete takeover of insurance regulation by the Federal Government if it were to establish efficient processes and the "right" policies, but there is no assurance that this would occur under Federal insurance regulation or that such processes and policies would be sustained over time. Hence, while Federal regulation might exploit certain inherent structural efficiencies and reforms would be easier to achieve from a legal standpoint, I am not convinced that it would necessarily result in better regulation and there is the danger that it could result in worse regulation.

I also have some reservations about the optional Federal charter proposal, although it does have some merits and may ultimately be the only feasible way to achieve the reforms I advocate. I understand that it is viewed as having certain desirable properties—most notably, it is voluntary in the sense that insurers could choose to be federally or State regulated and consumers could choose to buy insurance from federally or State regulated insurers. Further, it would increase the efficiency and reduce the cost of regulatory compliance for insurers with national operations. Some of my colleagues may also favor the idea because they perceive that it would promote "regulatory competition" and they tend to view competition as a good force. However, in my view, competition between individuals and firms in markets for goods and services may yield efficiencies and benefits that do not always carry over to competition between governments.

The crux of the problem is that the ultimate arbiters of what governments do and the companies that insurance is purchased from—voters and consumers—are woefully ignorant about insurance and its regulation. I am concerned that many consumers would not understand or be able to evaluate the differences between and the implications of Federal versus State-regulated insurers or differences between the policies of the two regimes. Hence, more of the power and benefits of choosing the regulatory venue could tend to accrue to the regulated not to the intended beneficiaries of regulation. It could weaken the oversight of State-regulated insurers and encourage States to ease regulations in ways that would be desirable to insurers "on the fence" but not in the best interest of consumers.

Further, it would probably lead to increased market concentration as federally chartered insurers would able to increase their competitive advantage over State-regulated insurers and State regulation would not be able to impose the entry barriers and high compliance costs that they currently do on national insurers. Increased concentration is generally viewed as a bad thing but this would not necessarily be the case if it derives from the increased efficiency of federally chartered insurers and the benefits of these efficiencies are passed to consumers. I would expect that concentration would not increase to a level that would impair competition and reduced entry and exit barriers would contribute to competition. Hence, I do not view the likely market restructuring results of Federal chartering to be a reason to oppose this approach. State and regional insurers would probably diminish and focus their operations to "niche markets" that would not be served by national insurers.

There is the risk of fraudulent insurers slipping through the gaps between Federal and State regulation, taking advantage of the confusion and gullibility of many consumers and small business owners. These problems have been demonstrated in the Federal carve-out of ERISA-qualified health insurance plans and the problems that have occurred with some risk retention and purchasing groups. One can imagine the frustrations and problems that would occur for a consumer with legitimate complaints about an insurer who contacts one regulator and is told that the insurer is regulated by another entity or perhaps not regulated at all.

All of this said, the alternative institutional approach I favor may not prove to be workable in the process of designing it and negotiating its features between the Federal and State governments. If that proves to be the case, then the optional Federal charter approach may be the next best solution. It does have a number of attributes and it would enable consumers to choose to buy insurance from insurers that are not hobbled by inappropriate or unnecessary State regulatory restrictions and mandates.

The approach that I would prefer arises from my belief that the high tension between the Federal and State governments over insurance regulation has had very positive effects. Vesting insurance regulatory authority unequivocally in one entity or the other potentially reduces its incentives to implement needed reforms and could decrease the transparency of its policies and practices. At various times in history, the States have made great strides in improving their regulation of insurance when Federal intervention or takeover is threatened. In this struggle, the Federal Government has a big hammer and the greatest power that also has increased over time as it has gained more allies. The States, with their remaining allies, have less countervailing power but enough to force a good and transparent debate. For reasons that I do not yet fully understand, the debates and legislative threats that occur during these periods seem to promote a healthy and transparent examination of insurance regulatory systems and policies and the States feel compelled to institute reforms that are generally good ones.

However, there is a legitimate question as to whether the States would have the ability and desire to fully achieve the kinds of ultimate reforms that I and others advocate. Many States, if not all, believe that they should retain some prerogative to regulate their own markets as they see fit—"market regulation" pertains to things such as prices, policy forms and market practices. For example, if public officials in a State believe that it should still regulate prices for personal lines insurance, then they may strongly resist any pressures to do otherwise. The NAIC can and has strongly encouraged States to reform and standardize their regulation of insurance markets, but it has no authority and generally little leverage to compel States to do so. The NAIC has also created systems to facilitate single portals for insurer/intermediary filings and applications, but the requirements for approval of what is filed and applied for still vary among States with exception of life and annuity products.

In contrast, the NAIC is able to compel much greater uniformity and quality with respect to the financial or solvency regulation of insurance companies (which I distinguish from market regulation) because of the greater inter-connections between State polices and practices in this area.

Only the threat of Federal intervention, either full takeover or optional chartering, can potentially induce all the States to move further toward uniformity and reform than they would otherwise choose to do so. Even then, certain States may draw a line in the sand, beyond which they are unwilling to go unless forced to by some higher authority. Hence, the issues of regulatory reforms and the question of the institutional structure that would be established by Congress are intertwined and not yet resolved. Congress would be wise to hold its cards until these issues and questions are resolved.

Detailed Discussion of Specific Reforms

Below I attempt to explain and support my recommendations in greater detail. Unfortunately, given the short notice I received, time did not permit me to fully explain all of my recommendations so I have focused on those that I believe are the most important and likely to encounter the greatest controversy. I can further explain my ideas and respond to other questions in additional testimony submitted after today's hearing.

Regulation of Insurance Products

The regulation of insurance products refers primarily to the policy forms that insurers must file for approval with State insurance departments before the policies can be used in the market. The term "product" may be more appropriate because insurers may be required to file and receive approval for related materials such as marketing plans. Insurers are typically required to file for approval both new products and changes to existing products. Typically, the States require prior approval of products sold to persons and small business (*e.g.,* auto insurance, home insurance, life insurance, business owners polices, *etc.*) or that are subject to State governmental mandates, such as workers' compensation insurance. The level or degree of regulation of products sold to medium size and larger firms tends to be less, especially in States that have embraced NAIC templates for the "reengineering" of commercial lines regulation. These firms, with the assistance of informed risk managers and brokers, should be able to protect their own interests in assessing products and insurers and negotiating contract terms.

For most property-casualty products that are more intensively regulated, State requirements and mandates for approval vary both formally (State laws and regulations) and informally (regulators' preferences with respect to policy language, policy form formats, *etc.*). Understandably, this greatly frustrates insurers seeking to sell similar products in multiple States and increases the cost of delays in the introduction of new products or product changes. I would be more sympathetic to the States' view on this if I accepted their argument that differences in State conditions justify differences in product requirements. However, with the exception of differences in the cost of living (it probably costs more to get a car repaired in New York than in Mississippi), I do not believe that differences in State needs justify the degree of variation in State requirements. Most of the variation, in my opinion, results from different political environments or philosophies, as well as the particular preferences of the insurance regulators that help make and interpret the rules. Hence, I believe that substantially greater uniformity and reduction of unnecessary or excessive requirements would substantially decrease transactions costs, would not harm the consumers in specific States, and would ultimately work to their benefit whether they realize it or not.

The regulation of certain life insurance, annuity and health insurance products do warrant special discussion. Through the years, there have been periodic problems with the sale and representation of certain more complex life/annuity products, such as universal life policies, and variable life and variable annuity products, among others. Other products can be complex, such as Long Term Care (LTC) policies and hybrid life-LTC products. I discuss these issues and NAIC/regulatory responses in greater detail in the second edition of the text I wrote for the NAIC—*A Regulator's Introduction to the Insurance Industry (NAIC: 2005).*

I believe that these areas of product and market practice regulation will be particularly crucial in the years ahead as more households will need to consider the purchase of these products. I think effective and adequate regulation could be accomplished through uniform requirements among States as reflected in NAIC model laws, regulations and other guidelines but the requirements must be rigorously enforced and updated as products continue to evolve and new products and/or problems may emerge. Hence, regulation in this area may need to be strengthened, not necessarily in terms of the model requirements that the NAIC has developed, but in terms of the allocation of regulatory resources and the intensity of regulatory monitoring of compliance. Reducing or eliminating regulation in other areas where it is not needed could potentially make more resources available for the regulation of life, annuity and LTC products and practices. Certain other types of insurance products such as "critical illness" policies may also fall into this category.

It appears that the NAIC and the States may be well on their way to achieving this objective with respect to life and annuity products with a singular filing process and uniform product requirements with the development of its *InterState Insurance Product Regulation Compact* (IIPRC) which I understand has 27 States signed on and anticipates becoming fully operational in early 2007. I have not had the opportunity to fully assess this mechanism nor evaluate any objections or criticisms by insurers or associations that do not believe that it is sufficient to address their concerns about the current system. There is also the question of how many additional States will be expected to join and how quickly they will do so. At a minimum, the Federal Government could encourage more States to join with the enactment of Federal standards.

Deregulation of Rates/Pricing

Because of the highly competitive nature of most insurance markets (title and credit insurance being exceptions), prospective regulation of rates (*e.g.,* prior approval of rates or rate changes) is unnecessary. Numerous studies of price regulation in auto and workers' compensation insurance effectively reveal no benefits but potentially severe problems from insurance rate regulation. For the most part, regulators are compelled to approve the same prices or rates that would otherwise be set by the market. It is also difficult to sustain cross-subsidies through the manipulation of rate structures when low-risk consumers have choices about who they buy insurance from and/or how much insurance they buy. However, there are instances, some quite notorious, where regulators have sought to forestall or avoid economic reality by suppressing rates below adequate levels and/or substantially compressing rate structures (*i.e.,* the rate differences between risk classes or geographic areas).

Regulators can "get away" with modest rate suppression or compression for limited periods of time, but if they take it too far and too long, major market problems result. The amount of coverage that insurers are willing to supply voluntarily plummets far below what consumers need or want. Further, rate suppression/compression distorts insureds' incentives to control risk and losses. In its worst manifestation, severe rate suppression can result in the collapse of a market as occurred in the Maine workers' compensation insurance market in the early 1990s.

Some might blame State insurance commissioners for such behavior but this is myopic. Most voters and consumers tend to harbor misconceptions about insurance rates and what is ultimately in their best interest and special interest groups can knowingly seek cross-subsidies in their favor. The point is that a commissioner who seeks to approve adequate and actuarially fair rates when costs are escalating can encounter significant political opposition that will eventually remove him or her from office. Hence, the blame should lie with those who ultimately control the political fortunes of Governors, regulators and legislators.

This contributes to the argument for rate deregulation. If regulators have no authority to approve or disapprove rates prospectively, then this should divert some of the political pressure that they would otherwise face. Of course, deregulation does not totally solve the problem if there is always the danger that voters or special interest groups can reinstitute rate regulation or legislate rate restrictions.[2] Still, if Federal standards and interstate compacts make this less likely, then the potential danger and threat is reduced.

It should be noted that market-based prices are not necessarily perfect or stable. Insurers can make pricing mistakes by failing to anticipate cost increases or decreases or accurately determine differences between risk classifications. However, such mistakes tend to be short-term in nature as markets tend to correct these mistakes fairly quickly. One example of this is that increases in homeowners insurance rates in the Midwest during 2001–2002 have stopped and rates are starting to come down in these areas. The situation for property insurance along the Gulf and East coasts is somewhat more complex and does not lend itself to simple explanations or predictions.

There is another problem that can last somewhat longer. Certain commercial insurance markets in "long-tail lines" (*i.e.,* lines where there can be a considerable lag between when premiums are set and collected and claims are fully paid) are subject to cyclical shifts in the supply and price of insurance—this is commonly known as the "underwriting cycle". The cycle begins with a chronic "soft market" phase in which insurers tend to under-price the coverage they sell and overly relax their underwriting standards. Academics and practitioners continue to probe and debate why this occurs, but regardless of the causes the reality is that it happens. Ultimately, after insurers lose a lot of money and can no longer ignore their under-pricing, the supply of insurance tends to tighten sharply and prices can rise dramatically—this is called the "hard market" phase. Hard markets tend not to last too long (roughly 2 years at most unless claim costs continue to escalate) and once insurers begin earning positive profits the supply of insurance begins to increase and prices fall. Hence, the ultimate implications of this cyclical behavior is that commercial insurance buyers have to deal with some volatility in what they pay for insurance but over the long term they tend to get a price break because insurers' long-run profits tend to fall below what would be considered a fair rate of return.

If rate regulation could mitigate this phenomenon it might provide a partial argument for retaining some regulatory control of pricing. However, the research indicates that rate regulation does not mitigate the cycle and may in fact worsen it because of lags between the filing and approval of rate changes. Also, in commercial

[2] The passage of a popular referendum in California, Proposition 103 in 1988, in which voters approved a mandatory 20-percent decrease in their premiums for auto insurance offers one of the most egregious examples of the misuse of political and democratic processes to attempt to manipulate the price of insurance.

lines, if insurers want to cut prices they have a number of ways to circumvent any regulatory attempts to stop them.[3]

The only strategy that regulators might employ is to take action against an insurer that is cutting prices to the point that its solvency is threatened. Unfortunately, Pennsylvania regulators failed to do this in the case of the Reliance Group until it dug a $2 billion hole that will be covered by consumers, taxpayers, other insurers and unpaid creditors. At the same time, firms that bought insurance from Reliance when it was obviously charging too little and spending too much conveniently ignored an inevitable reality.

All of this discussion leads me to argue for rate deregulation for all lines (with the exceptions I noted). It does not seem to offer any benefits but it can cause a lot of problems. To help satisfy the skeptics and ensure adherence to the requirements of the McCarran-Ferguson Act, regulators should monitor competition in insurance markets and retain some residual authority to intervene if competition should fail for some reason. This could be accomplished by requiring insurers to file rates for informational purposes, but not for approval either before or after their implementation. Further, if insurers' rates are not subject to approval, it would seem that there would no reason to require approval of the loss costs filed by advisory organizations.

There are related issues with the administration and regulation of what are known generally as State "residual market mechanisms". These are mechanisms established by the States to provide coverage to people and firms that, in theory, cannot obtain coverage in the "voluntary market". They are typically found in auto, home and workers' compensation insurance and sometimes in medical malpractice insurance. If a residual mechanism is managed properly such that it applies stringent requirements for accepting applicants, charges adequate rates to cover its full costs, and rates in the voluntary markets are allowed to rise to adequate levels, then these mechanisms tend to remain small in volume and do impose a significant burden.[4] However, if their rates are suppressed and the other conditions do not hold, then they can swell and begin to contribute to significant market problems and distortions. Hence, rate deregulation must be accompanied by responsible management of residual mechanisms in order for voluntary markets to work properly.

Singular Product Filings and Licensing Applications

The NAIC has sought to greatly improve the efficiency of insurer rate and form filings which provides a single point for filings that are not subject to the IIRPC—the *System for Electronic Rate and Form Filing* (SERFF). According to the NAIC's testimony, the system has grown dramatically with complete State participation and participation by a large number of insurers. While SERFF make filings easier, it does not fully solve the problems perceived by insurers who operate in a large number of States. Each State must ultimately approve or disapprove these filings according to its own laws, regulations and requirements. Hence, products must be modified for different States and their approval in a particular State may still be delayed.

A truly "singular" process would allow an insurer to file one product that would be subject to review and approval by one entity that would automatically apply to all States or at least a large group of States. Of course, this is one of the major objectives of insurers supporting the optional Federal charter bill. In order for the States to replicate the same kind of process they would need to: 1) have uniform product and licensing requirements; and 2) entrust the review and approval of filings and application to a central entity. This would be a major step beyond where the States are currently moving. A number of States might object to taking this step because they would view it as a major abrogation of their individual regulatory authorities.

However, as I have Stated earlier, I do not see a need for States to have differing regulatory requirements nor is it unprecedented for them to delegate their regulatory approvals to a central entity. Hence, in my view, it comes down to how far the States are willing to go in the institutional framework I propose versus the optional Federal charter approach. If the States would be unwilling to take this step, it would strengthen the case for an optional Federal charter.

[3] The reality is that regulators rarely, if ever, try to stop them. Understandably, commercial insurance buyers would oppose any regulatory price floors and regulators see little value in taking on that fight.

[4] Occasionally residual mechanisms can swell during periods of significant market adjustments as is occurring for property insurance in coastal areas. However, they should depopulate fairly quickly if the market is allowed to adjust to a sustainable equilibrium and new capital is attracted to the market to help absorb consumers who temporarily could not obtain coverage in the voluntary market.

There is also the issue of company licensing applications. According Commissioner Iuppa's testimony for the NAIC, it has developed a Uniform Certificate of Authority Application (UCAA) that establishes the base forms for use in company licensing applications. An electronic system has been built to facilitate the expansion application and communication processes, making it easier for insurers to expand to other States. Commissioner Iuppa also Stated that the NAIC and the States have largely addressed the issue of State-specific requirements often cited by the industry and have provided transparency for the State-specific requirements that remain.

While these developments are commendable, they stop short of a truly singular licensing application process that would allow an insurer to file one application and be approved for licensing in multiple States. Understandably, the States would like to retain their individual authorities to accept or reject license applications according to their standards and assessment of an insurer. I do not know how satisfied insurers are with the current state of affairs and their views of further streamlining the application process. It would not surprise me if a gap remains between what the States are willing to accommodate and what insurers would like to see. If that is the case, then it seems further progress could be made to "unifying" the application and approval process without admitting "rouge insurers" to quote Commissioner Iuppa. It comes down to how much farther the States are willing to go to concede some of their discretion on approving applications and how much farther insurers think the States should go to achieve an optimal balance of efficiency and regulatory protection.

Financial Regulation and Administration of Insurer Receiverships

The States have made the greatest strides in the financial or solvency regulation of insurers. Because States' interests are more intertwined in the financial regulation of an insurer (because the financial regulation of an insurer by its domiciliary State affects the interests of all States in which the insurer does business) the NAIC has been able to go a lot farther in terms of getting the States to adopt and enforce strong and uniform standards, as well as engage in more cooperative efforts. Further improvements could be made but the States tend not to oppose uniformity in this area contrary to their views on market regulation.

The reforms that have been instituted are beyond the scope of this testimony. My publications and Commissioner Iuppa's testimony discuss some of these initiatives. Commissioner Iuppa's testimony did not address requirements for "dynamic financial analysis" for property-casualty (p-c) insurers consistent with what is occurring in the development of international insurer solvency standards. In my opinion, this is an important area for consideration and perhaps one of the remaining linchpins that could be incorporated into p-c insurers' financial requirements. However, it appears to be a highly controversial idea. Most large insurers already engage in this kind of analysis, but many p-c insurers, both large and small, may resist the notion of being compelled to perform this analysis and have it scrutinized by State insurance regulators. Life insurers are already more acquainted and comfortable with this kind of regulation because it has been tied historically to their asset-liability management.

I believe that this is an issue on which the p-c insurers must eventually give in because it makes good sense despite their objections and it represents one of the final elements of a set of rigorous and appropriate financial requirements that have already been adopted in certain other countries with advanced regulatory systems. Of course, exactly what will be required is a legitimate issue for discussion and negotiation. Beyond that, the challenge for the States will be to have the personnel and infrastructure in place to properly evaluate the analyses that will be performed and submitted by insurers. Another issue will be how regulators use this information and how they will act when an insurer's analysis indicates the need for some form of regulatory attention or intervention.

As with the regulation of market conduct, financial regulators must deal with a shifting landscape, new developments and threats, insurer practices and mega-events and catastrophes that could have sweeping effects on a number of insurers. It appears that the NAIC has tended to respond to new issues, albeit a little late, but the action or reactions of individual State regulators within existing standards or the revision of standards may occur with too long of lag. Spurring regulators to quicker action within existing standards may be something that could be accomplished through the strengthening of existing NAIC committees and mechanisms to coordinate State regulatory action. Revising standards is another matter because of the long deliberative process that is somewhat inherent to the NAIC's structure and lack of actual authority. It is not clear how this might be resolved unless some central entity would be given the authority to "fast-track" quickly needed changes in financial standards and requirements (such as that kind of authority that is vested with Federal financial regulatory agencies).

For the most part, the number and severity of insurer failures is low but there are some exceptions such as Reliance. Why regulators did not act more quickly still remains unclear. It would be desirable to vest some entity with authority to conduct "post-mortem" investigations of certain insolvencies where there are legitimate questions either about the causes of the insolvency, or more importantly, the actions or the timing of actions by the responsible regulators.

There is also the issue of how the receiverships of impaired or insolvent insurers are managed. After I and two of my colleagues submitted a critical report on this matter, the NAIC set forth an extensive and ambitious program of reforms that in part will be facilitated and endorsed by the NAIC but ultimately must be implemented by the States. While the reforms are ambitious considering this area has been subject to the greatest inertial resistance by certain vested interests, I still believe they may fall short in a couple of key respects. Most importantly, there must be effective oversight and control over appointed receivers and the domiciliary regulators of insurers in receivership to minimize waste and maximize efficiency. Second, full exploitation of alternative workout plans for impaired p-c insurers must be explored as an alternative to liquidations that typically result in higher "deficits" that eventually are paid by creditors, the "public" and others that bear little or no responsibility for the insolvency. Some policyholders and claimants are covered by guaranty associations that pass their net costs to other insurers, their insureds and taxpayers.

State Enforcement of Market Regulations

Even with uniform requirements for and singular approval insurance products, there will still be a need for the States to monitor and enforce insurers' and intermediaries compliance with all State laws and regulations, uniform or not. I believe that this would best be done at the State level if the States can demonstrate that they can do this appropriately, effectively, and efficiently. State regulators are closest to the activities of insurers and intermediaries in their markets and it would be a costly and substantial enterprise to replace the compliance infrastructure that is already in place.

The NAIC has pushed an agenda that would make "market conduct" regulation more efficient and effective, but its recommendations fall short of what I would advocate and we do not know yet whether the States will even implement what the NAIC recommends. Commissioner Iuppa's testimony cites some promising statistics but there is still a high mountain to climb in terms of achieving the level of efficiency that is possible and in the best interests of consumers and insurers.

Based on studies and surveys I have conducted as well as others, it appears that a large number of States and market regulators still seem to be resistant to the kinds of reforms that are warranted. Some States and regulators seem to zealously defend their prerogative to regulate market conduct the way they think is appropriate, regardless of whether it conforms with NAIC or other national standards or recommended policies and procedures.

State preferences can make a big difference in the costs and burdens of market conduct regulation for insurers with no evidence of a "return" on these costs in terms of better market conduct or increased compliance. Some States insist on conducting their own market conduct exams of licensed insurers in their States that means that a given insurer can be subject to 5–10 market conduct exams by different States in a year that basically plow the same ground. Some States share information on their market conduct examinations with other States and others do not. Some States conduct exams relatively efficiently and others waste substantial regulatory and company resources. Some States recognize and consider self-compliance activities of companies and other States ignore them. Consequently, while I commend what the NAIC is trying to do and acknowledge that it has made some progress in reducing the amount of inefficiency, I reserve judgment on how much further progress it will be able to make with its current program and influence.

If market conduct regulation is going to be really reformed in all States there will be a need to establish strong national standards and approved methods that the States will be compelled to implement. These standards and methods will need to be embodied in the vehicles that the Federal Government and the States will use to unify and rationalize other aspects of insurance regulation. I have co-authored reports and articles that outline a number of recommendations on market conduct regulation but there are three that I will mention here that should be included in any Federal standards. The first is that an insurer should be subject to only one routine or targeted market conduct examination that will serve all interested States. The second recommendation is that all States should be required to give some consideration to insurer self-compliance activities, whether performed individually or cooperatively through an industry self-regulatory organization. The third is that all States should be required to improve their monitoring and detection systems to better target their investigations to potentially significant and emerging problems and not toward massive error-finding scavenger hunts. In sum, all States should stop wasting resources on things that yield little value and focus their resources on serious problems that have the greatest impact on consumers.

Producer (Intermediary) Licensing and Regulation

It appears that the NAIC has made some strides in facilitating more efficient licensing and appointment of insurance producers, especially those that wish to operate in multiple States. I have not had the opportunity to assess how much progress has been made in making this process more efficient but I suspect that some national agents and brokers are not satisfied by what has been accomplished so far. It appears that even though NAIC systems facilitate electronic applications to multiple States using a standardized form, the individuals States still set their own standards and make their own determinations as to who will be given a license.

Recently, I had the opportunity to review a survey of State producer licensing and education requirements and it seemed that there was a significant amount of variation that was difficult for me to rationalize. Like insurance product requirements, it is not clear to me why producer standards should vary greatly by State. Further, I fear that some States' regulation of producers and their educational requirements are inadequate and instances of producer fraud and incompetence continue to abound. I would support the concept of a standardized but rigorous set of producer licensing requirements that would be closely enforced by the individuals States if they demonstrated the capability to do so. This would permit a producer to submit one application to be approved to do business in multiple States but the producer would be held to high standards that would help reduce the abuses and mistakes that continue to occur.

Other Recommendations

Time does not permit me to explain the other recommendations I made in the introduction section of my testimony but I will offer two related opinions that I consider important. The first has to do with the data that are reported and maintained that allow legislators, regulators, researchers and others to monitor and analyze the insurance industry and its issues. Data from insurer financial statements is quite extensive and public access is relatively good so I do not view this as a problem area. The problem lies with other kinds of data that go beyond financial data in helping us understand how insurance markets are working and allow us to further probe issues such as cost trends, causes of increasing costs, pricing and underwriting issues, and a host of other important questions. Over time, public access to this kind of information has actually declined as statistical and advisory organizations have converted from non-profit organizations with a public mission to for-profit organizations with an essentially proprietary mission. Insurers are also more zealously guarding access to their data for proprietary reasons.

As a researcher, I am finding it increasingly difficult to access data to conduct studies while the actual amount of data held by certain organizations has actually increased. We need to find some kind of balanced resolution of this problem that will facilitate better and more research while addressing insurers' proprietary and privacy concerns and the costs of collecting such data by the organizations that have it.

The other serious problem that needs to be addressed is the tremendous amount of consumer and public ignorance about risk, insurance and regulation. The ability to rely on consumer choice and market forces rather than regulation is directly tied to consumers' knowledge and cost of acquiring information. There is probably a small segment of the population that read the articles by financial journalists and are relatively knowledgeable but I suspect there is much larger group of people who are badly uninformed or harbor many misconceptions. I personally encounter this ignorance in a variety of interactions with various people.

Public and private organizations have undertaken extensive consumer education efforts but most people probably do not avail themselves of these services. We need to think about even greater proactive and aggressive public education efforts that reach more people and "encourage" more of them to become informed. Ironically, we seem to accept such a notion when it comes to things like public health but not financial health which is just as important. Some of my colleagues may object to such efforts but we are paying a heavy price for consumer ignorance that will only increase as people are required to make more decisions. The claimed ignorance about the flood exclusions on homeowners insurance polices, the failure to save and prepare for retirement income needs, and the general misconceptions about what insurance is are exacting heavy tolls and make it harder for legislators and regulators to pursue economically sound policies. We cannot expect to get every consumer and voter to become well informed but we need to see if we can achieve a significant reduction in the level and breadth of ignorance.

Concluding Observations

Clearly, there are a range of interests and different opinions on how insurance should be regulated and who should do it. I will not accuse any group of being insincere in the opinions they express, but to borrow a concept of one of my old professors, people tend to perceive the world in a way that best suits their interests. This does not mean any particular opinion is invalid, but every opinion including mine must be scrutinized and tested against a set of principles and valid facts. Ultimately, what matters is what is in the best interests of consumers and the general public and this is what the Congress has to determine.

Designing a regulatory system and setting regulatory policies by necessity is a balancing act. The benefits and costs of relying on "free choice" and market forces have to be balanced against the benefits and costs of regulatory constraints and mandates. The choice of an institutional framework also affects costs and effectiveness and may have implications for how incentive conflicts between different insurance market participants are resolved. I have offered my opinions on what I think insurance regulation should like but I do not claim to be omniscient or invulnerable to error. The important thing is that the Committee is facilitating a full airing of the issues and opinions that will allow it to make the most informed and best decisions that will serve the public interest. I would be happy to continue to engage in communications with the Committee and comment further on any questions it may have.

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