ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM

Tuesday, October 30, 2007

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:17 p.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Moore of Kansas, McCarthy, Lynch, Scott, Bean, Davis of Tennessee, Sires, Klein; Pryce, Hensarling, Baker, Shays, Royce, Barrett, Gerlach, Price, Davis of Kentucky, Bachmann, and Marchant.

Chairman KANJORSKI. The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order.

Without objection, all members' opening statements will be made a part of the record.

Good afternoon. I would like to thank Ranking Member Deborah Pryce and members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises for being here for today's hearing on additional perspectives on the need for insurance regulatory reform. I would also like to thank Ms. Pryce for joining me in inviting our panel.

Today's hearing is the second in a series on insurance regulatory reform. It is also the second hearing on the need to improve insurance regulation. Earlier this month we heard from key participants of the insurance industry on the need for reform. At that hearing, regulators, agents, brokers, and company representatives testified.

Our first hearing reinforced my belief that Congress should take some action on insurance regulation. I expect today's witnesses to add to our knowledge base on insurance and help inform each of us on what Congress should do before we make any policy decisions in this area. The vast majority of interested parties in the debate on insurance regulatory modernization agree that the system is not perfect and needs improvement.

Today we will hear from additional parties, including State legislators, consumers, and industry representatives on the need for reform in insurance regulation. These additional perspectives will add greatly to our discussion, as each will relay a unique point of view.

Although regulated by the many States, Congress has the responsibility to oversee the insurance industry. The aftermath of September 11th taught us all how important insurance is to a vibrant and thriving economy. We have also heard a lot about maintaining the competitiveness of the United States capital markets, including insurance, in an increasingly global economy.

The importance of insurance to consumers, both large and small businesses, and individuals in each of our districts is another area we cannot forget. It is our responsibility as lawmakers to decide the best course to take on any issue, and in my view, we should do so in a thoughtful and a deliberative manner. The current system has been in place for over a century, and any changes we proffer should consider all potentially affected constituencies.

In closing, I expect today's testimony will continue to help guide us into specific areas to review. Even more so, I would like consensus and bipartisanship to dictate what areas we choose to focus on. I am optimistic that we can achieve this goal.

Future hearings will explore policy options for reform. We will likely review general and broad reform ideas as well as options targeted on specific areas. Nevertheless, until we explore options, we will remain focused on why there is a need for improvement in insurance regulation. Our hearing earlier this month was a great beginning, and I look forward to another open dialogue with today's panel.

I now recognize Ranking Member Pryce for 5 minutes for her opening statement.

Ms. PRYCE. Well, thank you, Mr. Chairman. I won't use much of my time. I just want to thank you for this, the second in a series of hearings on what is a very important subject for this committee.

I want to thank you also for agreeing to invite witnesses on a very bipartisan basis. I think this is reflective of a shared interest in going forward with reform, which is so very important in a thoughtful, considerate way. And I for one am very appreciative of your willingness to share this responsibility with the minority.

I yield back.

Chairman KANJORSKI. Do we have any other members who wish to make an opening statement? The gentlelady from Illinois, for 3 minutes.

Ms. BEAN. Thank you, Chairman Kanjorski, and Ranking Member Pryce, for holding a second hearing on insurance regulatory reform. In addition, I would like to thank all of our witnesses for sharing their expertise with us today. In particular, I would like to welcome Mr. Alessandro Iuppa, head of government and industry affairs for general insurance for Zurich North America, which is headquartered in my district. Welcome.

Most members—and we discussed this in the last hearing—on this committee do agree that America's economic preeminence in the world hinges upon the health of our capital markets and our global leadership in the financial services industry. Earlier this year, New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer commissioned a report on what changes were needed to keep the United States competitive in the global marketplace.

One of the report's top recommendations was the creation of an optional Federal charter for insurance. In July, Representative Royce and I introduced the National Insurance Act of 2007 to address issues of competitiveness and consumer choice. The bill would create an optional Federal charter for life and property casualty insurers.

Designed to emulate the regulatory structure found in the dual banking system, the NIA would give insurance providers the choice of being regulated at the State level or by the new Federal regulator. The bill gives consumers what they want, choice and protection. Insurance customers will have more pricing and product options, driven by a competitive marketplace freed from State price controls and regulatory hurdles, without sacrificing consumer protections.

The current State-based regulatory system has hurt the U.S. insurance industry's ability to compete globally. In 2006 alone, the U.S. insurance services trade deficit totaled $24 billion. The current system, which requires insurers to work with 51 different State regulators, is burdensome and slows the new product's time to market, sometimes by years. This discourages insurance innovation and product development. A national charter would foster greater industry innovation and competitive agility.

The insurance industry has changed and evolved dramatically since 1871 when the National Association of Insurance Commissioners was established. But for 136 years, the regulatory system has not significantly changed. It is time to allow the insurance industry to move into the 21st century so that it can more effectively compete on the global stage and provide more pricing and product alternatives to our Nation's consumers.

As a resident of and representative for Illinois, I have seen firsthand the benefits to consumer pricing and product options in a deregulated environment. We can extend those benefits nationally with this bill.

For years, hearings have been held identifying the problems inherent in the current State-based system. Insurance reform needs to happen, and we should start now.

I look forward to your testimony and recommendations for how we should proceed. Thank you. I yield back.

Chairman KANJORSKI. I will recognize the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you very much, Mr. Chairman. I would also like to thank you, Mr. Chairman, for your continued leadership on this issue.

This being our second hearing on the need for insurance regulatory reform in a month, I think we look forward to investigating this issue further. At the last hearing we held, we heard from the National Association of Insurance Commissioners yet again on the progress they claim to have made in streamlining regulations at the State level. However, at that time we also heard frustration expressed from other witnesses, who pointed to the structural flaws in the State-based system as the major reason why meaningful reforms continue to elude the NAIC and the insurance sector.

With 50 State insurance commissioners and 99 State legislative chambers needed to agree upon regulatory models proposed by the NAIC, it is easy to see why these proposals fail to garner any type of unanimous support. And quite often it is the two or three large States with the largest insurance markets, representing the bulk of the marketplace out there, that refuse to implement changes that momentarily might be agreed upon by the other members.

Unfortunately, the only substantive reforms universally adopted have come about in large part because of Federal pressure in the past. Uniform solvency standards, that is because of the Federal pressure. Reciprocal agent licensing standards, that followed the mandates and threats that came from Congress.

While this back and forth between Congress and the State regulators had produced some results, it is time to pursue a different path. We have yielded to the States for 136 years. We don't have a national market here. We should. And we have yielded only to see the fundamental problems remain unaddressed.

If America's stronghold as the financial capital of the world was not at risk, the urgency of this matter would not be as strong. But we are now competing in a global marketplace where capital flows to the most efficient markets in all corners of the globe, and it does it at the click of a mouse.

The Bloomberg/Schumer report understood this and explained it. The U.S. Chamber of Commerce report details this problem. And I believe the Congress will come to understand that an optional Federal charter is needed if our insurance industry and our financial services sector are going to compete globally in the future.

We need a world-class regulator able to properly oversee and address issues that arise in that sector. The banking and securities industries have ample representations when major policy decisions are formulated in this town. Whether in responding to a national crisis or formulating tax policy or negotiating a major trade agreement, the Fed is there. The OCC is there, the SEC. They all have a seat at the table when the policy is developed or when we are trying to get into that foreign market.

I believe the time has come to give the insurance industry equal representation, able to voice concerns on behalf of the industry, and able to enact substantive regulatory reforms.

At the previous hearing, the independent insurance agents highlighted their opposition to an optional Federal charter, but their support for the National Association of Registered Agents and Brokers subtitled in Federal legislation in the Gramm-Leach-Bliley Act, which creates a clearinghouse for interstate license.

However, the NARAB is intended to do for agents and brokers what an OFC would do for the entire insurance industry, streamlining regulation and allowing insurance providers to better serve their customers is the central theme of an OFC.

Now that there is a virtual consensus that Congress should act, we must decide which path we should take. I believe creating an optional Federal charter is the best option. It will provide insurance consumers, producers, and sellers a viable alternative to the tangled bureaucratic web currently in place. And for this and other reasons, including the cost, I have cosponsored Representative

Bean's National Insurance Act, which would create an OFC for insurance.

In closing, I think it is worth noting that we have our second former president of the NAIC testifying in favor of creating an optional Federal charter. I believe serving in this capacity has given them a unique insight into the difficulties faced by the NAIC. Mr. McCartney eloquently highlighted the failures of the NAIC to successfully streamline and modernize insurance regulation at the last hearing, and I look forward to Mr. Iuppa's testimony today.

Again, I would like to thank you for holding this hearing, Chairman Kanjorski, and I look forward to hearing from our distinguished panel of witnesses here. Thank you.

Chairman KANJORSKI. Thank you, Mr. Royce.

We will now move to the panel welcomed before us today. Thank you for appearing before this subcommittee. Without objection, your written statements will be made a part of the record, and you will each be recognized for a 5-minute summary of your testimony.

First we have the Honorable Craig Eiland, Texas House of Representatives, testifying on behalf of the National Conference of Insurance Legislators.

Representative Eiland.

STATEMENT OF THE HONORABLE CRAIG EILAND, TEXAS HOUSE OF REPRESENTATIVES, TESTIFYING ON BEHALF OF THE NATIONAL CONFERENCE OF INSURANCE LEGISLATORS

Mr. EILAND. Thank you, Chairman Kanjorski, and Ranking Member Pryce. It is good to be here today. As noted, I am a State Representative from Texas, and I am here on behalf of NCOIL, a group of State legislators from approximately 35 States. Most of us are a member of an insurance committee or chairman of those committees.

And we do exciting things 3 times a year, like meet for 3 days and discuss insurance and only insurance. We adopt model bills, and we debate model bills, and we take those bills back to our representative States and try to get them enacted.

I usually sit where you sit, and I prefer sitting there much better than being down here. But I appreciate Congressman Marchant, my former House colleague in Texas, being here, and hope you will have some softball questions for me sooner or later.

[Laughter]

Mr. EILAND. With that said, I think that when you have a product that is a national product, you have much more of an argument for having some type of uniformity. We have recognized that in the States and we are moving that way specifically for life insurance, annuities, and those types of products that are the same no matter where you are. We are doing that with the compact which was discussed in the last hearing. And we are doing that with market conduct exam reform, which I will talk about in a minute.

But what you will find in the difficulty is that if you have a product where if you live in Dallas, Denver, Des Moines, or Detroit, it is completely different based upon your coverage and your price. There is no uniformity there. And that is why you have difficulty in the property/casualty area trying to come up with uniform products and rates and forms.

By way of contrast, with life insurance, if you live in Dallas, Detroit, or Des Moines, and you are a male, 50 years old, and a non-smoker, with each company you are going to have basically the same price quote. And if you move to one of those other cities, it doesn't change. You still have your life insurance. You still have your annuity.

Not so if you own a house. Even if you have a trailer house and you move it from Dallas to Denver, you are going to have different coverage and a different price. The same with your auto. And so there are differences that we have to recognize.

I know it was brought out last time in NAIC's testimony, but it is also important to note that California is the 6th largest insurance market in the world; New York is the 7th largest, Florida is the 8th largest, and Texas is the 10th largest in the world.

I don't think any of those markets are going to give up their regulatory power or authority, certainly not without a fight. And I think that what they are doing is they are doing what they think those markets need to meet local issues—the wildfires in California, storms along the Gulf Coast, and snowfall in the Northeast. Those types of things are different, and that is why the policies and the exposures are different.

I would point out that what we have tried to do on the State-based regulation is when you all set the Gramm-Leach-Bliley deadlines, we met them, to institute those reforms. We have done the compact, like we discussed, for life insurance-type products.

A couple of years ago we started working on market conduct exam reforms, and in Texas, I was the first one to pass that. We now have four States that have passed it. There is some concern that we are not moving fast enough. I would point out that on market conduct exam—and this is not sexy stuff. This is nuts and bolts. If you had a press release on filing a market conduct exam bill, you are in dire need of more legislation.

But this is one of those nuts and bolts where we are trying to attack. The industry didn't even come together on what they felt was needed until the spring of 2005, and so far, we have four States that have instituted market conduct exam reform.

And so when you look at what the States have done for trying to have some rate reforms, especially on the commercial lines, and then having some type of filing use and the States moving that direction, you will see that where possible, we are moving in the right direction with producer licensing. We are moving in the right direction with uniformity on uniform products. We are moving in the right direction on market conduct exams, trying to reduce the number of those exams. And we are moving in the right direction on rate and modernization on forms.

And so we certainly stay here hoping to work with you on the reforms that you all determine are necessary so that we hope that we can support them and work to help reform this. I do note that on reinsurance issues, there does need to be a national debate on what we do with reinsurance issues. We have been discussing this along with NAIC, and there are very technical, detailed things that have to happen on a worldwide basis, not just what we do.

The international accounting standards have to be aligned so that we are looking at the same issues across the pond as we are here. And so it is not always as easy as it seems. And I see my red light says stop, so I will.

[The prepared statement of Mr. Eiland can be found on page 48 of the appendix.]

Chairman KANJORSKI. I think you are the first one who has ever responded to that red light.

[Laughter]

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

Next we will hear from Mr. Alessandro Iuppa, senior vice president for government and industry affairs at Zurich, testifying on behalf of the Financial Services Roundtable.

Mr. Iuppa?

STATEMENT OF ALESSANDRO IUPPA, SENIOR VICE PRESIDENT, GOVERNMENT AND INDUSTRY AFFAIRS, ZURICH, TESTIFYING ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. IUPPA. Thank you and good afternoon, Chairman Kanjorski, Ranking Member Pryce, and members of the subcommittee. My name is Alessandro Iuppa, and I am senior vice president, government and industry affairs, for Zurich North America. I appreciate the opportunity to speak with the committee on behalf of Zurich and the Financial Services Roundtable on the subject of insurance regulatory reform.

I come to the issue of insurance regulatory reform with a perspective perhaps somewhat different than the other witnesses at today's hearing. Prior to joining Zurich in January, I was an active member of the regulatory community for the past 20 years, serving as deputy commissioner and commissioner for the State of Nevada, as deputy and superintendent of insurance for the State of Maine, and in the interim, providing consulting services exclusively to insurance departments seeking to rehabilitate financially troubled insurers.

During my 9-plus years as Maine superintendent, I was engaged on insurance issues nationally and internationally through the National Association of Insurance Commissioners and the International Association of Insurance Supervisors. I had the honor to serve as an NAIC officer from September 2004 through 2006, when I served as president, and from 2004 through 2006, I also served as chair of the IAIS executive committee.

Financial markets in general have undergone extraordinary growth and structural change in recent decades. Much of this change is due to developments such as the worldwide integration of capital markets, the revolution in information technology, as well as shifting attitudes towards competition and protection in the financial services area.

Unfortunately, the current U.S. regulatory structure is not fully equipped to supervise the sophisticated marketplace of the 21st Century. The need to operate within the State patchwork of regulation in the United States hinders insurers with risk issues confronting clients who operate on national and international bases.

Zurich and the Roundtable are not opposed to the regulation of insurance. If they were, I would not be here. We do, however, support prudent, strong, state-of-the-art insurance regulation that allows insurers to meet the needs of their policyholders and encourages competitive and thriving markets. Although the existing structure works for some, it impedes our ability to achieve those goals.

To their credit, State insurance regulators individually and through the NAIC have attempted to institute regulatory reforms, and have made strides towards simplifying and streamlining regulatory requirements. The reality, however, is that today's marketplace demands far more dramatic action than the States alone are able to provide. Competition and efficiency in the insurance industry lag behind the other financial services sectors, due in large part to the regulatory inefficiencies and inconsistencies in the State system.

Over the past several years, I have spent a great deal of time working on behalf of the U.S. regulatory community with our foreign colleagues. What I learned is that despite our best efforts, our effectiveness on the international stage was limited, not necessarily in the development of policies and ideas, but in terms of implementing those policies and ideas at home.

I will give you an example. The IAIS has become the standard-setting with respect to international insurance standards. U.S. regulators have been and continue to be active participants in the development of those standards. But no matter how much agreement exists among the regulators, the U.S. representatives cannot bind the U.S. regulatory community or their States to adopt those standards. The national insurance commissioner, with the authority to negotiate and perhaps bind the Federal Government, would add immeasurably to the effectiveness of our international endeavors.

Let me now mention three areas that can benefit from Federal regulation: market deficiencies; speed to market; and commercial policyholder issues. The lack of a sustainable market for terrorism coverage and coverage shortfalls in some coastal regions illustrates a deficiency in the U.S. marketplace. There are many reasons insurers do not cover terrorism or certain property risks, and we should all be clear from the beginning that even with a Federal regulator, that regulator will not solve every problem that arises in the marketplace.

Regulation, however, can play an important role by helping markets operate as efficiently as possible by maintaining the proper equilibrium among suppliers and purchasers. At the other end of the spectrum, by sustaining each State as an individual market, we inhibit the ability of insurers to spread that risk and enhance capacity.

The problems created by mega-catastrophes tend to be regional in nature and national in nature. A Federal regulator with the responsibility for a national market will be better able to respond to regional and national problems.

A number of States still require prior approval or the filing of rates and policy forms before the products can be offered for sale. Several States have deregulated the commercial insurance marketplace for rates and forms. Others, however, continue to maintain some level of preapproval requirements.

My experience as the Maine superintendent taught me that of the approximately 1,000 companies that were licensed to underwrite insurance products in Maine, few intentionally sought to introduce products that did not comply with Maine law. For those products that did require prior approval, the search for the few problems at the beginning substantially slowed the pace of product introduction.

It is also important to remember that not all policyholders are individuals. Commercial entities constitute a very large segment of the insurance market, and each has specific risk management criteria. Our company, for example, works with many of the Fortune Global 100 companies. To serve those clients, we developed the Zurich multi-national insurance proposition.

With it, our global customers can be confident that their out-of-territory coverage is aligned with local licensing and premium tax requirements. For our clients indemnifying risks in the United States, compliance would be much more simple if Zurich had a Federal charter. I mention this because compliance in these areas is an important policyholder protection.

After 20 years as an insurance regulator, I can conclude that despite recent improvements, the States are not likely to solve the problems on their own, so I believe congressional action is necessary. For better or worse, many of the States' regulatory modernization efforts have been the result of external pressure, and there is no guarantee that the States will adopt further meaningful reforms. Building consensus among regulators is a very difficult thing to do, and at times almost impossible.

An optional Federal charter would give insurers and products a choice between a Federal regulator and multiple State regulators. It will not dismantle the longstanding State insurance regulatory framework; rather, it will compliment the State system with the addition of a Federal partner.

It is likely that many insurers and producers, particularly those who operate in a single State or perhaps a small number of States, would choose to remain State-licensed. Large national and international companies, on the other hand, would more likely opt for a Federal charter, thereby relieving themselves of the burden of compliance with 56 different regulatory regimes.

I thank you for your time, and I look forward to your questions.

[The prepared statement of Mr. Iuppa can be found on page 126 of the appendix.]

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

Next we will have Mr. J. Robert Hunter, director of insurance for the Consumer Federation of America.

Mr. Hunter.

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. I even have broader experience than that. I was a Federal regulator. I ran the Federal Insurance Administration and the National Flood Insurance program, and I was an insurance commissioner and served on the executive committee of the NAIC.

You asked that we focus our oral presentation on the areas of regulation that needed improvement, and I am going to do that.

There are serious problems that consumers face today. Here are just a few of them.

First, claims abuses: Hurricane Katrina shows the mess regulation in the States is in. People are being denied the money they are entitled from their insurers. The taxpayers are paying flood claims for wind damage that should have been paid by the insurers. Beyond Katrina, insurers are systematically cheating consumers, using computer programs like Colossus to turn their claims departments into profit centers. Most regulators have done nothing.

Second, unfair prices: Here are a few examples. If your education goes up, your rate goes down. If you have a low-paying job, you will pay more. If you bought the limits of liability the State requires but didn't buy a lot more, you will pay more. If you are curious and ask about a hypothetical claim, your rate goes up even if you don't file the claim. Most regulators have done nothing.

Third, excessive prices: In 2006, insurers paid out the lowest percent of their premium dollars in history, 50 cents per dollar of premium. Despite the major storms, insurance companies reaped unprecedented profits over the last 3 years, totaling $500 from every man, woman, and child in America, this at the same time they had Hurricane Katrina. This is because insurance companies are increasingly transferring risks and costs onto consumers and taxpayers. Most regulators stand by helplessly, doing nothing. Worse, insurers are exempt from State and Federal antitrust laws and are allowed to collude in setting prices and other matters that would be criminal if the played by the same rules as the other businesses in America.

Fourth, even large sophisticated buyers have been cheated. Elliot Spitzer proved that with his finding of collusion, hidden kickbacks, and illegal bid rigging.

Fifth, poor information. People don't know what is in their policies. There are no real plain language policies. There is no standard coverages.

Sixth, new classes not related to risk are being created, such as credit scores, destroying the insurance loss prevention function by disconnecting price from risk, little control exercised by the regulators.

Seventh, regulation is weak because regulators are not independent. We know about the revolving door in insurance, don't we, Al? And also, we know that part-time State legislators often work for insurance companies.

Eighth, few States have told consumers their rights. Only Texas requires a bill of rights with every policy. People don't know their rights for things like cancellation restrictions and so on.

Ninth, except for California, States have not controlled expenses that are built into insurer rates, expenses such as huge sums used to contribute to politicians, or to lobby Congress, or inappropriate costs like losses of lawsuits and fines and penalties. These are all passed on to consumers in almost every State. The regulators are failing.

There are many other problems I could list. There are problems waiting to emerge that will be uncovered by lawsuits, not the regulators, or by the media. Consider life insurance market conduct abuses of a decade ago. The largest life insurers told people their premiums would disappear, and confused them into believing their life insurance was an investment. It took lawsuits to uncover these problems.

Now, consumers don't care who regulates insurance. We really don't care if it is Federal or State. But we do care if it is any good, and it isn't good today.

But consumers are also not clamoring for speed to market. The collusive and near-simultaneous introduction of the outlandish anti-concurrent causation clause into homeowners insurance policies is one example of speed to market that we don't want. It makes the policies bad. In a very short time, 46 States approved this awful provision, which has caused havoc in the wake of Hurricane Andrew.

Consumers do not want uniform regulatory systems if it means gutting the few consumer protections we have to achieve it. It is hard to believe that the OFC that has been introduced would make matters worse for consumers. It is almost impossible to write a bill like that. But they did it. The insurers are very good at writing bills. Consumers do not want speed to market of junk insurance products or uniform weak regulation. We want real protection.

One other myth we should puncture: Tough oversight of the insurance market is not incompatible with vigorous competition. The best State regulatory regime is California, from a consumer perspective, and it achieves both goals. Appropriate regulation enhances competition, requires insurers to compete fairly and in a manner that benefits consumers, and results in good returns for the insurance companies.

Insurer-backed proposals in Congress do nothing to increase scrutiny of insurer actions that have caused severe harm to consumers. Indeed, these proposals would harm consumers.

It is possible to create a regulatory system, whether it is State or federally based, that protects consumers and forces competition. We proposed a number of detailed measures in our testimony for this. Repeal of the McCarran-Ferguson Act antitrust exemption is one of them. Requiring clear disclosure of the policies is another.

Simply stated, we need a strong, effective consumer protection in place in the country, not weak regulation. An OFC guarantees regulatory arbitrage. The drafters admit it. A race to the bottom. If you really want uniformity, why don't you propose a Federal bill to take over regulation, and then we can argue about the level of protections. Have the courage if you really believe in it. It is not uniform if you have two systems on top of each other.

The subcommittee has a vital role to play in making sure that any Federal role increases regulatory standards so that America's consumers have adequate protections.

[The prepared statement of Mr. Hunter can be found on page 78 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Hunter.

Next we will hear from Mr. Frank Nutter, president of the Reinsurance Association of America.

Mr. Nutter.

STATEMENT OF FRANK NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Mr. Chairman, thank you very much. I am Frank Nutter, president of the Reinsurance Association. I would certainly like to shift gears from Mr. Hunter's presentation to focus on the role that reinsurance plays in regulation.

I do want to commend Chairman Kanjorski and Ranking Member Pryce for their continued leadership in this area of insurance regulatory reform, and I welcome this opportunity to discuss why the 50-State system for regulating reinsurance in the marketplace is in need of reform, why the system does not work well for the sophisticated global marketplace like reinsurance, and explain the RAA's position in support of an optional Federal charter.

Reinsurance is a global business. According to the NAIC-filed annual statements of U.S. insurance companies, in 2006 more than 2,300 foreign reinsurers assumed business from U.S. ceding companies. Although most insurers principally engaged as assuming reinsurers are located in a small number of countries, the 2,300 named reinsurers identified by U.S. ceding companies were domiciled in more than 95 foreign jurisdictions. Their share of the U.S. market underwritten directly by foreign-based reinsurers has grown steadily to 53 percent in 2006, from 38 percent in 1997.

Some foreign reinsurers also establish U.S. subsidiaries. If the amount of U.S.-based ceded revenue to these foreign-controlled entities were added to the percentages I quoted above, the total non-U.S. share would be 85 percent.

These percentages should not be misconstrued. Non-U.S.-based reinsurers and their U.S. subsidiaries bring much-needed capital and capacity to support the extraordinary risk exposure in the United States and to spread that risk throughout the world's capital and capacity providers.

The United States employs two methods of reinsurance regulation, direct regulation of licensed U.S. reinsurers, and indirect regulation of the reinsurance transactions ceded by U.S. insurers to unauthorized reinsurers. The fundamental concept underlying the U.S. regulatory system is that a reinsurer must either be licensed in the United States and subject to the full spectrum of multi-State reinsurance solvency regulation, or if not licensed in the United States, provide collateral to ensure the payment of the reinsurer's obligation to U.S. ceding companies.

Capital providers to the reinsurance market in recent years have clearly opted for the latter approach to avoid the multi-State system of licensing that exists in the United States.

Following the 1992 hurricane season, eight new reinsurers were formed, reflecting $4 billion of new capital. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion in capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed.

Nearly all of the new capital came from the U.S. capital markets. However, other than the U.S. subsidiaries of some of these new non-U.S. companies, no new U.S.-domiciled reinsurer has been formed since at least 1992. For these new non-U.S. startups, the ease of establishment, capital formation, and regulatory approvals in non-U.S. jurisdictions contrasted with the cumbersome and protracted nature of getting a license in multiple States.

We have identified in our statement three areas of concern regarding reinsurance regulation:

First, credit for reinsurance laws and regulations based on the NAIC model has been debated extensively in recent years. Some have advocated for the reduction of collateral for these reinsurers that choose not to be subject to U.S. licensing. However, U.S. primary insurers have largely opposed this effort, believing that it weakens U.S. regulation and dilutes the financial security of U.S. insurers and their policyholders.

Second, collateralization is a surrogate for licensing. It eliminates a regulator's need to assess the level of regulation in the non-U.S. reinsurer's domiciliary jurisdiction, or the financial strength of it. It also reflects the challenges facing 50 State regulators with resource constraints and competing regulatory demands.

Unfortunately, it seems that initiatives by some States suggest that a patchwork of State laws relating to financial security may be emerging. The RAA believes that it is essential to maintain a strong but uniform regulatory structure in the United States. In that regard, the RAA commends the sponsors of H.R. 3200 for proposing an optional Federal charter.

We have also highlighted the problems associated with extra-territorial application of State laws. While the NAIC and State regulators should be applauded for seeking greater uniformity in laws, this has not prevented the States from pursing varying and sometimes inconsistent regulatory approaches. One of the best examples is the extra-territorial application of State laws, meaning that State law not only applies to insurers domiciled in that State, but to insurers domiciled in other States.

We have also highlighted mutual recognition as an issue to be addressed. The United States imposes a highly structured and conservative level of regulation upon licensed reinsurers. However, it has long been recognized that the level of reinsurance regulation varies in countries throughout the world, and there are several globally recognized methods of conducting regulation.

The RAA is encouraged by the inclusion in H.R. 3200 of a system of mutual recognition among the countries which would allow reinsurers to conduct business in the United States based upon their home country's jurisdiction, and allow U.S. reinsurers to do business in foreign countries based upon U.S. regulatory requirements.

In conclusion, the core characteristics of an appropriate reinsurance regulatory structure are a single regulator or regulatory system for reinsurance with national regulatory oversight, and the power to prevent conflicting or inconsistent State laws and regulations in an effective and efficient manner.

A single regulator's authority should provide for recognition of substantially equivalent regulatory standards and enforcement in other competent regulatory jurisdictions. The regulatory structure should support global capital and risk management, financial transparency so that the cedents can assess counter-party risk. And regulators should have access to all necessary financial information.

We have identified in the statement several options that can be achieved, including the option of a Federal charter for reinsurers, which is the one that the RAA strongly supports.

Thank you very much, Mr. Chairman, and we welcome this opportunity to continue to work with the committee.

[The prepared statement of Mr. Nutter can be found on page 139 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Nutter.

Next we have Mr. Scott Gilliam, assistant vice president and government relations officer of the Cincinnati Insurance Companies.

Mr. Gilliam.

STATEMENT OF SCOTT GILLIAM, ASSISTANT VICE PRESIDENT AND GOVERNMENT RELATIONS OFFICER, THE CINCINNATI INSURANCE COMPANIES

Mr. GILLIAM. Thank you, Chairman Kanjorski, Ranking Member Pryce—a fellow Buckeye, number one right now—and members of the subcommittee. My name is Scott Gilliam. I am assistant vice president and government relations officer for the Cincinnati Insurance Companies.

Our group of companies market property and casualty insurance and life insurance in 34 States through independent insurance agencies. Based on 2006 revenues of $4.5 billion, we are the 23rd largest publicly traded property and casualty insurer in the United States. I would also note that we are not a member of a national trade association, so we come here with an independent voice today.

In presenting our views on insurance regulatory reform this afternoon, we have three goals: one, identify the problems we see with the current system of State regulation; two, emphasize our support for a continued system of State insurance regulation; and three, suggest that public policymakers and interested parties may need to take a fresh approach to insurance regulation reform and consider alternatives to the current proposals on the table.

We come to this debate on behalf of hundreds of small and medium-sized insurers like ourselves who collectively insure millions of individuals and small businesses across this country. These insurers value their connection to their State and local governments, a connection which carries over into the business of insurance, which by its very nature is uniquely local.

Consider the decision to purchase insurance, which is rooted in many local risk factors. Consider the types of occurrences for which individuals and businesses purchase insurance, all of which are uniquely local in nature. And also consider the body of State and local laws that apply when insurable events occur, including State tort law, contract law, and social policy law.

It is in this context that the States have been established as the primary regulator of the business of insurance, and it is for these reasons that the States should remain the primary regulator of the business of insurance since the activities and occurrences which necessitate insurance and its regulation are not uniform from place to place or State to State.

But there is great consensus that several areas of State-based insurance regulation are in need of reform. The areas which seem to attract the most complaints, and which are sometimes problematic for our company as we endeavor to market property, casualty, and life insurance products in 34 States include product regulation, rate regulation, producer licensing, company licensing, and market conduct examinations.

But I cannot offer any horror stories. Rather, the company line at Cincinnati Insurance seems to be: State regulation of insurance is sometimes challenging, but we can live with it. Nor is the current system of State insurance regulation grinding our operations to a halt.

But that is not to say that State regulation is without flaws. The Cincinnati Insurance Companies believe the major problem with the current system of State regulation is the needlessly repetitive nature of the system. We simply do not believe that 34 separate jurisdictions need to regulate each and every aspect of our business.

In many instances, regulation by an insurer's domiciliary State would be sufficient to protect all persons or entities with an interest in an insurance transaction or the operation of an insurance company. Areas of regulation where this might work, among others, include product regulation, producer licensing, company licensing, and financial regulation. These are the areas of regulation which we view as more organizational in nature, of which there is no need for every State jurisdiction to demand its own approval.

At the same time, we acknowledge that there are some aspects of the business of insurance which need to be regulated in every jurisdiction in which we conduct business. These include the areas of regulation which are more transitional or conduct-related, such as consumer protection, fraud, claims handling, and possibly market conduct.

We hasten to add, however, that an important aspect of reforming State regulation is to demand more uniformity in the procedures the several States would employ to regulate in those areas of regulation, which would remain subject to multi-State regulation. And of course, the devil is identifying which aspects of the business of insurance demand multi-State jurisdiction and which would be more appropriate for exclusive regulation by a domiciliary State.

But the idea here has quite a simple premise, one that is analogous to the full faith and credit of a State-issued driver's license. I am licensed to drive by the State of Ohio, but I can drive in any State with that license. But when I leave Ohio and drive to Wilkes-Barre, I am subject to the public safety laws of the Commonwealth of Pennsylvania.

Let's apply this analogy to insurance regulation. Why not let my company's licensure by the State of Ohio serve as a national license to conduct business of insurance in every State, while keeping my company subject to the insurance consumer protection laws in Pennsylvania and every other State.

We therefore suggest that consideration be given to a modernized State system of insurance regulation that would reserve certain areas of insurance regulation to a single State regulator, most likely the insurer's domiciliary State, to the exclusion of all other States, but allow all States to regulate in those areas not reserved to a single State regulator.

We realize there may be unintended consequences of an approach like this, and this may not be the right solution to what currently ails State regulation. But we feel that it is this type of outside-the-box thinking that needs to be explored before we give up on State regulation in favor of anything Federal.

Let me close by suggesting that H.R. 1065, legislation passed unanimously by the House in June and pending in the Senate, might serve as a template for how a single State/ multi-State system of State regulation might be achieved. We believe that the approach embodied in H.R. 1065, targeted Federal legislation identifying specific areas of insurance regulation reserved to the regulator of an insurer's domiciliary State, is worth consideration as a means to implement the single State/multi-State proposal we have described this afternoon.

That concludes my testimony. I would be happy to answer any questions.

[The prepared statement of Mr. Gilliam can be found on page 67 of the appendix.]

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

And last, we will hear from Mr. Felton, president of the Tennessee Brokerage Agency, testifying on behalf of the National Association of Independent Life Brokerage Agencies.

Mr. Felton.

STATEMENT OF JOHN W. FELTON, PRESIDENT, TENNESSEE BROKERAGE AGENCY, TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT LIFE BROKERAGE AGENCIES

Mr. FELTON. Mr. Chairman and members of the subcommittee, my name is John Felton. I would like to thank you for having me here this afternoon. I am the current chairman of the National Association of Independent Life Brokerage Agencies, or NAILBA. I am also the president of Tennessee Brokerage Agency in Knoxville, Tennessee.

I am appearing today on behalf of NAILBA, the principal trade association representing wholesale life brokerage. NAILBA is a nonprofit trade association with over 350 members in the United States. We represent 100,000 producers, who deliver over $1 billion of life premium a year.

A normal NAILBA member agency may employ anywhere from 10 to 30 employees, and operate in an average of 31 States. We are small businesses, but we represent the fastest growing distribution of life insurance. Currently, we produce over 60 percent of the life insurance written in the United States today, and it is projected by the year 2020, we will be writing over 80 percent.

I appreciate the opportunity to appear before you to discuss the critical need to streamline and modernize the insurance regulatory system in the United States. Despite the best efforts of the National Association of Insurance Commissioners via the Interstate Compact, the current State-based system does not enable insurance carriers and agents to provide new competitive products to consumers throughout the United States in a timely fashion.

Additionally, the current system lacks uniform and equal opportunities to every citizen in the United States to access similar products and protections. For wholesalers that are licensed in multiple States, the inefficiencies and inconsistencies within the State system are costly and potentially harmful to consumers.

I would like to take you inside a typical NAILBA agency so that you have a greater understanding of why Federal regulation of insurance would greatly increase insurance distribution productivity, increase sales, increase consumer satisfaction, lower consumer and broker confusion, and lower the potential for errors of omission and other litigation.

All NAILBA member agencies have contracts on an average of 15 to 20 different life insurance carriers. The NAILBA agency is a wholesaler whose customers are insurance brokers and agents. These clients in turn market insurance products to the insurance-buying public.

The insurance carrier will outsource sales, marketing, agent training, and some underwriting functions to NAILBA member agencies. By eliminating these functions, it allows a life insurance company to focus on product manufacturing and applying the savings to more competitive and consumer-friendly products.

The insurance agent or broker is served by accessing product from the NAILBA member agency because the agency is independent and able to provide unbiased advice to help the broker select the best company and product to meet the needs of customers. The consumer is served by a distribution system that creates a demand for competitive products and increased efficiency these products deliver.

All NAILBA member agencies have a substantial customer base of insurance brokers. They may be located in a different State, or may solicit insurance in multiple States. On average, NAILBA member agencies are licensed in 31 States and spend nearly $12,600 per year just to update the proper State regulatory forms.

The multi-State nature of a NAILBA agency forces us to be keenly aware of the pitfalls of the current system. In my written testimony, I provided detailed examples of the maze that is the current State-based system.

In closing, NAILBA believes an optional Federal charter approach would provide consumers with increased access to competitive and market-reflected products more quickly. The reduction of costs associated with working with 1 regulator, not 50, would be reflected in the pricing of products. This would have the effect of reducing costs to the consumer and providing consistent agency licensing standards and continuing education requirements.

Centralized control of agent status through a national database would provide consumers with a higher level of confidence in those who represent the insurance industry. NAILBA certainly believes that OFC is an idea whose time has come. Thank you.

[The prepared statement of Mr. Felton can be found on page 60 of the appendix.]

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

I thank the entire panel for your testimony. It has certainly been interesting, and quite conflicting in its basic positions.

I guess I would start off with one question, Mr. Eiland, just a practical question. What kind of complaints do you get as a State legislator from your constituents in Texas about insurance? And if you could tell me, what do you do about them?

Mr. EILAND. Yes. The first one a lot of times is about health insurance, and most of the time we have to tell them, we can't help you because ERISA preempts it, or something like that.

The second one is usually about companies pulling out of areas, companies not wanting to write products, homeowners, in certain areas. You know, most of the big—Allstate, State Farm, and Farmers, most of them over this last summer decided they weren't going to write within an arbitrary—a mile or a half-mile within a major body of water.

So you have people who say, look, I have been an Allstate customer for 30 years, I have never had a claim, and now they are dropping my homeowners insurance. And we say, well, you know, we can't really do anything at that. So there are those complaints.

Then there are complaints about pricing, that they are getting less and less coverage for more and more premium. And that is a big concern.

Chairman KANJORSKI. Well, does the regulator—do you refer that then to the Texas commissioner of insurance?

Mr. EILAND. Yes.

Chairman KANJORSKI. And do they follow up and do they regulate on those issues?

Mr. EILAND. Yes, they do. The problem is, one of the things that we have been talking about that we have been doing is getting away from such heavy regulation on rates and forms. So we give the insurance companies the ability to change their coverage and price whatever they want to as long as it is not excessive in the regulator's eyes.

So even though it goes up—but that is not what the consumer sees. The consumer sees: I have the same house; I have the same company; I have no claims; and they want to raise up my prices by 20 percent. And there has been no storm. So what is the deal?

Then we find out—several of the companies come in and they blame it on reinsurance. But it is their own reinsurance. They have a reinsurance subsidiary which they purchase their reinsurance through, or at least part of it. They let the reinsurer raise those prices because we don't have anything to do with their rates. And then that raises the rates for the policyholder. And we can only look at the end product, the end price, to see if it is excessive and unreasonable.

And then we have to—the way our system in Texas, which we reformed about 6 years ago, the commissioner for one company recently denied a rate and said, that is excessive. They went ahead and they are allowed to charge it, and now the commissioner has to beat them in court to prove that it is excessive.

And so when you hear all these people talking about how they want regulatory reform, I do believe I agree with Mr. Hunter on this. Consumers don't want less regulation. I mean, they want good quality regulation and to be able to do something about it. That is what we hear about the most.

Chairman KANJORSKI. Speaking of Mr. Hunter, you do not have a lot of good stuff to say about the insurance industry, Mr. Hunter.

Mr. HUNTER. Oh, there is a lot of good I would say if you wanted me to list some of the good things. You said, what were the problems? It is good that they are making money. I mean, I am not for them going broke or anything. I just think they are making too much.

But there are a lot of good things about the insurance industry. It makes a lot of jobs in the Nation. It makes things happen. When it is working smoothly, it is great. But when it isn't, then there needs to be intervention.

Chairman KANJORSKI. Do you think it is not working smoothly because of avarice, or a thoughtful intent to deny paying customers, or attempting to target and only make special monies in special areas?

Mr. HUNTER. I think it is—

Chairman KANJORSKI. From the areas that Mr. Eiland is talking about?

Mr. HUNTER. I think it is a fundamental change in corporate culture over decades, to the point now where, for example, McKinsey could come in to Allstate and say, we want to turn your claims operation into a profit center, and here is how you can basically cheat your customers. And Allstate didn't kick them out.

When I was a young man in the insurance industry, I think we would have called the cops if somebody came in and made such a proposal, and now probably 17 of the top 20 insurers are using that methodology.

Chairman KANJORSKI. Mr. Gilliam, do you agree with Mr. Hunter that the standards for the insurance industry have materially changed as a result of culture? Or do you think it is getting better?

Mr. GILLIAM. I am not quite sure how to answer that because Mr. Hunter and I don't agree on very many things.

Mr. HUNTER. I didn't think you would.

Mr. GILLIAM. But, you know, we are a major regional insurer. We have over 4,000 employees. We sell insurance in 34 States. And we think that the current system of regulation strikes a nice balance between allowing a competitive market, letting us get our products to market, and also fair consumer regulation.

I would hold the Ohio Department of Insurance out as probably one of the best examples in the country of a striking a fair balance between the consumer and the company and—

Chairman KANJORSKI. But you do business in 34 States. How about some of the other States, for instance, the coastal States, Texas, Louisiana, Alabama, and Florida?

Mr. GILLIAM. Do I have to respond about Florida?

Chairman KANJORSKI. We would sure like to know. We hear a lot about Florida these days.

Mr. GILLIAM. Well, you know, the areas where the risks are the greatest produce the greatest challenges for the industry. And it is tough. It is tough in the Gulf States where hurricanes arrive all the time. And this is an issue that I have been on my soapbox for

11 years in Congress, and we still believe that if you peeled back the clock 20 years and allowed risk-based rates, we wouldn't be in the problems we are in the Gulf States. There has been political suppression of rates for dozens of years, and we are paying the price today.

Chairman KANJORSKI. Well, wouldn't that economically discriminate against a lot of us who would like to have nice sunshine and oranges, but we just couldn't afford to live there?

Mr. GILLIAM. If you want the sunshine and oranges, you have to pay for it. If you want to live in Iowa, it is a different set of circumstances. But those who choose to live in the risk-prone areas—

Chairman KANJORSKI. So California is going to belong to the millionaires. Is that acceptable? I don't know.

Mr. GILLIAM. Well, you know, there is another dynamic to this that is just starting to make itself known, and that is you can't put the cost of insurance on the backs of insurers, to some extent. There are some people who, no matter what the circumstances, low and moderate income, they can't afford a risk-based rate.

An interesting study was released in the last several weeks by the RAA, and I believe the AIA, talking about the social side of the problem with catastrophe insurance. For those who can't afford it, there are thoughts of using some Federal ideas like home heating oil subsidies and telecommunications because there is a certain segment of the population who just can't afford a risk-based rate. That is a social, societal problem.

Chairman KANJORSKI. The formula to provide subsidies to a certain percentage of the income.

Mr. GILLIAM. Yes. I read the study rather quickly but that is, I think, the general idea they are throwing out there, a new idea for consideration.

Chairman KANJORSKI. But some of my friends—and I am not indicating they are on the right—they may call that a bit of socialism.

Mr. GILLIAM. Well, I am probably as conservative as it gets, and I don't want to have the Federal Government do anything. Don't quote me on that.

Chairman KANJORSKI. Don't worry. We don't do very much.

Mr. GILLIAM. There is a social aspect of this whole problem with catastrophe insurance. And I think that until we address it, it is the big elephant sitting over in the corner.

Mr. NUTTER. Mr. Kanjorski, can I address this comment about the socialization issue?

Chairman KANJORSKI. Yes, very quickly, because I am robbing my colleagues of their time.

Mr. NUTTER. We published a study with the American Insurance Association, co-authored by Bob Litan of the Brookings Institution, largely focused on fixed and low-income people, and recognizing that many of those people do live in catastrophe-prone areas. Because of their resource limitations, perhaps there ought to be some kind of State or Federal program that really does provide vouchers or something very targeted to help those people. That was the nature of the study.

Chairman KANJORSKI. Very good. Can we get a copy of that? And Mr. Gilliam, if you could give us a reference on the study that you recently went through, that would be helpful.

Mr. GILLIAM. Sure.

Chairman KANJORSKI. Thank you very much.

Ms. Pryce?

Ms. PRYCE. Thank you very much, Mr. Chairman.

Mr. Eiland, I was wondering, as you were talking with the chairman about companies pulling out, do you have an opinion whether optional Federal chartering would assist in that in our country?

Mr. EILAND. It would have nothing to do with it.

Ms. PRYCE. Nothing to do with it?

Mr. EILAND. No. One of the dichotomies that we have to recognize in insurance is most corporations, especially shareholder-held corporations, have a duty to try to maximize profit. An insurance company theoretically is supposed to accept risk and spread the risk.

And the way that you maximize profits, one of the things that was alluded to in other testimony, is not accept the risk, they avoid the risk. That is one thing I disagree with Mr. Iuppa on, is that he mentioned that they want—with this optional Federal charter, they could spread the risk across State lines, etc.

Hogwash. They want a rate down to zip code level. That is why we have credit scoring, not so they can figure out if they want to transfer risk from Texas to Maine, but so that they can avoid risk as much as possible within zip codes inside Texas or—

Ms. PRYCE. Does anybody on the panel disagree with that, that Federal chartering wouldn't make any difference, that there would still be massive pullouts in high-risk areas?

Mr. HUNTER. Not with the drafts I have seen because they would have no authority to tell the insurance companies, you need to write everywhere as part of the deal here. If it had that authority, it could.

Ms. PRYCE. Mr. Iuppa?

Mr. IUPPA. Yes, if I may. I mean, one of the things to keep in mind is the ability to attract new business into the country, quite frankly. Yes, we have thousands of insurance companies doing business here. But the reality is, with the existing system, it is difficult to—there is a barrier in the sense of coming into the United States because you have to be licensed State by State by State. So there is that factor there.

And I think, too, with regard to specifically whether or not an OFC in and of itself would help in that regard, I think the answer is yes, that it would help to attract additional capital into the marketplace, as opposed to other jurisdictions around the world.

Ms. PRYCE. Okay. Let me—somebody else on that? Yes?

Mr. NUTTER. Ms. Pryce, the only thing I would add to that is consistent with Mr. Iuppa's point, a streamlining of the regulatory process by which companies come into the U.S. market to be licensed or do business in the U.S. market, even if they choose not to be licensed, would probably facilitate capital formation that would serve the risk in the U.S. market.

That would certainly have a valuable effect going down the line to insurance companies, and presumably then to consumers.

Ms. PRYCE. Mr. Felton?

Mr. FELTON. Yes. This is—you know, a lot of this is talking about the property and casualty insurance. But the life insurance, the way it is priced, it is priced off mortality of all 50 States. So the OFC obviously would not affect the life insurance on this end because it is all priced based on the full mortality.

Ms. PRYCE. Well, I think we were talking about property and casualty.

Mr. FELTON. Right. Right.

Ms. PRYCE. But let me get to that then and maybe address my next question to my fellow Buckeye. Mr. Gilliam, one of the major arguments that you use, and many others, is that the insurance marketplace isn't uniform from place to place or State to State, that there are different geographical and weather influences, floods and tornadoes, whatever. And State commissioners are better suited to understand the differences in these markets.

Do you think that level of uniqueness translates to all insurance products? I guess that bespeaks the testimony Mr. Felton just attempted to give. Are products that cover someone's home and their automobile really that different from one State to the next? And then, Mr. Felton, I will let you continue with your answer about life insurance.

Mr. GILLIAM. I would answer that the products—I acknowledge the argument of the life industry that their products are more uniform from State to State, and maybe lend themselves more to a national or Federal regulator.

Let's take auto insurance, for example. State tort law is what governs auto insurance because you really don't need your auto insurance unless you have a claim, and you don't have a claim unless you have been in an auto accident. There are uniquenesses in every State on automobile laws.

Sure, in general they are the same, just like the speed limits are generally the same. But when you are talking about how do you resolve a claim in Pennsylvania versus New Jersey versus California, there are tremendous uniquenesses that need to be taken into account.

And maybe an analogy is, I hear over and over, insurance is like banking, so why not the optional Federal charter? Well, a key distinguishing factor is this claims process. You don't have to go through a claims process to withdraw money from an ATM. But if you have an auto accident, you can't get your claim resolved by going to an ATM. You have to talk to a claims adjuster, who has to look at the laws of that State. There are just so many things that distinguish especially property/casualty.

Ms. PRYCE. Well, thank you. And Mr. Felton, very briefly, do you want to continue making your point on life insurance?

Mr. FELTON. Yes. The point was that the way the life insurance companies in the United States price their products, it is priced off the mortality of the total population. However, people in certain States—I will give you an example. In Tennessee, we can buy a guaranteed issue life insurance product. If we can't get anything else, we can buy that product in the State of Tennessee.

If we lived in North Carolina, we could not buy that product because it is not approved in North Carolina. That is where some of the shortcomings of the NAIC—I think they are doing a great job with the compact. But unfortunately, it is not doing enough.

Ms. PRYCE. Thank you. Thank you, Mr. Chairman.

Chairman KANJORSKI. Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

Let me ask you, if each of you would care to comment very briefly on this issue of some disparity between the competing products, similar products, between banks and life insurers. For example, competing with similar bank products, life insurers have claimed to us that they are at a disadvantage with their retirement and asset accumulation products.

It is true that banks can introduce new products in a relatively short period of time, say, a couple of weeks, whereas the insurers can sometimes take up to 2 years to obtain all of the necessary approvals for similar products. And that is a true fact.

What are your thoughts on this and your opinions on ways that we can improve on this disparity to try to bring some equalization here and some relief, again making progress on this in a fair and competitive way without a complete overhaul?

Mr. FELTON. I will be glad to take a shot at it. A lot of the products—I assume the products you are talking about with banks, you are talking about CDs and IRAs and money market ACSC's?

Mr. SCOTT. Yes. Retirement asset accumulation.

Mr. FELTON. Because banks do sell a lot of life insurance these days. And they are selling products that any agent in the United States can sell as well.

Now, when it comes to CDs, they are able to bring that to market quicker because they are determining those rates themselves. If a life insurance company were to try to bring an annuity product out that would compete with this CD or money market or whatever it was, it would be a long process to get it approved in all 50 States, if you could even do that. Right now it may be approved in one State and not approved in the other.

So there is a little bit of disparity there. And as far as competitiveness, they are to give products—or put products on the market that the life insurers can't compete with in a timely manner. Is that kind of—

Mr. SCOTT. Yes. Is there anything we can do about that disparity?

Mr. FELTON. Well, it would be nice if we had a little more speed to market with the products for the life insurance carriers, and that is kind of what we are pushing for on the life side. We need to be able to bring a product out, and rather than just have it approved in 32 States, have it approved in all 50 States so we can take it to the consumers and they can take advantage of the better pricing.

Mr. GILLIAM. Could I jump in there?

Mr. SCOTT. Yes, sir.

Mr. GILLIAM. One of the things I spoke of is this problem of 34 jurisdictions demanding approval of the same thing. Now, there might be, you know, quite a bit of debate on this, and it might strike fear in the hearts of State insurance commissioners everywhere.

But I think what needs to be looked at is why couldn't that product be approved in that insurer's home State and be allowed to be used nationwide the next day? I think that is what we really have to look at here. That is the whole linchpin of this debate. It is about getting your product to market.

We wouldn't be here today if there were delays in getting products to market. That is what is driving this entire debate. And until we really get our arms around that, we are going to be foundering.

Mr. SCOTT. Do we have any way of—and I will get to you in a minute—but do we have any way of measuring the impact of loss to the insurers by not having this disparity addressed?

[No response]

Mr. GILLIAM. Sounds like we don't.

Mr. SCOTT. Would you say it is a significant loss? Is it a big enough issue for us to wade in on, or is it something that we just let the market take care of itself, do nothing about?

Mr. FELTON. I would venture to say it is a growing loss. As the banks become more—invest in the selling of financial products, I think it grows every year. But what that number is—

Mr. SCOTT. All right. We have no quantity?

Mr. FELTON. Not to my knowledge. There might be. I don't know it.

Mr. SCOTT. Yes, sir?

Mr. EILAND. I think one of the things—the question is what can you all do. One of the things that I think members of this committee and the subcommittee and the full committee can do is for those 20-odd States that have not joined the compact, you can go back to those States and, number one, ask why that legislature has not joined the compact by passing the bill and/or the commissioner and/or the governor and encourage them to do so because then you could accomplish a filing at one single point for life insurance, annuities, long-term care, and disability insurance in all 50 States instead of just the 30-some-odd that you can get done now, once that gets fully implemented and operational.

Mr. HUNTER. I agree with that, that the charter—the NAIC is recognizing the difference between life and property/casualty with its compact. And I think that is the short-term solution to the life insurance kind of thing. Certainly it is not the State of domicile.

I was a Texas insurance commissioner and I couldn't get a certain State to take an insurance company down that was clearly broke because the ex-governor served on the board of directors and they were afraid. So I had to go into their State courts and take down the company.

So I think the State of domicile has some political pressure problems. But the NAIC charter with a multi-State—if the States would give their good actuaries and good reviewers of policies to that charter, it can actually quickly do a good review that would even satisfy consumers.

Mr. SCOTT. Yes, sir?

Mr. IUPPA. Just a quick point on the quantification. I think you phrased the question in terms of cost to the insurers. I think we are losing focus here. It is a loss to consumers, not the insurers.

I mean, they are losing opportunity cost because products can't get into the marketplace.

Mr. SCOTT. Okay. Fine.

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

Mr. Royce?

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

I wanted to go to Mr. Iuppa. Mr. Iuppa, you were a former president of the National Association of Insurance Commissioners. And I was going to ask you, do you believe it is necessary that all lines of insurance, including life insurance, property/casualty, commercial, personal lines, should they all be included in an optional Federal charter? Should Congress go down that path? Should we attempt to create one national market for insurance in that way?

Mr. IUPPA. Yes. The short answer is yes. I think the important thing to keep in mind, what we are talking about under the bill that you and Representative Bean have proposed, is an optional Federal charter. I think that all the companies who do business in the United States, regardless of line, ought to have the opportunity to make that decision, to make that choice. So the short answer is yes.

Mr. ROYCE. We face a $24 billion deficit in insurance services nationwide. We hear that a lot of it has to do with the Balkanization of the market here. We know that in Europe, they now have a market. On the other hand, we look at banks and other financial services. There they have a $28 billion surplus in terms of our trade overseas.

Do you think that this has an impact, this nature of the market here in the United States today under this structure?

Mr. IUPPA. Yes. I think it does. I think the thing to keep in mind is that the United States probably represents the largest market, certainly, in the world with regard to insured purchases, whether you are talking about property, life, all kinds.

Again, the inability to come in through a single point is a deterrent with regard to capital moving into this country to create new insurance companies, whether it is at the reinsurance level, whether it is at the primary carrier.

So I think there is clearly a barrier there, and I can say with certainty that in my dealings with even my former colleagues at the E.U., that that was probably one of the most significant complaints that they would raise, both from the industry side as well as the regulatory side.

Mr. ROYCE. Who from the United States currently represents the collective interests of the sector of insurance at international conferences, at meetings, at summits, when regulatory matters are discussed, when it comes to economic advocacy purposes, when it comes to trying to get into markets where we are locked out?

Mr. IUPPA. Well, I think it is a multi-faceted approach. And, I mean, the fact that you don't have a Federal regulator for, for instance, USTR to go to directly or Commerce directly to go to—they do go to the States and the NAIC, who represent the regulatory community.

Mr. ROYCE. And apparently that hasn't been very effective.

I wanted to go to Mr. Felton with a question because he is a representative of one of several agent groups—we have agents for change—that came out in support of the concept of an optional Federal charter as well.

Now, for the NAILBA, you say the average member does business in a number of States, probably 31 States, on average. You said in your testimony, if I got this right, that it costs each of them about $12,000 to keep up with the separate States in terms of the redundancy, the bureaucracy.

I think one of the business schools did a study and said these costs for the consumers translate to $5.7 billion, if you believe that when you have competition and so forth, that consumers ultimately pay a price for the regulatory burden imposed and the costs imposed.

I was going to ask you, how could an optional Federal charter approach benefit agents, but also benefit producers and consumers in your mind. And maybe you could provide a specific example where consumers are adversely impacted by the current system.

Mr. FELTON. Sure. The way it works now is—and the numbers we gave you were averages. I personally am licensed in 49 States, so I have a person on my staff who is in charge of keeping up my license in each one of these States. There is a fee for each State, and those fees are not the same. Some States are much more expensive than others.

If I do that, an agent has—if he is going to sell in a different State, he has to have a license in that State as well. So he has to fill out the paperwork and pay the fees. It goes all the way up to the insurance companies. If they are going to sell in a State, they have to pay the licenses in each State they are in.

Those are costs that the insurance company pays. That will come out in the pricing because whatever it costs them to produce a product, and life insurance is a product, it is going to be borne by the consumer because they are going to have to pay a price and the insurance company is going to price that product to where they can make money on it.

So it kind of runs downhill. If they are paying more to be in all 50 States than they would to have one national license, that cost will be borne by the consumers. And if nothing else, in money and man-hours, it is a real hassle.

Mr. ROYCE. Thank you, Mr. Felton. Thank you, Mr. Chairman.

Chairman KANJORSKI. Ms. Bean?

Ms. BEAN. Thank you, Mr. Chairman.

I also have a question for Mr. Iuppa. There is ample evidence to suggest that States that have imposed price controls in the interest of consumers have often gotten results that don't benefit those consumers, and that in other States, like mine in Illinois, or States like New Jersey who have had a market-based approach, there have been benefits in terms of price and product options to consumers.

Do you have any examples of either the positive or the negative effects based on a regulated or deregulated environment?

Mr. IUPPA. Yes. And for that, to respond to that, I will go back to my tenure as a superintendent in Maine.

The health insurance market in Maine, like most States, is divided into three markets, the individual, the small group, and the large group. And in the State of Maine, the most heavily regulated is the individual market, then followed by the small group, and then the large group, which is basically experience rated.

But what has effectively happened in the Maine marketplace is that the market in the most turmoil is the individual market. The effect of the oversight that has been put in place there has effectively killed the market. There are maybe four carriers left who will write business in Maine when it comes to health insurance.

So I think that is an example of where good balance and equilibrium hasn't necessarily worked well.

Ms. BEAN. Do you have any converse, the other side, by chance?

Mr. IUPPA. Well, certainly Illinois is an area that, with its market-based approach, has been rather positive. Certainly, again drawing on my experience previously, looking at things like auto insurance rates, Illinois was always favorable compared to some of the other States.

I do know in New Jersey, where they effectively had no market for auto insurance just a few short years ago, with the changes they have made there companies have now come back into the market. So I think there are some positive examples, too.

Ms. BEAN. Some more consumer options. Thank you. I have a little more time. so I would like to ask you one other question, based on your experience as a regulator. Most of us on this committee would agree that it would be a desirable objective to increase capital flows into the United States and minimize capital from flowing offshore, particularly if it is in reaction to a regulatory environment.

Do you have any comments on the impact our current regulatory system has towards that objective?

Mr. IUPPA. Sure. The first thing I want to do is point out that with regard to capital inflows, that Zurich started capital inflows into the United States back in 1912. We were the first foreign insurance company to become active here in this market.

But I think that again, we have to look at this in the context of that this is very much a global marketplace that we are operating in now. Yes, risks can be local. But for a carrier like Zurich, where we do business in 170 different countries, we have the ability to spread that risk around.

And capital is the essence of an insurance company's ability to write business. Absent capital coming in, creating the surplus within the companies to write business, it is just not going to happen.

We certainly saw—after September 11th is a good example. There was a tremendous amount of capital that actually came into the insurance marketplace, something like $18 or $20 billion. Most of that went to companies being formed in Bermuda.

And the primary reason that I was hearing at the time, and being told when I was asking about it, was because we just do not want to have to put up with the hassle of becoming licensed in all the States. It is too time-consuming. It can take us a year or 2 years to get through the entire process. Whereas other jurisdictions, they were able to bring that capital in and they were able to form the companies, and they have been underwriting risk here in the United States ever since.

Ms. BEAN. Thank you, and I yield back.

Chairman KANJORSKI. The gentleman from Kentucky, Mr. Davis.

Mr. DAVIS OF KENTUCKY. Thank you, Chairman Kanjorski. I apologize to the witnesses for missing some of the earlier testimony. I was finishing some meetings back at the office.

But this is the second hearing that we have had on insurance regulatory reform in Congress. It is evident from the panel today that there is, to put it mildly, a diversity of opinion on how we need to tackle this. I don't see why we can't move forward in absence of agreement with perhaps a focused, targeted modernization, with measures that are going to directly benefit consumers.

My question at this point in the committee's discussion of the issue is for any of the witnesses who support a Federal regulator. And I would like to frame it like this: Have you fundamentally decided your organization can't work with those in the industry who oppose a Federal regulator as a means to find common ground or to build consensus on key parts of the overall debate of regulatory modernization?

Mr. FELTON. I think on behalf of NAILBA, we are willing to work with anyone that is going to improve the life insurance arena for the consumer. That is—you know, we are willing to move it forward. We want to be able to speed the product, improve the way we license our agencies, and just make it easier to do business. So that is kind of where we stand.

Mr. DAVIS OF KENTUCKY. Anybody else? Mr. Nutter?

Mr. NUTTER. If I might comment. I represent the reinsurance market. It is probably the one area where there is increasing support around the idea of streamlining the current system. Even the NAIC has a proposal before it that would facilitate a single State as a port of entry for reinsurers being licensed in the United States, and a system of mutual recognition for reinsurers doing business from outside the United States into the United States.

So even the State regulators recognize that the global nature of the reinsurance market lends itself most readily to a single regulator, national or Federal.

Mr. DAVIS OF KENTUCKY. Anybody else?

Mr. IUPPA. Yes. You know, like the prior two speakers, I mean, we are certainly interested in moving the agenda of an OFC forward. And I think—again I go back to a comment I think I may have made while you were not with us, Representative.

But it is an optional, what we are talking about. We are not talking about scrapping the State system. We are not talking about making an either/or in terms of the proposal that is out there at this point.

So I think that at the end of the day there are certain things, certain structures that come into play depending on a company's business model. For a company that does business in only one or two States, they may not be interested at all in an optional Federal charter, whereas a company that I work for, that does business in 170 different countries, all the States and territories, there is a much greater likelihood that we would be interested in that and are interested in that.

And one of the driving factors is that many of our customers do business on a national and international basis. We are basically a commercial writer, so we have a different clientele, if you will, within the company.

So there are different needs, I think, that are out there. And I think what we are all looking for is to try and strike the right balance and have good legislation come forward.

Mr. DAVIS OF KENTUCKY. Go ahead.

Mr. HUNTER. In support—I am representing consumers, mostly individual type consumers. And I believe, and you weren't here, we are agnostic about whether it is federally or State-based. If it is excellent, we will be for it, whatever is the best. So if we had a very strong Federal system, we could be for that. We don't like optional. We don't like choice going back and forth for the insurers. We think that sets up a regulatory arbitrage.

Mr. GILLIAM. A brief comment on that? Even though I am not a supporter of the OFC, the point I want to make bears on this tremendously. Here is our biggest concern: The word "optional" is a red herring because if Congress decides to go with an optional Federal charter and they close the books on insurance regulation, you are done. You are not going to do anything to try and help reform the State system.

Then we are going to have two unlevel systems. And those who use the simple Federal system are going to have a tremendous competitive advantage over the rest of us who still have the State system that, while good in its basis, needs modernization.

Mr. DAVIS OF KENTUCKY. Yes. I would suggest just one thing. In retrospect and perspectives, I have never seen anything the Federal Government has done that seemed helpful other than—taking the analogy, it is like swallowing a polar bear trap. It may seem good going down, but when it springs on you, you suddenly find out it is holding onto you from the inside.

And I suppose the question having come out of a professional background dealing with systems integration, you know, in the high tech world, much of the problem—the legislative challenges that we face, depending on how it is done, could create a vast market advantage for one side or the other, depending on how you do this.

But when I get below the symptom level and I begin looking at root causes, the root causes are very common. There is a lack of information standardization, lack of best practices among the States, and from the standpoint of creating common standards for interchange between the States would seem like a way to begin this process, to establish this common ground on what those critical data entry points are before creating a new Federal bureaucracy that isn't necessarily going to have the interests of the States in mind. And particularly for the small insurance brokers and small companies, this could create some challenge in multi-State.

You know, on the flip side, I understand as a business owner the challenges of trying to write insurance when you have to deal with someone licensed in seven different States to try to get the same health insurance policy done. It is a nightmare for the insurer, for the person out at the tip of the spear, but also for the small business owner as well.

And I think having seen this as a consumer and as an integrator, one of the places to start is with this common ground rather than create something and then find a way to fit the States or the Federal Government into it.

And with that, I yield back, Mr. Chairman.

Chairman KANJORSKI. The gentleman from Berks County, Pennsylvania, Mr. Gerlach.

Mr. GERLACH. Thank you, Mr. Chairman. Really following up on Representative Davis's comment there, and some of your comments and prior conversations on this whole issue of an optional Federal charter, I wonder, with the existence of this compact—and I am not even sure how many States have formally entered into this compact—I wonder, when you look at the issue of Federal charter and you look at the benefits that it proposes, as well as the concern on the other side that you are creating a new Federal bureaucracy, and what it looks like in year one may be totally different from what it looks like in year ten and beyond, has there been an effort within the industry overall, and perhaps Congress can be part of the effort, to first see if there can be established a uniform insurance code that would be accepted by States?

Perhaps, you said, a minimum number of States, that if accepted then creates a nationwide system where you have uniform definitions. You have uniform product issues defined. You have a process for approval that is standard. You have a standard licensing and review process.

So that on the one hand, you have created that uniformity that many seek, and on the other hand, you still retain the ability of States to regulate that uniform code without having to create a new Federal bureaucracy to do that.

If for some reason a minimum number of States do not adopt a uniform insurance code by a certain date, then you certainly have perhaps Congress giving the ability to then move into an optional Federal charter because you have given the States the ability to adopt that and they have failed to do so and correct the problems that you describe.

So is there any thought on taking an interim step before you move to an optional Federal charter, at least for some lines of insurance like life or property, where you establish a model uniform insurance code and then you set the process to move forward from there, and if 80 percent of the States adopt it within a certain period of time, all 50 States then must comply, and if there is not an ability to get 80 percent within a certain time period, you move to an optional Federal charter type program.

Any thought given to that, or what is your comment on something like that?

Mr. HUNTER. We have had that. I see Mr. Baker here. He introduced that, basically, in the SMART Act, which we happened to oppose and other people supported. So I think we have had that debate, and it obviously can always be reintroduced. It is not a new idea.

Mr. IUPPA. I guess, if I can, just a couple quick comments on that. One is going back to Gramm-Leach-Bliley and the NARAP proposal or provisions in that law which effectively looked to put together or require a uniform producer licensing code or law. And it had to have a certain number of States, 27, I think it was, or maybe 26, which would trigger it. The reality is, and I think we would hear from Mr. Felton, that we don't have a uniform licensing system in the United States even with that provision in the law.

The other thing I just would mention is that—well, the other thing to keep in mind is that since—and I had the opportunity to look back at some of the early minutes of the NAIC just in the last couple of years. And really, what you have just articulated is one of the goals of the NAIC.

There is some debate as to which commissioner it was who actually came forward first, but New York generally gets credit, to try and bring the commissioners together back in the 1870's and come up with uniform financial reporting in particular at that point in time, but also more uniformity amongst the different aspects of the oversight.

I think the reality is what you have is the same kind of—you know, one of the strengths of our country is the State system in the sense that we have it as a means of using it for experimentation. It is one of the strengths that we have, I think, as a country.

But that also brings into it an awful lot of opportunity for creating diversity, even when uniformity would be better off than diversity. And certainly in some areas relative to insurance regulation, we would be better off with uniformity. And again, as I mentioned earlier, I think that the optional Federal charter would provide that for those companies that are looking for a uniform policy of regulation and supervision. And then you would also have the ability for companies like Mr. Gilliam's to be able to continue to be supervised at the State level.

Mr. EILAND. I think you have the tools out there right now. What we need to do is make sure they work better. With the compact in place, up and running at least for 30-some-odd States, you have the framework to work from there for the most logical lines.

I don't know if you were here, but my comment earlier was that until you have a product that is the same price and form in Dallas, Denver, Des Moines, and Detroit, if it is different in each of those places, you are going to have a tremendous problem trying to get uniformity because it is not uniform by its very nature.

The four products that we have in the interstate compact commission—life, disability, long-term care, and annuities—it doesn't matter if you live in Dallas, Denver, or Detroit. And if you move, it goes with you, and the premium doesn't change. And so that makes sense. Let's work on that first. We have that framework.

If there is licensing and producer licensing tweaks and reform that needs to be done, we have the basis there. We have done it before on Gramm-Leach-Bliley. If we need to enhance that, make it better, we can do that, and we can do that on the State level.

And so those two are there for those products. And those are the most logical ones at least to start with. If you try to do a nationwide insurance code, we will all be gone, I think, by the time that gets done.

Mr. FELTON. Yes. I think in my opening comments I stated that, you know, NAILBA says that the NAIC's compact was a good idea. At this point, I think, as has been said, we have 30-some-odd States involved. Unfortunately, there is no enforcement. If a State chooses not to take part in that compact, I don't know who—what is the downfall for them? I don't think there is any.

Mr. GERLACH. Please.

Mr. GILLIAM. Be careful what you ask for when you ask for a Federal insurance code. But I will say that the idea is somewhat intriguing since it would reserve the ultimate regulatory authority to the States for this reason. As Mr. Iuppa said, the reason the NAIC came into existence was to try to create a set of uniform laws across the States for insurance.

And those of us who attend the NAIC meetings four times a year see that with great fanfare they pass a model law, and then we all start placing bets on how many States will actually adopt it, and then of those, how many will tweak it their own little way. So there is no model law. There are model ideas, but they never turn into model laws. So it is an intriguing concept.

Mr. GERLACH. Thank you. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Gerlach.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. Iuppa, I want to review with you and get your opinion concerning the actions the Congress has taken so far in the context of our stated regulatory reform goal. And I say this as a fellow who has spent some time in this effort with Mr. Hunter and others over decades, it seems.

State catastrophe funds where the State injects itself as a risk-taker, prices policies below what a normal business venture would say is the actuarial risk, subsidizing it from maybe center-of-the-State consumers who are supporting the on-the-beach consumer with a lower rate. Does that system and any incentives given to promote a State net cat program diminish the enthusiasm of a company like yours of attempting to enter the market?

Mr. IUPPA. Well, I think—I mean, from our perspective, and I think that history generally will bear this out, that when it comes to natural catastrophes, that the industry has sufficient capital. It has sufficient expertise to underwrite those risks and pay the claims when they do come in. I think history is a pretty good indicator of that.

I think that there is a danger when the—whether it is the Federal Government or the State government begins to interject itself into how the market actually works, that there are going to be problems.

Mr. BAKER. Well, let me move on to another one. We have considered flood insurance, this Congress, which I would note for the record, even though I am from Louisiana and we have significant interest in the matter, that the reason why we had the wind versus water snafu in the first place is because of the Federal intervention in the flood market.

If a lender is going to make a loan in a flood-prone area and there were no flood insurance program, I assure you there would be a flood insurance market in the private sector that would price that risk appropriately.

But the remedy that we adopted in this community was not to reform a program which has an $18 billion debt and an actuarial inability to pay that debt off, but merely to add the wind program at an estimated $100 billion a year exposure with no increase in premiums.

From a market perspective, does that appear to be on a sound financial basis?

Mr. IUPPA. From a taxpayer perspective, I think the answer is no.

Mr. BAKER. Well, let me move on to terrorism. Maybe we got it right there. You know, we extended the term. We mandated the nuclear/biological/chemical/radiological. We included group life. We lowered the amount the industry has to put into the game. And we increased the potential liability of the taxpayer with a perhaps as long as 15-year exposure; it could be a 10-year.

What does that look like from a market perspective? Are we on sound actuarial footing there?

Mr. IUPPA. Well, I think that with regard to terrorism, unlike natural catastrophes, we don't know when the terrorist attacks are going to occur. We knew the full magnitude—

Mr. BAKER. But you are going to have to offer the NBCR.

Mr. IUPPA. Yes. Well—

Mr. BAKER. And how are you going to price that, I wonder?

Mr. IUPPA. Well, we can still price it from an actuarial perspective. We take into account all the various factors that will go into the products that we put into the marketplace.

Mr. BAKER. Yes. But do you have an extensive actuarial database for terrorism?

Mr. IUPPA. For terrorism, there is no—

Mr. BAKER. So it is somewhat of an operational problem?

Mr. IUPPA. Well, it is an assumption of risk.

Mr. BAKER. In our pursuit to simplify insurance regulatory regimes, we have a record already this year which is looking a little on the thin side, wouldn't you say?

Mr. HUNTER. Are you running for the Senate?

Mr. BAKER. Don't do that to me.

[Laughter]

Mr. BAKER. No. Up until a few minutes ago, my reputation was in good standing.

No. I merely point out that this is going to—if we are about reform, we are going to have to get by a lot of the various stakeholders in the marketplace who have various reasons for the current regulatory regime. And we also have to recognize the consequence of untenable losses in this industry, which, by the way, has the lowest rate of return on equity of any sector in the financial marketplace, contrary to many people's thoughts.

People are going to withhold their investment and go elsewhere—London, Dubai, Hong Kong, who knows. I think the facts demonstrate that there is already a flight of capital from this country. And the principal reason why this industry will suffer more than any other is this ham-handed kind of regulatory approach, as opposed to—and I know there are differences of opinion on this matter—allowing markets to function and people to price risk based on their actuarial view of that property in the near term for which the policy contract is obligated.

And all of the governmental intervention to the contrary has not served people well. It has only ensured that private risk-takers are less likely to go into those markets, and therefore less competition, therefore higher prices—unless, of course, the State is arbitrarily subsidizing the rates, further complicating the matter.

And I know it wasn't a question, but I felt like I needed to get that off my chest. Thank you.

Chairman KANJORSKI. Thank you.

Mr. GILLIAM. Could I jump in there? Could I go back to point one, State cat funds? I couldn't let that one go.

As a company who is looking at entering a new market or staying in an existing market, the presence of a State cat fund is an economic red flag to us because our belief is that if risk-based rates were followed, you would never need a State cat fund.

So to us, it is always, look carefully before you enter a market like that because it suggests market dislocation, disruption, and not letting the economic forces of the business of insurance operate the way they were intended to.

Chairman KANJORSKI. Thank you, Mr. Baker. Do you think we are any further along this year than we were 5 years ago?

Mr. BAKER. Well, the only thing I can tell you, Mr. Chairman, is I know what won't work, if that helps you.

[Laughter]

Chairman KANJORSKI. In some of the comments from the panel, you talked about the relative dysfunction of the existing State system. I think it may have been you, Mr. Gilliam, who talked about that. Do you consider the State system, as it presently exists, to be dysfunctional?

Mr. GILLIAM. It is functioning. It needs some help. And I will go back to this idea, and I think this is what is driving the optional Federal charter proponents, is that they have to wait 2 years to get their product improved. If a home State could approve the product and the next day it is open for business nationwide, kind of like the driver's license, I think that there would be a tremendous meeting on common ground.

Now, when that idea is out there, people will say, that is very dangerous because then you are going to have people going to the State where they think they have the worst regulation, the easiest regulation, they can slip by. So that is the other side of the coin.

But I think until—you know, we hear about this globalization. But let's talk about globally within the United States. There is no reason why, if we didn't put our heads together, why can't you have a product approved in your home State and use it immediately, as opposed to waiting 2 years for 34 States to follow suit?

I think that is the linchpin of this entire debate, in many areas of regulation.

Chairman KANJORSKI. Well, I am not an expert in insurance. But I am impressed with the fact there are what, 20 States that don't belong to the compact and have no intent. And they are usually the large States—California and Texas, I believe.

Mr. EILAND. We are in.

Chairman KANJORSKI. You are in now?

Mr. EILAND. We are in. We were one of the first. We were the first big State to be in.

Chairman KANJORSKI. Very good. Is New York in?

Mr. EILAND. Not yet. But just on that issue, as you well know, being a legislator, oftentimes when a new idea comes along, you want to take a look at it. And it doesn't always make it through the full session the first time. And so that is one thing that is happening, I mean, that—

Chairman KANJORSKI. Well, how long has this new idea been a new idea?

Mr. GILLIAM. Since 1870.

Chairman KANJORSKI. 1870?

Mr. EILAND. I would say that the model legislation for the interstate compact was completed around 2003 or so.

Chairman KANJORSKI. I think that was only in reaction to some of the hearings we were beginning to have here in Congress and, you know, a recognition that we actually may act, and almost did.

And then they moved along and everyone pulled back, including Mr. Baker, and we said, let's give them a chance. I remember attending several of their conferences. I was highly unimpressed or impressed. I am not sure. I knew they wanted to do something, but I didn't get that sense they were going to accomplish it.

Yes?

Mr. IUPPA. I just wanted to follow on to Mr. Gilliam's comment on the speed to market. I mean, speed to market is important, but it is not the only issue moving some of us towards an optional Federal charter. I think we really are taking at it from a more holistic view—the kinds of businesses that we market products to; our footprint, whether it is regional, local, national, international, also comes into play as well.

Chairman KANJORSKI. Do you believe if we did an optional Federal charter, we could have State-by-State enforcement, or would we have to have Federal enforcement?

Mr. IUPPA. Well, I think if we had an optional Federal charter and we had a Federal chartering system for those entities that chose to incorporate or establish themselves through that Federal charter, that the Federal court system would be the natural place for enforcement actions with regard to—

Chairman KANJORSKI. Well, I am talking more about the regulator now. Why can't we just reverse and say that the attorney general or whomever would be the enforcement officer of the various States, even though it is a Federal charter and it is a violation of the Federal charter or a contended violation, that we expect the attorney general of the State in which it occurred to be the enforcement officer? Do you see a problem with that?

Mr. IUPPA. Well, I am not an attorney, but I would imagine there may be some constitutional issues there. And I will defer to the constitutional experts with regard to that.

Chairman KANJORSKI. Is Ann Coulter in the courtroom?

Mr. IUPPA. But I think you are going to end up with the same kind of disparity amongst the States because you will have different levels of enforcement based on that particular individual and that State, even though you may have a uniform product that is—you know, that crosses State lines and so forth. I think that would—I would not suggest necessarily going in that direction, I guess.

Chairman KANJORSKI. Well, you were a former active person with the NAIC. What is your value and judgment of where they have come so far?

Mr. IUPPA. Well, I think, as I said in my testimony, I think tremendous strides have been made in efforts to try and streamline, try and move the ball forward. I think in some areas there has been more success than there has been in others.

With regard to financial oversight, we heard about standardized data. Well, there is an annual statement that has over 500,000 standardized data elements in nit.

But in other areas, when it comes to things like the product approval, rate approval, the market conduct activities have been very laborious. And I can tell you, speaking firsthand as an active member of that organization, to drive or arrive at a consensus on almost any issue is incredibly difficult, and in some cases impossible.

And then even when you do get to that consensus, as others have said, and I think you will also hear—insurance commissioners to a certain degree even say, you know, we get a model passed at the NAIC. Now we have to go back and deal with our State legislatures.

And with all due respect to my panel mate here and a gentleman that I consider a friend—we have known each other for a number of years now—each State likes to put its own little twist on the model laws.

You look at the financial accreditation program. I was here back in 1988 when that program was being conceived. When that was first conceived, there were actually going to be punitive measures against States that were not accredited. For instance, their financial exams that they did on their Democrat companies were not going to be accepted by the other States.

Well, as time went on and you had fewer and fewer States who were unaccredited, the punitive nature of that program became a significant issue, to the point where ultimately there are no punitive measures per se against a State that is not accredited.

So, I mean, you have some examples where I think it has worked well. I think as a practical matter, we need to recognize that it is now the 21st Century. Things have changed. You know, I joined this regulatory community as a regulator 20 years ago, and it is a very different industry today than it was even 20 years ago.

I think with the pace of change, the fact that this is a financial sector industry, that it is dependent upon capital and capital flows as well as the customer base, that we need to modernize that system for those companies that are operating in that more global national environment.

And I think that improvements still need to be made to the State system even for those companies and entities that want to be regulated at the State level or are comfortable with it.

Chairman KANJORSKI. Thank you. I think I have taken my time.

Ms. Bachmann, now are you going to join us?

Ms. BACHMANN. Thank you, Mr. Chairman. I appreciate the opportunity to be able to ask a question. And I apologize, too, for not being able to hear all of your remarks, although I appreciate having them in written form.

I want to thank you for all of the various views that you have been able to present this afternoon. I have heard from a number of organizations. Last Friday I was back in my district, and I met with a large insurance corporation there and heard their views on a Federal charter. And I met with all of my smaller—not all, but I met with many of my smaller insurance companies as well and their views against this.

And the issue that I ask each one of them, and the issue that I would ask you to comment on in a general way, would be regarding the issues of competitiveness and prosperity. After all, that is really what we are after. We want to make sure that you succeed wildly. You are a very important part, each one of you, of the financial services industry. We want you to be successful. The large, the small, we want you all to be.

Could you answer for me in a very general way—and in many forms, you have been doing this throughout our great discussion this afternoon—but in a general way, could you respond to me how your opinion on this issue would contribute to prosperity and to the issue of competitiveness in the United States?

Mr. FELTON. I will be glad to tackle that from the life insurance perspective because that is really what I am here to talk about.

Life insurance, unlike these other products, is a product that has to be sold. People buy property and casualty insurance. They buy their home insurance. They know they have to have it. And they buy their car insurance.

You have to sell life insurance. And if you are in a State that doesn't have a product as competitive as your neighboring State, you are at a disadvantage and you are not going to prosper as much as you might if you were able to sell a different product.

So it is tough to make a living in life insurance, and the optional Federal charter would give the agents a chance to sell the same products nationwide. Because right now they can't do that, and that puts them at a competitive disadvantage.

Mr. NUTTER. I would answer with respect to the reinsurance market. I represent the reinsurance, much of which is written by companies that are offshore, not in the United States, or have U.S. subsidiaries that are offshore.

There is no question that the 50-State system is a cumbersome system, if you will, for a company that is managing its capital on a global basis, seeking to write coverage in the United States, often on a multi-State basis.

So for our sector of the industry, a single regulator, national or Federal, that would streamline the process of approval, licensing, and solvency oversight, would be a much more efficient system for providing capital, and that capital will help make it a more competitive industry for the insurers and their consumers.

Mr. HUNTER. I represent consumers, and when you talk about competitiveness and making the insurance industry profitable, we want that. We don't want insolvent insurance companies. But we do not want excessive profits for the property/casualty industry.

For example, it is heading for its fourth record in a row, even with Katrina and all those losses. It is clear that what they are paying back to consumers is now down to 50 cents out of every dollar. It has become a very inefficient system.

They are making too much money right now. And the market is softening up, so we are going toward now down the slide down the other side of the cycle. But that economic cycle has nothing to do with regulation.

Ms. BACHMANN. Could I ask as well if you could comment on the argument I hear from the littler guys who say, we don't want the burden of answering to two masters?

Mr. HUNTER. Well, I don't think they would have to if they were a little guy. They can be State-regulated or Federal-regulated. Under an optional Federal charter, they could choose who to be—they may have to pay for both because you are going to have two systems, one on top of the other.

Ms. BACHMANN. And again, I am not advocating any particular position here. But one of the arguments that I am getting with the idea of answering to two masters is that the smaller guys are saying, inevitably they will have to answer to two masters. It won't be just one. And if you would just comment.

Mr. HUNTER. Inevitably, if there is an optional Federal charter, there will only be Federal regulation.

Mr. GILLIAM. I will jump in as a smaller guy. I don't know if you were here a little earlier, but one of the comments I made is we are a regional insurer. We are in 34 States. We are not across the country. I will put ourselves in the medium category.

If we pass an optional Federal charter and leave the current State system unmodernized, it will create a tremendous unlevel playing field because those of us who are familiar and want to stay in the State system will stay in the broken State system, while the big companies go to the Federal system. And it will be so unlevel, at some point we will feel like, well, gosh, do we have to change to a Federal company?

And then we will get the game of people jumping back and forth. You know, they will have one company that is Federal and one State, and it is going to be a morass of people jumping back and forth and playing the system. And a lot of companies our size can't afford the cost of jumping back and forth like that.

Mr. IUPPA. Yes. I want to go back to your first question about the competitiveness and so forth, and perhaps give you even a different look at it. And I am looking at it from the competitiveness of this country globally. I mentioned earlier that, I mean, we are basically the largest insurance market in the world. Depending on how you tally up the figures, it is either us or the E.U. or Japan.

But there are an awful lot of other countries out there right now who are going to be competing for the capital that in the past would necessarily have come into the United States that others are now beating a path to that capital. And that capital is beginning to flow into the emerging markets.

I have had the opportunity to work with regulators from emerging markets for several years. And when you talk to these people, one of the first things they look to do is set up an insurance market because they know that you can't grow prosperity, you can't grow a middle class, unless you have an insurance marketplace.

As people begin to acquire assets, whether they be commercial assets for small businesses or their personal assets—homes, property, and so forth—where you begin to develop an insurable interest, that is what contributes to the middle class and the prosperity.

And I think that we need to have a regulatory system here in the United States that recognizes that there are a variety of players in the insurance marketplace that go down to the single State entities, and in some cases that may only write business as a county mutual, to large multinational companies that do business throughout the world. The needs are going to be different.

We want to be sure that capital continues to flow into this market. We want to be sure that the capital that is here has the ability to be used in innovative and creative ways, and provide additional products into the marketplace.

And the other thing, as I said, we are now competing with other parts of the world where for the last century, at least for the first three-quarters of it, we weren't. I think that is a dynamic that we can't lose sight of.

Mr. EILAND. From a State legislature and legislator perspective, what can we do, I think is your question, on ensuring competitiveness. We can make sure that we have, where we can, a streamlined and efficient regulatory scheme in this country. But by the same token, we can't force uniformity where there is none.

And in certain product lines especially, you are going to have wide-ranging products and coverages across the country. And simply having a Federal regulator try to regulate that from Washington, D.C., is not going to work because you are going to have to have Federal regulators in Washington State and in Oregon State and in Rhode Island and everywhere else so that they can see how that particular market is functioning.

So the main thing is to make sure that you have an efficient regulatory scheme. By the same token, we also have responsibilities for consumers, to make sure that they get good value for what they are buying, and can afford it in many instances.

Ms. BACHMANN. Thank you.

Chairman KANJORSKI. Thank you very much, Ms. Bachmann.

The gentleman from Georgia, Mr. Scott. You had additional questions?

Mr. SCOTT. Yes. Thank you. We have such a distinguished panel that I did not want to let another question that is on my mind go by. And I would like to get your take on this.

We are faced with a world view here of our financial services industry. And we are having budget deficits. We are having trade deficits. We are borrowing over $2 trillion from a handful of nations around the world. Our debt is—the sky is the limit. And now I understand we are running deficits with our financial services products in the world.

And I would like to ask you two questions about this, if you would care to comment. Why do you believe the United States has consistently run a deficit in insurance services with the rest of the world? That is the first part of the question. If we can get a response as to why is this happening from your point of view.

Which leads to the second part of the question, which is—and I am beginning to get worried that the growing internationalization of our financial services industry may mean that these governments may find it difficult, in isolation from other nations and other jurisdictions, to find a way to deal with their regulatory reform in isolation as opposed to being with other countries and other nations and other international developments.

In other words, what I am saying is that we are now an international player. I mean, we have always been, but in a much bigger way. Our indebtedness and our deficits give us an Achilles heel. And I am just wondering, why is this happening, number one? And number two, is it something for us to be worried about in the growing internationalization of the financial services industries, and in terms of these countries finding it difficult to deal with their own regulatory reform in isolation from other countries, other jurisdictions, and other international developments?

Mr. EILAND. I will take the first stab at that. It seems to me that the reason we have a trade balance on insurance services is because other countries, the insurers in other countries, especially reinsurers and Lloyds of London, like our regulatory system here. It is predictive. They can come in here. They can insure. They know the system. And then can make money, and have for hundreds of years. And so that is the first.

The second is many of our own insurance companies may be reluctant to go to other undeveloped or underdeveloped countries where their system is not as well-established, where their risks may be greater, where they have risks that we are not used to like terrorism. And so there is plenty to do here at home, so they stay here at home.

Mr. SCOTT. I see. Yes?

Mr. IUPPA. Yes. I am not sure I can really respond to the first part of your question. But I did want to talk a little bit about sort of these other countries and operating in isolation and so forth.

I think one thing to keep in mind is that, as I mentioned in response to some of the earlier questioning, was that there are an awful lot of emerging markets now that have come into being with newly acquired independence and whatever the case may be. And they are all putting together regulatory schemes when it comes to financial services.

One of the things that I was able to engage in because of my prior position was I would often hear from some of these countries and ask, why do you have a State system? Why don't you have a single regulator, a Federal regulator? And again, part of it is historical. It is the system we have.

But when you look to these countries—and they don't just send people here to the United States to look at our system. They send them to Europe. They send them to Japan, the other developed countries. And they all seem to be going towards a model that is Federal in nature, and even moreso than here, they are increasingly consolidated regulators where you have an entity analogous to the FSA in the U.K., which is a model that has been pointed to and a model that is being moved towards in a lot of these emerging markets. So I think that there is a growing move in that direction.

And just with regard to the isolation piece, through the International Association of Insurance Supervisors, it has effectively become the de facto international standard-setter for insurance supervision in the world. It is analogous and on par with the Basel Committee for banking supervision as well as IOSCO for the securities marketplace.

There are standards that are being developed there for use in an international basis, and you are beginning to see those standards come out. You are beginning to see those standards be put into effect in various jurisdictions. And the emerging markets in particular are very hungry to adopt those international standards because they see that as a means of legitimizing their economy, legitimizing their regulatory approach.

So it goes back to my earlier response to the question on competitiveness. I mean, we are really competing not only amongst ourselves commercially, but we are competing against many other countries in the world today that we didn't have to before.

Mr. NUTTER. If I could supplement that, if your time permits. I represent the reinsurance market. All of our companies are licensed in the United States. They are probably all licensed in all 50 States. And yet much of the reinsurance is written by companies that have U.S. subsidiaries but are foreign-owned, foreign-domiciled, or written directly offshore.

That is exactly what you would want for a country of the risk that this country has, catastrophe risk and other kinds of risk. You do want to spread it throughout the world's capital markets. That is the real function of reinsurance.

Depending on the timeframe you look at, there probably is a net inflow of reinsurance payments into the United States largely because of the catastrophe events of 2001, 2004, and 2005, notwithstanding the profitable years of 2006 and probably 2007.

Secondly, to Mr. Iuppa's point, we would probably say that a number of other jurisdictions have taken on a more progressive role with respect to regulation of the reinsurance market. The E.U. has created a passport system that is not unlike what we have endorsed. And the sponsors of H.R. 3200 have included a mutual recognition piece that would allow the United States to recognize other countries that have satisfactory regulatory regimes so that U.S. companies can do business in their countries and companies in their countries can do business here on a mutually recognized basis based upon their home country's regulation of those markets.

So it is not all bad, if you will, that there may be trade imbalances between countries in our area because it depends on the loss experience of the companies doing business here.

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

Chairman KANJORSKI. Mr. Baker?

Mr. BAKER. Just a couple of quick questions, Mr. Chairman. Thank you.

Mr. Iuppa, speaking as a Zurich official, what would you guesstimate annually is the number of filings for new product approvals that a company of the size of Zurich would engage in on an annual basis in the various insurance domestic jurisdictions?

Mr. IUPPA. I am going to imagine that is certainly into the hundreds, and perhaps thousands. And, I mean, as an example, we have a commercial auto policy where the policy itself is probably about 15 or 20 pages long. But along with the basic policy, there is probably about 500 pages of amendatory language in order to take into account all the filings in all the States.

Mr. BAKER. But is it safe to say that it is several hundred a year from one single company perspective?

Mr. IUPPA. Easily. Easily.

Mr. BAKER. Mr. Eiland, I want to acknowledge the correspondence that the NAIC forwarded to the OFC. I do appreciate it. And just make note of one element of the content of that correspondence with my office, Mr. Chairman.

In a prior meeting, I inquired as to the new compact approval process for new product and how was it progressing. And at the time, there was uncertainty about the number of products. In the correspondence, it indicates there were eight filings that were approved.

I just wish for the record, Mr. Chairman, to establish that Zurich only has several hundreds of filings annually in the domestic marketplace. One can only imagine it must be literally in the thousands, if not tens of thousands, for the entire industry.

And to hold that number up in contrast with the current compact approval process, I think, points to the continuing disparities between where we want to go and where we seem to be.

I yield back. I thank you.

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

To the panel, I want to thank you all very much. I found it very interesting and very diverse, to say the least.

The Chair notes that some of the members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Before we adjourn, the written statement of the National Association of Insurance and Financial Advisors will be made part of the record of this hearing. Without objection, it is so ordered.

Chairman KANJORSKI. The panel is dismissed, and this hearing is adjourned. Thank you.

[Whereupon, at 4:29 p.m., the hearing was adjourned.]

APPENDIX

October 30, 2007

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON "ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM"

TUESDAY, OCTOBER 30, 2007

Good afternoon. I would like to thank Ranking Member Deborah Pryce and Members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises for being here for today's hearing on "Additional Perspectives on the Need for Insurance Regulatory Reform." I would also like to thank Ms. Pryce for joining me in inviting our panel.

Today's hearing is the second in our series on insurance regulatory reform. It is also our second hearing in that series on the need to improve insurance regulation. Earlier this month, we heard from key participants of the insurance industry on the need for reform. At that hearing, regulators, agents, brokers and company representatives testified. Our first hearing reinforced my belief that Congress should take some action on insurance regulation. I expect today's witnesses to add to our knowledge base on insurance, and help inform each of us on what Congress should do, before we make any policy decisions in this area.

The vast majority of interested parties in the debate on insurance regulatory modernization agree that the system is not perfect and needs improvement. Today, we hear from additional parties, including state legislators, consumers and industry representatives on the need for reform in insurance regulation. These additional perspectives will add greatly to our discussion, as each will relay a unique point of view.

Although regulated by the many states, Congress has the responsibility to oversee the insurance industry. The aftermath of September 11 taught us all how important insurance is to a vibrant and thriving national economy. We have also heard a lot about maintaining the competitiveness of the U.S.' capital markets, including insurance, in an increasingly global economy. Insurance's importance to consumers – both large and small businesses, and individuals in each of our districts – is another area we cannot forget. It is our responsibility as lawmakers to decide the best course to take on any issue and, in my view, we should do so in a thoughtful and deliberative manner. The current system has been in place for over a century and any changes we proffer should consider all potentially affected constituencies.

In closing, I expect today's testimony will continue to help guide us into specific areas to review. Even more so, I would like consensus and bipartisanship to dictate what areas we choose to focus on. I am optimistic that we can achieve this goal. Future hearings will explore policy options for reform. We will likely review general and broad reform ideas, as well as options targeted on specific areas. Nevertheless, until we explore options, we will remain focused on why there is a need for improvement in insurance regulation. Our hearing earlier this month was a great beginning, and I look forward to another open dialogue with today's panel.

COMMITTEE ON FINANCIAL SERVICES
Subcommittee on Capital Markets
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

Donald A. Manzullo (IL-16)
Opening Statement

October 30, 2007

Thank you, Mr. Chairman, for another opportunity to review the need for insurance regulatory reform. At our October 3 hearing on this subject, there were significant differences in the views expressed as to the degree to which reform is needed and what approach this reform should take. Indeed, I expressed significant concern that the testimonies suggested big ideas for federalizing the insurance industry in the name of reform, but not a workable plan on how to implement it.

I appreciated the diverse views that were put forth at the hearing, because federalizing the insurance industry is a significant proposal that merits serious consideration. I was therefore understandably distressed to hear rhetoric that characterized the debate as one that has reached a "consensus." Based on what I heard at the October 3 hearing, I would beg to disagree. Nothing resembling a consensus was reached. Various methods to achieve reform were mentioned and debated, and while the proposal to create an optional federal charter for insurance was discussed, this approach to reform was also criticized. I would like to emphasize to all of my colleagues that there are plenty of views that still need to be heard, which is why I appreciate the Chairman calling this second hearing today.

Thank you, Mr. Chairman, for the opportunity to issue a brief statement. I look forward to hearing from the witnesses.

NCOIL
National Conference of Insurance Legislators
...for the states

**STATEMENT OF THE
NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)**

**BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
UNITED STATES HOUSE OF REPRESENTATIVES**

**HEARING ON
"ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE
REGULATORY REFORM"**

TUESDAY, OCTOBER 30, 2007

**THE HONORABLE A. CRAIG EILAND
TEXAS HOUSE OF REPRESENTATIVES
CHAIR, NCOIL STATE-FEDERAL RELATIONS COMMITTEE
PAST PRESIDENT OF NCOIL**

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Introduction

Good afternoon Chairman Kanjorski, Ranking Member Pryce and Members of the Subcommittee. Thank you for inviting me to testify before the Subcommittee on the very important issue of insurance regulatory reform.

My name is Craig Eiland. I am a Texas State Representative. I recently served as President of the National Conference of Insurance Legislators' (NCOIL) and presently chair the NCOIL State-Federal Relations Committee.

NCOIL is an organization of state legislators whose main area of public policy concern is insurance. NCOIL legislators chair or are members of the committees responsible for insurance legislation in their state houses. NCOIL states represent a large majority of the premium volume written in the U.S.

I am pleased to be here today on behalf of NCOIL to discuss with the Subcommittee the insurance regulatory marketplace and how the current state system impacts consumers, specific areas that warrant reform and state-based efforts to address them, and the growing importance of global competition.

It would be unrealistic of me to say that state insurance regulation is flawless and modernization is unnecessary. But not as unrealistic as the approach taken by some—that we should abandon a tried and true system for an unproven scheme.

States have fostered—and will continue to work to improve—a dynamic and competitive insurance marketplace. Our states are major players in the global insurance economy. Twenty-six of the top 50 insurance markets in the world are located in the U.S. California has the sixth largest insurance market in the world, New York the seventh, Florida the eighth, and my home state of Texas the tenth.

As a group of legislators dedicated to sound insurance public policy, NCOIL stands by the old adage "if it ain't broke, don't fix it." That being said, NCOIL sees that states need to modernize certain key areas: speed-to market for insurance products, rate and form approval, market conduct, and agent and company licensing. NCOIL has been actively working toward reform, while striving to maintain—and build upon—vital state-instituted consumer protections.

Consumers Benefit from State Regulation

States successfully have regulated the business of insurance for more than 150 years. During that time, state legislatures, regulators, and attorneys general have responded to their constituents' needs and have developed oversight suited to states' unique market demands.

States are adaptable and are equipped to assist consumers on a daily basis, as well as to offer recourse in times of trouble. Consumers, like the many recent victims of natural disasters—including the wildfires last week in California—are best served by having state officials on the ground—people who share with them not only geography, but economic, political and social realities.

While everyday, successful transactions between John Doe and his insurance agent may be overshadowed by headlines of claims problems and profiteering—the current state system does work. It lowers the costs that consumers pay for insurance and promotes availability of coverage. Insurers can share loss history and other information under state-based regulation. This lets smaller and more regional companies compete with the larger carriers. And these smaller companies are important in a functioning market—particularly in times when the market is strained.

State regulation also—through safety nets like guaranty funds and residual market mechanisms—protects the rights of claimants whose insurance companies have failed and ensures that consumers who otherwise could not secure coverage may do so.

Speed-to-Market for Life Products

Providing consumers with access to new, innovative products and offering insurers streamlined product review was NCOIL's goal when it worked with the National Association of Insurance Commissioners (NAIC) and the National Conference of State Legislatures (NCSL) in 2003 to develop the Interstate Insurance Product Regulation Compact.

The Commission created by the Compact serves as a central point of electronic filing for certain insurance products, including life insurance, annuities, disability income, and long-term care. A company can complete a single product filing with the Compact Commission and, upon approval, offer that product to consumers in all member states. The Compact does not preempt a state's ability to address consumer complaints and deceptive trade practices—state insurance departments retain authority to address abuses in their own markets.

By 2006, in a surprisingly short time, the Compact met its threshold of 26 member states and/or 40 percent of life insurance premium volume. Today, 30 states are members of the Compact—representing more than 50 percent of premium volume. Member states include Pennsylvania, Ohio, Texas, Michigan, and Virginia, among others. Compacting legislation is pending in the District of Columbia, Illinois, New Jersey, New York, and Wisconsin.

NCOIL, NCSL, NAIC, and the Compact staff continue to work towards the adoption of Compacting legislation. We expect several states to reintroduce bills during the 2008 session and believe that once New York, Florida, or California join, most other states will follow suit.

To date, the Compact has approved 36 standards and continues to receive and approve company filings.

Rate and Form Modernization

You have heard in the past from elements of the property-casualty industry that say a federal regulator is the way to achieve rate deregulation. It is true that more needs to be done. But those who support a federal approach fail to tell you about what we have achieved.

Almost 30 legislatures have enacted some form of rate deregulation—including "no-file" commercial lines language in the historically restrictive commonwealth of Massachusetts. These laws are based significantly on two NCOIL model acts. The first, which we adopted in 2001, would establish use-and-file for personal lines, no-file for commercial lines, and exemption from rate and form-filing requirements for large commercial policyholders. The second model law, adopted in 2004, would set a flex-rating band of 12 percent for those states moving toward modernization.

According to a November 2005 compendium of state property-casualty laws, approximately

- 39 states have some form of *commercial lines* deregulation
- 23 states have some form of more open *personal lines* regulation
- Seven (7) states have some form of *flex-rating* for commercial and/or personal lines

More and more states are recognizing the need to streamline their rate-filing requirements. That is not to say that NCOIL, the NAIC, or other groups can back off their own modernization efforts. But it is to say that we should acknowledge, and appreciate, the change that is taking place.

Market Conduct Examinations

NCOIL commissioned a ground-breaking study in early 2000 that—after exhaustive research and testimony—concluded that the underlying system of market conduct examination regulation was in need of reform.

In response to the study, NCOIL in 2006 adopted a *Market Conduct Surveillance Model Law*, which advocated a new, targeted system for market conduct exams. Our model provides a much-needed statutory approach to market conduct oversight. It would cut out costly and unnecessary duplication of market conduct examinations. It focuses on market analysis measures prior to examination, methods for collecting market data, a structure for performing targeted exams, and domiciliary state responsibility.

Already, since its adoption late last year, six (6) states introduced bills based largely on the NCOIL model act. Washington and Hawaii enacted bills. My home state of Texas and the state of Colorado had previously adopted NCOIL-based laws.

We anticipate introduction and enactment of market conduct measures in 2008 and urge the NAIC and insurance regulators to assist in promoting modernization efforts in market conduct surveillance.

Agent and Company Licensing

Producer licensing is also a key element of financial modernization. Congress—by passing *The Gramm-Leach-Bliley Act* (GLBA), otherwise known as *The Financial Modernization Act*, in 1999—challenged states to enact uniform agent and producer licensing laws. GLBA threatened that if fewer than 29 states adopted uniform laws and regulations, a new National Association of Registered Agents and Brokers (NARAB) would come into play and promote that uniformity.

NCOIL has historically supported reciprocity and uniformity in licensing and has worked closely with state insurance departments and legislatures to develop related legislation nationwide. We served as a liaison between legislators and regulators and as a clearinghouse of information for states considering producer-licensing legislation post GLBA. Key NCOIL legislators introduced legislation in their respective states.

In August 2002, due in part to the work of NCOIL, the NAIC certified that 35 states complied with GLBA licensing provisions, thereby avoiding NARAB.

NCOIL recently convened a panel of industry representatives to discuss the current marketplace and to consider strategies to promote uniform licensing—as some in the insurance industry say that uniformity has not been achieved and that reciprocity has eroded. We agree that qualified agents and brokers should not jump through hurdles to sell coverage, and we continue to work to effect change.

Regarding company licensing, NCOIL adopted a model law in 2002 that requires all states to use the current version of an NAIC Uniform Certificate of Authority Application (UCAA). This is a process that allows insurers to file copies of the same license application for admission in numerous states. Our model also calls for the repeal of state company licensing requirements and forms outside the UCAA. As a result of this effort, all states are now considered "uniform" states.

Global Impact

Recent events along the coastal United States have demonstrated how significant U.S. and non-U.S. reinsurance is to our national economy. Since 2000, NCOIL has facilitated discussion of existing reinsurance collateral requirements and current proposals to reduce non-U.S. reinsurance collateral, as well as pending international accounting standards and other international issues that affect the states today and that will impact them in the future. NCOIL legislators continue to meet with EU parliamentarians and regulators to discuss mutual concerns and proposed reforms.

NCOIL has resolved that collateral rules should provide sufficient security for reinsurance contracts, while avoiding excessive mandates that would increase costs or reduce capacity. NCOIL acknowledges that it is critical that reinsurance rules are effective and fair and that collateral requirements are imposed only as needed.

In 2002, the NCOIL International Insurance Issues Committee adopted an *Approved List of Reinsurers Model Act* that would provide for reduced collateral requirements for non-U.S. reinsurers that meet certain financial solvency criteria. The model has been held in the NCOIL Executive Committee in response to NAIC requests for more time to address the issue. We have urged the NAIC regulators to resolve the issue and continue to monitor and input on NAIC efforts.

An Optional Federal Charter (OFC)

NCOIL believes that though optional federal charter (OFC) proponents claim an OFC would take two steps forward, it would actually take three steps back. It would add rather than lessen costs, as it would ultimately impose the expense of a needless federal bureaucracy upon businesses and the public.

An OFC would allow insurance companies to opt out of state oversight and ignore carefully crafted protections resulting from years of consumer and business input and thoughtful consideration by state legislatures. An OFC could not, by its very nature, respond, as state regulation does, to states' individual and unique insurance markets.

An OFC would specifically

- result in a morass of federal and state directives
- cause duplication and ambiguity
- negatively impact smaller companies
- compromise state guaranty fund mechanisms
- threaten key premium tax revenue that funds education, health care, infrastructure, and other state programs, and
- lead to higher business taxes to make up for premium tax shortfalls

While NCOIL vigorously advocates for the modernization of insurance regulation, creating a bifurcated system of insurance regulation is not the way to move forward. State legislatures and insurance departments are proactively modifying statutes, regulations and systems to streamline insurance regulation, promote competition, and improve efficiency.

As state and federal legislators, we have common goals—that of a healthy insurance marketplace and consumer satisfaction—but NCOIL must strongly disagree with an OFC approach, as it would prove counterproductive to these objectives. Though perhaps well-intentioned, OFC proposals are ill-advised and that would bring more harm than good to the consumers we all serve.

Conclusion

State legislators work alongside regulators and consumer and industry representatives to create an insurance environment where consumers receive the highest possible degree of protection, products are accessible and affordable, competition thrives, and companies can bring innovative products to the market quickly to meet consumer demands.

We understand that insurance products and environments constantly evolve and believe that state officials who are close in proximity to developing issues are better positioned to act than would be a federal bureaucracy and a 1-800 number. The federal government should not burden itself with overseeing a new entity when states have readily accepted and successfully governed the business of insurance.

We do believe and agree with members of this Subcommittee that insurance modernization is necessary—particularly in the areas that I have outlined today. We would cordially recommend that Congress rely on states to continue to address marketplace issues as they develop. We are making important progress—progress that has been trivialized by proponents of OFC and other proposed federal measures that would preempt state authority.

NCOIL believes that states have a winning track record in their role as what former Supreme Court Justice Louis Brandeis aptly called "laboratories of democracy." We believe that states should keep on playing that role and build on the great successes achieved to date.

NCOIL will continue to work with all interested parties to ensure a strong, vibrant insurance market. We welcome any input from Subcommittee members regarding regulatory reform. Thank you for the opportunity to address this Subcommittee and I look forward to your questions.

# # #

NAILBA

NATIONAL ASSOCIATION OF INDEPENDENT LIFE BROKERAGE AGENCIES

STATEMENT OF

THE NATIONAL ASSOCIATION OF INDEPENDENT LIFE BROKERAGE AGENCIES (NAILBA)

BEFORE THE

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
OF THE
COMMITTEE ON FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRSENTATIVES**

ON

THE NEED FOR INSURANCE REGULATORY REFORM

October 30, 2007

Statement Made by:

John W. Felton, IV
Chairman of NAILBA and President of the Tennessee Brokerage Agency

National Association of Independent Life Brokerage Agencies
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Mr. Chairman and Members of the Subcommittee, my name is John Felton. I am the current Chairman of the National Association of Independent Life Brokerage Agencies or (NAILBA) and the President of the Tennessee Brokerage Agency in Knoxville, Tennessee.

I am appearing today on behalf of NAILBA, the principal trade association representing wholesale brokerage of life insurance. NAILBA is a nonprofit trade association with over 350 member agencies in the U.S. and Canada, representing 100,000 producers who deliver more than one billion dollars in first year life insurance premiums annually. A normal NAILBA member agency may employ anywhere from 10-30 employees and operate in an average of 31 states. We are small businesses but represent the fastest growing distribution source of life insurance and are expected to deliver close to 80% of the domestic market by 2020.

I appreciate the opportunity to appear before you today to discuss the critical need to streamline and modernize the insurance regulatory system in the United States. Despite the best efforts of the National Association of Insurance Commissioners (NAIC) via the Interstate Compact, the current state-based system does not enable insurance carriers and agents to provide new competitive products to consumers throughout the United States in a timely fashion. Additionally, the current system lacks uniform and equal opportunities to every citizen in all states to access similar products and protections. For wholesalers that are licensed in multiple states, the inefficiencies and inconsistencies within the system are costly and potentially harmful to consumers.

I would like to take you inside a typical NAILBA agency so that you have a greater understanding why federal regulation of insurance would greatly increase insurance distribution productivity, increase sales, increase consumer satisfaction, lower consumer and broker confusion, and the lower the potential for Errors & Omissions (E&O) and other litigation.

All NAILBA agencies have contracts on average with 15-20 different life insurance carriers. The NAILBA agency is a wholesaler whose customers are insurance brokers and agents. These clients in turn market insurance products to the insurance buying public. The insurance carrier will outsource sales, marketing, agent training, and some underwriting functions to NAILBA wholesale agencies. By eliminating these functions it allows the life insurance company to focus on product manufacturing, applying the savings to more competitive and consumer friendly products. The insurance agent or broker is served by accessing product from the NAILBA member agency because the agency is independent and able to provide unbiased advice to help the broker select the best company and product to meet the needs of the customer. The consumer is served by a distribution system that creates a demand for competitive products and the increased efficiency delivers those products.

All NAILBA agencies have a substantial customer base of insurance brokers that may be located in different states or may solicit insurance in multiple states. On average, NAILBA member agencies are licensed in 31 states and spend nearly $12,800 per year just to update the proper state regulatory forms. This multi-state nature of a NAILBA agency forces us to be keenly aware of the pitfalls in the current system. Let me provide a few examples:

Something as basic as the determination of which of the 50 states will regulate a given case might not be as straight forward as you think. Our members and their agents must ask themselves the following:

- What state does the insured live in?
- In what state will the application be signed by the insured?
- Is the owner of the policy different from the insured, and if so, in what state will the owner or owners sign?
- In what state does the owner live?
- In what state will the policy be delivered?

If the answers to all of these questions are the same state we do not have a problem. However, if two or more states are involved then we need to find the universal state of jurisdiction rule book. As you know, this rule book does not exist. There are 50 different rule books any two of which may give us a different answer. The result is a huge regulatory maze.

A brokerage agency will not attempt to navigate this maze alone but rather seek guidance from the compliance department of the insurance company(s). However, when we provide two companies the exact same set of facts, we are likely to receive two different answers.

Determining the correct state of jurisdiction is only the beginning of the regulatory jungle. There is an obvious challenge of making sure that we quote a product that is approved in the state or states in question, taking special care that any rider or benefit discussed is both approved and is the most current version of the product for that particular state. Additionally, we make sure to send the most current state version of the application and sales literature for the product along with the required state specific disclosures and replacement forms if necessary.

As the process moves forward, before the NAILBA member agency can accept an application from a broker, we must determine if he or she is authorized to transact business in the state in question and further we must determine if there is an active appointment in that state with the correct carrier. A wholesale brokerage agency will have an entire department devoted to tracking, recording and solving licensing and contracting issues. As a group of small business owners, this is very expensive and does nothing to benefit consumers.

A simultaneous submission state is one where we can send in the broker licensing along with the first case submitted by the agent. Most of the states are simultaneous submission states but what about the other states? There are some states that require that the broker be appointed with an insurance company prior to the date of the application. Imagine you are a broker and you have to go back to your client to get a new signature on a currently dated application and you are trying to explain that you were not authorized to take the first application.

Still more challenging are states that require the appointment date before any solicitation of insurance on the part of the broker. How do you go about compliance in this case? We can make sure that all illustrations are dated after the date of the appointment but we cannot prove that there was no solicitation of a specific product prior to the appointment date. There is no insurance company compliance department consensus on:

- The list of simultaneous submission states;
- The list of sensitive states that require the appointment date prior to the application;
- The list of sensitive stated that require appointment prior to any solicitation of insurance.

We have had to send back applications or have the insurance company reject an application for all kinds of reasons. Imagine for a minute what happens if the broker's client were to die after the rejection of the first application signed by the consumer while we sort out the regulatory requirements necessary for a company to issue a policy. These unnecessary regulatory traps are fertile ground for litigation.

There is no question that the current 50 state regulatory system is broken. Because the NAILBA agency represents multiple companies in multiple states we see firsthand the unnecessary complications and inefficiencies this brings to our industry. We understand clearly how the current system multiplies the possibility of error, litigation and loss.

Conclusion

NAILBA believes an Optional Federal Charter approach would provide consumers with increased access to competitive and market reflective products more quickly. The reduction of costs associated with working with one regulator, not fifty, would be reflected in the pricing of products. This would have the effect of reducing costs to the consumer, providing consistent agent licensing standards and continuing education requirements. Centralized control of agent status through a national database would provide consumers with a higher level of confidence in those who represent the insurance industry. Additionally, NAILBA supports federal regulation of insurance that would put the insurance industry on equal standing with other financial services industries. Currently, the insurance industry does not have a central office to voice concerns or attempt to improve industry practices/standards in an efficient manner throughout the entire fifty states. This centralized system will also provide further protections for the consumer. Fraudulent producers must be prevented from illegal actions against multiple companies and consumers by moving from state to state. A national system would be a positive step to deter such occurrences.

Testimony of The Cincinnati Insurance Companies

Before The
Subcommittee on Capital Markets, Insurance
And Government-Sponsored Enterprises
Of The Committee on Financial Services
United States House of Representatives

On

"Additional Perspectives on the Need for
Insurance Regulatory Reform"

October 30, 2007

Scott A. Gilliam
Assistant Vice President & Government Relations Officer
The Cincinnati Insurance Companies

TESTIMONY OF
SCOTT A. GILLIAM
ASSISTANT VICE PRESIDENT & GOVERNMENT RELATIONS OFFICER
THE CINCINNATI INSURANCE COMPANIES

Introduction

Good afternoon Chairman Kanjorski, Ranking Member Pryce, and Members of the Subcommittee. My name is Scott Gilliam. I am Assistant Vice President and Government Relations Officer for The Cincinnati Insurance Companies, headquartered in Fairfield, Ohio, just north of Cincinnati.

Our group of companies market property and casualty insurance and life insurance in 34 states through an elite force of over 1,200 local independent insurance agencies. With over one million policies in force insuring businesses and families, our parent company, Cincinnati Financial, is the 23rd largest publicly traded property and casualty insurer based on 2006 revenues of $4.5 billion

This is the second in a series of hearings by the Subcommittee on insurance regulatory matters and the need to improve insurance regulation. These hearings come at a time when the current system of insurance regulation is under scrutiny by insurance companies, regulators, agents, consumer groups, trade associations and Congress. A re-examination of the current system and the need for reform is necessary and healthy and I commend the Subcommittee for holding these hearings.

In today's hearing the witnesses have been asked to detail how the current regulatory structure affects consumers, insurance agents and brokers, and insurance companies and to identify which areas of insurance regulation require improvement and why. We begin with the premise that the states are in the best position to satisfy the public policy objectives of insurance regulation—to protect consumers, to assure the financial soundness and solvency of insurers, to promote competitive markets, and to enforce insurance laws. At the same time, we acknowledge that our current system of state-based insurance regulation is in need of reform and modernization.

In presenting our views on insurance regulatory reform this afternoon we have three goals: (1) identify the problems we see with the current system of state regulation; (2) emphasize our support for a continued system of state insurance regulation; and (3) suggest that public policy makers and interested parties may need to take a fresh approach to insurance regulation reform and consider alternatives to the current proposals on the table.

We would also suggest to the Subcommittee that our company may have a more independent voice in the debate over insurance regulatory reform since we are a major regional insurer but do not belong to any of the national insurance trade associations.

Insurance Is Local

We come to this debate on behalf of the hundreds of small and medium-sized insurers like ourselves who collectively insure millions of individuals and small businesses across this country who value their interaction with and connection to their state and local governments. That connection carries over into the business of insurance which, by its very nature, is uniquely local.

Consider the decision to purchase insurance, which is rooted in many local risk factors: Where does the policyholder reside? Is the insured property subject to earthquakes or hurricanes? How close is the nearest fire department? What is the policyholder's risk of civil liability under the laws of the state? What is the structure of the local hospital and physician marketplace?

Consider the types of occurrences for which individuals and business purchase insurance, all of which are uniquely local in nature: personal injuries, auto accidents, health problems and illnesses, lawsuits brought against individuals and businesses, property fires, employment-related injuries, loss of life, accidents at home, accidents in retail establishments, construction project defaults, and the list goes on and on.

Consider also the body of state and local laws that apply when insurable events occur, e.g., state tort law, contract law and social policy law.

It is in this context that the states have been established as the primary regulator of the business of insurance and it is for these reasons that the states should remain the primary regulator of the business of insurance since the activities and occurrences which necessitate insurance and its regulation are not uniform from place to place or state to state.

<u>The Problem with State-Based Insurance Regulation: Needlessly Repetitive Regulation</u>

There is great consensus that several areas of state-based insurance regulation are in need of reform. The areas which seem to attract the most complaints, and which are sometimes problematic for our company as we endeavor to market property casualty and life insurance products in 34 states, include product regulation, rate regulation, producer licensing, company licensing, and market conduct examinations. But I cannot offer you any horror stories. Rather, the company line at Cincinnati Insurance seems to be "state regulation of insurance is sometimes challenging, but we can live with it." Nor is the current system of state insurance regulation grinding our operations to a halt.

But that is not to say that state regulation is without its flaws. The Cincinnati Insurance Companies believe the major problem with the current system of state regulation is the needlessly repetitive nature of the system. We simply do not believe that 34 separate jurisdictions need to regulate each and every aspect of our business. In many instances, regulation by an insurer's domiciliary state would be sufficient to protect all persons or entities with an interest in an insurance transaction or the operation of an insurance company.

The logic of just such a "one regulator" approach was recognized by Congress last year when the House unanimously passed H.R. 5637. That legislation provided that if a reinsurer's domiciliary State is an NAIC-accredited State or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, the domiciliary state would be solely responsible for regulating the financial solvency of the reinsurer.

We must hasten to add, however, that there are some aspects of the business of insurance which need to be regulated in every jurisdiction in which we conduct business. Of course, the devil is in identifying which aspects of the business of insurance demand multi-state jurisdiction and those in which one regulatory authority would be sufficient.

An Alternative Reform Idea: Single-State & Multi-State Insurance Regulation

The need for reform has been acknowledged by the National Association of Insurance Commissioners (NAIC) and to its credit, the NAIC has spearheaded a number of efforts to reform and modernize state regulation. In his testimony before the Subcommittee on October 3, NAIC President Walter Bell reviewed the NAIC's reform efforts in a number of areas, including:

- Speed to market (interstate compact and SERFF/electronic rate & form filing)
- Solvency and guaranty funds
- Consumer assistance and education
- Fraud detection
- Turnaround time on rate and form filings
- Producer licensing
- Company licensing

The NAIC's efforts are laudatory but we do not feel they have adequately addressed the problem we see with needlessly repetitive regulation.

And we are even more unmoved by the proposal for an optional federal charter given the uniquely local nature of the business of insurance and our concern that an optional federal charter would unlevel the playing field by giving a distinct competitive advantage to larger-sized insurers over small and medium sized insurers like ourselves.[1]

We therefore suggest that consideration be given to a modernized state system of insurance regulation that would reserve certain areas of insurance regulation to a single-state regulator, most likely an insurer's domiciliary state, to the exclusion of all other states, and allow all states to regulate in those areas not reserved to a single-state regulator.

We realize there may be unintended consequences of an approach like this. And this may not be the solution to what currently ills state regulation of insurance. But we feel that it is this type of "outside the box" thinking that needs to be explored before we give up on state regulation in favor of anything federal in nature.

Implementing a Single-State/Multi-State System of State-Based Regulation

Which aspects of insurance regulation should remain multi-state and which aspects should be reserved to a single-state regulator? Obviously, there would be many devils to work out in these details and my time this afternoon does not allow a scholarly review of how the various subjects of insurance regulation would be divided between single-state and multi-state regulation.

As a starting point, we would simply suggest that public policy makers consider the following areas of regulation as possibly being conducive to exclusive regulation by an insurer's domiciliary state: financial and solvency regulation, investments, product regulation, producer licensing and company licensing. This is by no means an exhaustive list and is simply offered as a starting point for discussion.

[1] Instead of fixing what's wrong with state regulation, supporters of the optional federal charter would simply jump to a new federal system and the leave the rest of the industry to deal with a state system still in need of reform. Many small and medium size insurance companies would not be able to afford to switch back and forth between state and federal regulation, thus they could potentially be stuck in a less favorable regulatory environment creating an unfair competitive disadvantage. There could be no greater unleveling of the playing field. A better course is to focus on what's wrong with state regulation and fix it for all competitors, as opposed to creating an optional system that will benefit one group of competitors over another.

As to how such a system of state-based regulation might be implemented, the devil is again in the details. That being said, we believe that the approach embodied in H.R. 5637 (targeted federal legislation identifying specific areas of insurance regulation reserved to the regulator of an insurer's domiciliary state) is worth consideration.

Conclusion

We appreciate the opportunity to share our views the problems we see with the current system of state regulation (needlessly repetitive regulation), emphasize our support for a continued system of state insurance regulation, and suggest that public policy makers and interested parties may need to take a fresh approach to insurance regulation reform and consider alternatives to the current proposals on the table.

As to whether a modernized system of state insurance regulation that divides regulatory authority between an insurer's domiciliary state and all other states will work, or is the right solution, we do not know. But we think it is representative of the type of thought and consideration that needs to become part of the debate over insurance regulatory reform before any decisions are made.

In addition, we incorporate by reference the views we expressed on the topic of state insurance regulation in a hearing before the Subcommittee in 2002, in which offered a detailed analysis of the benefits of state regulation from the consumer's perspective. A copy of that 2002 testimony is attached.

TESTIMONY OF
SCOTT A. GILLIAM
DIRECTOR OF GOVERNMENT RELATIONS
THE CINCINNATI INSURANCE COMPANIES

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT-SPONSORED ENTERPRISES
OF THE HOUSE FINANCIAL SERVICES COMMITTEE

ON

REGULATION AND COMPETITION IN THE INSURANCE INDUSTRY

JUNE 18, 2002

Introduction

Good afternoon Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Scott A. Gilliam. I am Director of Government Relations for The Cincinnati Insurance Companies, headquartered in Fairfield, Ohio, just north of Cincinnati.

Our group of companies market property and casualty insurance and life insurance in 31 states through an elite corps of fewer than 1,000 local independent agencies. With nearly one million policies in force insuring businesses and families, our parent company, Cincinnati Financial, is among the 17th largest publicly traded property and casualty insurer based on 2001 revenues of $2.5 billion.

This is the third in a series of hearings by the Subcommittee to examine regulation and competition in the insurance industry. These hearings come at a time when the current system of insurance regulation is under scrutiny by insurance companies, regulators, agents, consumer groups, trade associations and Congress. A re-examination of the current system and the need for reform is necessary and healthy and I commend the Subcommittee for holding these hearings.

I was asked to talk about consumer protection issues and how they impact the question of whether insurance regulation should remain a state-based system or whether a Federal approach to insurance regulation should be considered. While consumer protection issues will be the anchor of my remarks today, I cannot avoid sharing my company's concern about the future of insurance regulation and those who seem poised to jump to a Federal system for a quick fix. Nor can I avoid sharing our long held belief that the states are in the best position to satisfy the public policy objectives of insurance regulation—to protect consumers by assuring the financial soundness and solvency of insurers, promoting competitive markets, and enforcing insurance laws.

Consumers Are Served Best By State Regulation

Consumers clearly have an enormous financial and emotional stake in ensuring that the promises made by insurance providers are kept. Collectively, the insurance premiums paid for property/casualty and life insurance products by American insurance consumers in 2000 amounted to over $730 billion. With numbers like these, the interests of insurance consumers must be at the forefront of the debate over state versus Federal regulation of insurance.

We believe the state insurance regulatory system has served insurance consumers well over the past 150 years. For consumers, the strengths of the state-based system of insurance regulation lie in its ability to respond to consumers, to adapt to local market issues, and to enable states to experiment and learn from each other. State insurance commissioners become experts in the individual state issues they face, enabling other commissioners to learn from their experience. In that way, the insurance regulatory system evolves to meet new challenges.

Accessibility is another advantage that state insurance regulation has over the Federal regulation insofar as consumers are concerned. No one can quarrel with the fact that it is easier to deal with regulators in the consumer's home state than by having to call Washington or contact a regional Federal office in order to get help with a consumer insurance issue.

The accessibility of insurance regulators to consumers would also suffer under an optional Federal charter system given the likelihood of consumer confusion with the two systems. Under an optional Federal charter system, state-chartered insurers and Federally chartered insurers would operate side by side in the states. Under those circumstances, consumer access to regulatory protection would become needlessly complicated by the mere existence of dual regulatory systems and the resulting confusion as to which system has jurisdiction over a particular consumer complaint. Protecting consumers during the sales process would be even more problematic, since many state-regulated agents would also be selling products offered by Federally chartered insurers, further complicating the question of which system has jurisdiction over a particular transaction. Insurance consumers should not have to roll the dice when deciding whom to contact for a problem.

The warning made by Chairman Oxley in his opening statement last week, that consumers can not be adequately protected if insurers are subject to conflicting requirements at the Federal and state levels, seems equally applicable to the situation insurance consumers would face with conflicting Federal and state consumer protection systems.

It is also doubtful whether the Federal government would have the resources and expertise necessary to effectively and efficiently protect insurance consumers. It would take a huge effort to duplicate the activity of the states in this regard. Consider these facts:

- In the year 2000, insurance consumers made approximately 4 million consumer inquiries and complaints to state regulators.

- State insurance regulators employ 12,500 regulatory personnel nationwide and spend $853 million annually to be the watchful eyes and helping hands on consumer insurance problems (2000 data).

The numbers are no less significant for Ohio, which handled over 126,000 insurance consumer inquiries regarding companies and agents last year. The Federal government is simply not equipped to take on such a role and develop a regulatory authority for insurance consumer protection as sophisticated and widespread as a state system that has been 200 years in the making. And as we have seen many times, Federal regulatory systems often become self-perpetuating and non-responsive to the needs of those they regulate and protect. To ensure effective consumer protection and consistent quality and dependability for the vast array of products now available in the insurance marketplace, state regulation should remain the only vehicle for protecting insurance consumers and regulating our good industry.

The Benefits of State Regulation to Insurance Companies Also Benefit Insurance Consumers

The benefits of the state insurance regulatory system on insurance companies also translate into benefits for insurance consumers in the form of competitive markets. Consider the following attributes of state-based insurance regulation which ultimately benefit consumers:

Unique knowledge of the markets and local conditions. The states are the only logical choice for the comprehensive regulation of insurance given their unique knowledge of local markets and conditions. State regulators know the insurance markets within their borders. Although there are uniform national concerns in this industry, as in many others, in uncountable ways insurance involves concerns of an intensely local nature. The concerns in Ohio, for example, with its multiple urban centers, lake-front communities, and manufacturing base, are quite different from the insurance issues raised in Iowa, with its thousands of farmers and few large urban areas.

Less risk of regulatory mistakes. Under state regulation, good regulatory initiatives spread to other states and, conversely, the bad ideas tried in one state prevent others from making the same mistakes by offering real-market examples. Having fifty different regulators is less risky than gambling on a single Federal regulator who might have an axe to grind against the insurance industry—and ultimate power over the industry to swing the axe.

Anti-competitiveness. Federal regulation will create an unlevel playing field between those insurers who opt for Federal regulation and those whose insurance activities continue to be regulated by the states. With two completely separate and uncoordinated systems of regulation, there will be no uniformity in the forces and pressures competing insurers face as a result of regulatory oversight. With separate and competing systems of rate and form regulation, underwriting requirements, market conduct regulation, insolvency requirements, and other critical aspects of insurance regulation, another unnatural force will enter the insurance marketplace: choice of regulatory scheme (state or Federal). That will result in an unfair and anti-competitive distribution of market advantages and disadvantages based on choice of regulatory system, and it will destroy the level playing field on which our industry now competes.

The risk of a Federal advocate. Some argue that the insurance industry needs a Federal regulator who will fight for our interests against other financial institutions and advocate our views before Congress, just as the Securities and Exchange Commission and the Office of the Comptroller of the Currency champion the securities and banking industries. But consider the other face of Federal regulation: a single Federal regulator with ultimate power over an industry and an axe to grind. And as we have seen many times before, Federal regulatory systems often become self-perpetuating and non-responsive to the needs of those they regulate.

Flexibility. The attributes of an ideal insurance regulatory system include reasonableness, flexibility, adaptability to local markets, regulator expertise, and the ability to spread the risk of bad regulation. Federal regulation cannot compete with state regulation in these areas.

State regulation encourages innovation. Insurance companies often use a particular state as a laboratory for testing new product ideas or competitive strategies before they are introduced on a national level. Good products and good competitive strategies in one state often spread to other states. Likewise, unsuccessful strategies in one state often educate the rest of the industry and lead to better products and more competitive markets in other states.

New Federal bureaucracy. At a time when Congress is seriously considering empowering states in a myriad of areas, Congress should not strip the states of their authority to regulate in a business arena that has been within their virtually exclusive domain throughout this country's fruitful history. The last thing America needs is another Federal bureaucracy.

Modernizing And Streamlining State Regulation To Reflect The Changing Face Of The Industry

Since 1945, the insurance industry in the United States has been regulated by the states under authority of the McCarran-Ferguson Act. While state regulation of insurance has worked very well, the realities of changing market conditions, including globalization, financial services convergence, and consolidation, demand a more efficient regulatory system, including greater coordination and consistency across states.

While some are calling for Federal regulation to address the changing face of the insurance industry, we feel state regulation still works best. At the same time, we realize that in order to preserve state regulation during these changing times, the current system of state-based insurance regulation needs to be modernized, streamlined, and made more efficient.

A strong and growing effort is already underway within the National Association of Insurance Commissioners ("NAIC") to modernize state insurance regulation and a national regulatory agenda appears to be taking hold. In March 2000, the NAIC recognized that the realities of changing market conditions, including globalization, financial services convergence, and consolidation, demanded a more efficient regulatory system, including greater coordination and consistency across states. The NAIC responded by laying out its vision for the future in the unanimously adopted "Statement of Intent: The Future of Insurance Regulation," explaining as follows:

> "Fueled by enhanced technology and globalization, the world financial markets are undergoing rapid changes. In order to protect and serve more sophisticated but also more exposed insurance consumers of the future, insurance regulators are committed to modernize insurance regulation to meet the realities of an increasingly dynamic, and internationally competitive financial services marketplace. This will include working with all parties to combat and reduce the incidence of fraud, thereby providing a safer environment for consumers and lower costs.
>
> "We pledge to work cooperatively with all our partners – governors, state legislators, Federal officials, consumers, companies, agents and other interested parties – to facilitate and enhance this new and evolving marketplace as we begin the 21st Century."

Since the issuance of its Statement of Intent, the NAIC has been working to refine its vision for regulatory modernization through the development of detailed proposals to streamline the state insurance regulatory system. Confident in its belief that functional insurance regulation at the state level is the best insurance regulatory system, and showing commitment to its charge to protect consumers, keep insurers and producers accountable, and maintain a sound and non-discriminatory insurance regulatory system in the United States, the NAIC is already making significant progress in several critical areas of regulation. These include:

- promulgation of a uniform producer licensing model act and passage of the act or other uniform licensing laws by 46 states with the intent of satisfying the reciprocity licensing mandates of GLBA's NARAB provisions

- several speed to market initiatives, including a system for electronic rate and form filing, the implementation of rate and form filing checklists and review standards in forty-four jurisdictions to speed product approval, and two initiatives to create a single point of filing for new life, health and annuity products (an interstate collaboration initiative and the coordinated advertising, rate and form review authority)

- several initiatives to create uniformity in company licensing and corporate governance (the uniform certificate of authority application and the "national treatment" initiative)

- an initiative to coordinate the review of holding company transactions that impact insurance subsidiaries domiciled in multiple jurisdictions

- an effort to institute a "lead state" framework for financial regulation

- promulgation of uniform privacy laws and regulations and the passage of new privacy protection laws and regulations in forty-nine states and the District of Columbia to GLBA requirements

- several initiatives to enhance consumer protection, including an interactive web tool specifically created for consumer research of company complaint and financial data

- several initiatives to build a more effective and nationally coordinated market conduct and regulation system

We would be remiss if we did not acknowledge that these efforts by the NAIC to modernize state insurance regulation are only a start. Virtually every area of insurance regulation needs to be improved if the state-based system is to meet the challenges of a modern insurance market. But unlike those companies who would abandon the state-system and start over with Federal regulation or dual regulation, The Cincinnati Insurance Companies are committed to doing the hard work needed in the state capitols to modernize, streamline and increase the efficiency of state regulation, and preserve its use as the preferred method for insurance regulation and consumer protection.

We believe the road to regulatory reform runs through state capitals, not through Washington, D.C., and in the end insurance consumers will be the ultimate beneficiaries of this approach to reform.

Using Congressional Action To Encourage Regulatory Modernization In The States

While we believe Congress should defer action on optional Federal insurance charter legislation until the states have had a fair amount of time to institute the necessary reforms themselves and modernize, streamline and increase the efficiency of state regulation, we realize the states may need encouragement to carry the ball into the end zone. While state regulators and the NAIC can recommend standards for reform and raise the profile of important reform issues, we realize that they cannot act alone. They need state legislators and governors to engage in the process and enact the fundamental insurance regulation reforms necessary to modernize state insurance regulation in the 50 states.

But what if the states do not follow the lead of state insurance regulators and the NAIC and enact the reforms needed to modernize, streamline and increase the efficiency of state regulation, or do not act soon enough or do enough to reinvigorate state insurance regulation? In this event, we are intrigued by the possibility of using Federal legislation to encourage the states to undertake more rapid and comprehensive reform of state insurance regulation. While we are as yet undecided on the form such legislation should take, we would prefer a model that would allow the NAIC to be active in crafting the reform legislation states would need to enact to avoid Federal regulation.

We would also suggest that Congress avoid the use of a one-size-fits-all approach and instead consider a variety of legislative tools which could be employed on an issue-by-issue basis to take into account the realities of today's changing marketplace.

In suggesting that Congress consider the use of Federal legislation to encourage reform at the state level, we are mindful of the dangers incumbent in opening these issues up for Federal legislative debate. For example, a piece of legislation originally drafted for relatively narrow reasons could result in expansive new demands and expectations on the industry. While we recognize these dangers and are concerned about them, we believe that using Federal legislation to encourage reform at the state level as a last resort is certainly better than jumping hook, line and sinker into a Federal system of insurance regulation.

State Regulation Is The Preferred Method Of Regulation For All Lines Of Insurance

Many in the industry only think of my company as a property and casualty insurer. However, we do have a significant life insurance operation, the Cincinnati Life Insurance Company, which generated gross premium volume of $122 million in 2001. In fact, the Cincinnati Life Insurance Company is a former member of the American Council of Life Insurers.

I bring this to your attention in reply to the growing refrain in Washington that life insurance is different from property and casualty insurance in several critical ways which make it better suited for federal regulation than property and casualty insurance. Some even seem to think that we should not think twice about lobbing off the life industry and handing it over to federal regulators.

My company strongly disagrees with this point of view and believes that state regulation works best for all aspects of the industry, including life insurance as well as property and casualty insurance. We want to see state insurance regulation modernized, streamlined and made more efficient for all lines of insurance and will do all we can to achieve this goal. A reformed system of state insurance regulation for all lines of insurance, including life, is far superior to an unproven system of Federal regulation.

Conclusion

For those who support Federal regulation or an optional Federal insurance charter, it is easy to argue in favor of Federal involvement, since the debate is mostly hypothetical. But when one compares any hypothetical Federal system with the system of state regulation already in existence, together with the improvements in state regulation already underway, the benefits of the state system for consumers and the industry far outweigh any perceived advantage of a Federal system.

CFA

Consumer Federation of America

1620 I Street, N.W., Suite 200 * Washington, DC 20006

TESTIMONY OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE,
CONSUMER FEDERATION OF AMERICA

BEFORE

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES OF
THE COMMITTEE ON FINANCIAL SERVICES
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

REGARDING

"ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM"

OCTOBER 30, 2007

Good morning Mr. Chairman and members of the Subcommittee. My name is Bob Hunter and I am the Director of Insurance for the Consumer Federation of America (CFA). Thank you for inviting me here today to discuss the state of the property/casualty insurance industry in America and the quality of insurance regulation. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. I am also an actuary, a Fellow of the Casualty Actuarial Society, and a member of the American Academy of Actuaries.

America's insurance consumers, including small businesses, are vitally interested in high-quality insurance regulation. I am sad to say, however, that the quality of insurance regulation is weak and declining throughout the nation today. Therefore, your hearing is timely. We especially appreciate the fact that the Subcommittee is beginning its review with an overall examination of insurance regulation – why it exists and what are its successes and failures – rather than solely reviewing proposed legislation. In order to determine whether federal legislation is necessary and what its focus should be, it makes sense for the Committee to first conduct a thorough assessment of the current situation. If the "problems" with the present insurance regulation regime are not properly diagnosed, the "solutions" that Congress enacts will be flawed.

In this testimony, I will first discuss why regulation of the insurance industry is necessary, including a review of the key reasons regulation is required and why some current developments make meaningful oversight even more essential. I will then point out that consumers are agnostic on the question of whether regulation should be at the state or federal level but are very concerned about the quality of consumer protections that are in place, wherever the locus of regulation resides in the future. Consumer advocates have been (and are) critical of the current state-based system. However, we are not willing to accept a new regulatory structure that allows insurers to pit state and federal regulators against each other to further drive down standards or that guts consumer protections in the states and establishes one uniform but weak set of national standards. Next I will list a few of the most pressing problems, including claims practices and availability concerns, that insurance consumers are presently facing that require a regulatory response.

I will then provide a brief history of the insurance industry's desire for federal regulation in the early years of this country and the reasons why the industry switched to favoring state regulation in the latter half of the 19th century. The industry is now split on the question of whether state-based regulation should continue. I will point out that the industry has generally shifted its allegiance over the years to support oversight by the level of government that imposes the weakest regulatory regime and the fewest consumer protections. Since this balance shifts over time, some insurers now favor a new system where they can change from state to federal regulation or back again, should a regulator propose rules that they do not like.

Next I will explain why market "competition" alone cannot be relied upon to protect insurance consumers, in spite of insurer attempts to reduce or eliminate consumer protections. I will also touch on the absence of regulatory oversight of policy forms (i.e., coverages) and risk classifications (i.e., how consumers are grouped for the purpose of charging premiums), the hollowing out of coverage offered in insurance policies, unfair discrimination, and the abdication of the insurance system's primary role in loss prevention. Industry deregulation proposals – which euphemistically claim to focus on "modernization" or "uniformity" – will likely increase the already widespread problems of insurance availability and affordability and further erode incentives for loss prevention. Furthermore, industry claims that competition is incompatible with regulation are not borne out by the facts. The experience in states like California demonstrates that appropriate regulation enhances competition, while also ensuring that insurers compete fairly and in a manner that benefits consumers. The maximization of both competitive forces and regulatory oversight in California has resulted in a generous return for these companies and high-quality protection for consumers.[1]

I then set forth the principles for a regulatory system that consumers would favor, showing ways to achieve regulatory uniformity without sacrificing consumer protections.

Finally, I briefly discuss some of the regulatory proposals put forth in recent years by insurers, including the optional federal charter approach and the SMART Act, both of which CFA strongly opposes. We do support legislation that would repeal the McCarran-Ferguson Act's broad antitrust exemption that insurers enjoy, to end the collusive pricing and other market decisions that are legal today. For example, the Senate Judiciary Committee is considering S. 618, which also has broad support from other national consumer organizations.[2]

Why is Regulation of Insurance Necessary?

The rationale behind insurance regulation is to promote beneficial competition and prevent destructive or harmful competition in various areas.

Insolvency: One of the reasons for regulation is to prevent competition that routinely causes insurers to go out of business, leaving consumers unable to collect on claims. Insolvency regulation has historically been a primary focus of insurance regulation. After several insolvencies in the 1980s, state regulators and the National Association of Insurance Commissioners (NAIC) enacted risk-based capital standards and implemented an accreditation program to help identify and prevent future insolvencies. As fewer insolvencies have occurred from the 1990s to the present, state regulators appear to be doing a better job.

Unfair and Deceptive Policies and Practices: Insurance policies, unlike most other consumer products or services, are contracts that promise to make certain payments under very specific conditions at some point in the future. Consumers can easily research the price, quality and features of a television, but it is much more difficult to make a similar evaluation of complex insurance policies and how these policies will be interpreted and serviced at some point in the future. If they did, they would never accept policies with anti-concurrent causation clauses in

[1] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," Consumer Federation of America, June 6, 2000.
[2] Consumer organizations that support S. 618 include CFA, the Center for Economic Justice, the Center for Insurance Research, the Center for Justice and Democracy, Consumers Union, the Foundation for Taxpayer and Consumer Rights, New Jersey Citizen Action, Public Citizen, and United Policyholders.

them. Because of the complicated nature of insurance policies, consumers rely on the representations of the seller/agent to a far greater extent than for other products. Regulation exists to prevent competition that fosters the sale of unfair and deceptive policies and claims practices.

Unfortunately, states have fared very poorly in protecting consumers from unfair and deceptive practices. Rather than acting to uncover abuses and instigate enforcement actions, states have often only reacted to lawsuits or news stories that brought harmful practices to light. For example, the common perception among regulators that "fly-by-night" insurance companies were primarily responsible for deceptive and misleading practices was shattered in the late 1980s and early 1990s by widespread allegations of such practices among companies with household names like MetLife, John Hancock, and Prudential. MetLife sold plain whole life policies to nurses as "retirement plans," and Prudential unilaterally replaced many customers' whole life policies with policies that didn't offer as much coverage. Though it is true that state regulators eventually took action through coordinated settlements, the allegations were first raised in private litigation; many consumers were defrauded before regulators acted.

The revelations and settlements resulting from investigations by New York Attorney General Eliot Spitzer show that even the most sophisticated consumers of insurance can be duped into paying too much through bid-rigging, steering, undisclosed kickback commissions to brokers and agents, and through other anticompetitive acts. A *New York Times* article on long-term care insurance claims abuses provides another example of serious problems consumers face in the current weak regulatory climate.[3] The appalling behavior of many insurers in the wake of Hurricane Katrina that resulted from the long-standing use of deceptive practices like anti-concurrent causation clauses are also a noteworthy example of the inadequacy of state oversight.

Claims abuses: Consumers pay a lot of money for insurance policies, which are promises for future protection should some unfortunate event occur. If these promises are broken, the consumer can be devastated. Many concerns have been raised about such broken promises in the poor performance of property-casualty insurers in paying legitimate claims in the wake of Hurricane Katrina. Consider this startling blog from the President of the Association of Property/Casualty Claims Professionals, James Greer, which was posted on the web site of the Editor of the National Underwriter:

James W. Greer, CPCU:

Although I live and work in Florida, my home is on the Mississippi Gulf Coast where I have family spread from one side of the state to the other. I spent six months there leading a team of over 100 CAT adjusters and handling the wind claims for the state's carrier of last resort. I personally walked through the carnage, saw the people, and felt the sorrow. I climbed the roofs, measured the slabs, and personally witnessed very visible and clear damage caused by both water AND WIND.

I also observed something else that surprised me, and, after 28 years as a claims professional who has carried "the soul" of a bygone industry in my practices and preachings, I was ashamed

[3] "Aged, Frail and Denied Care by Their Insurers," *New York Times*, March 26, 2007.

of those to whom I had vested a lifetime career: An overwhelming lack of claims adjusters on the Mississippi Gulf Coast. The industry simply did not respond.

The industry appeared as distant to the Miss. Gulf Coast as the federal government was accused of being to New Orleans. *It was as if some small group of high-level financial magnates decided that the only way to save the industry's financial fate from this mega-disaster was to take a total hand's off approach and hide beneath the waves and the flood exclusion.*

While media reps repeatedly quoted, "Each claim is different and will be handled on its own facts and merits," the carriers behaved as one...if there was evidence of water, or you were within a certain geographic boundary, adjusters were largely absent on the coast. (Emphasis added.)

(Actually, State Farm did have one of the largest CAT facilities, located centrally on the coast, but there was little evidence of other carrier presence.)

I personally observed large carriers simply refusing to respond, or even consider arguments of wind involvement...well-rationalized sets of facts, coverage and legal arguments. The silence from industry officials "far from the field" who retained the authority for claim decision-making was deafening.

In an article posted on the Association of Property & Casualty Claims Professionals' Web site shortly after Katrina hit, I described the catastrophe as "Claims Greatest Challenge," and pondered the industry would respond. Now we know.

As a member of an old Aetna family that has been widely dispersed since its demise in the '90's, I remember the day when leaders of that fine company routinely cited, and tried to honor, the social/moral contract the insurance industry had with society. It is clear that, in today's business environment, the soul of the insurance industry is missing, and despite the rhetoric of its PR machine, the industry no longer recognizes such a social/moral obligation.

As a lifetime claims professional, I will never quit writing, teaching and showing those who are interested the way things should be done to serve the best interests of the industry and its customers according to the best practices and behaviors of a bygone claims age. Perhaps someday a change in mindset will once again begin to evolve.

Clearly, for the Mississippi Gulf Coast, the Katrina catastrophe, the animosity and the litigation, it was never really about flood...nor was it about the flood exclusion. It was, and is, about the failure of the insurance industry to keep its promise...a promise that it will respond when loss occurs.

The only thing sold in insurance is peace of mind. The victims of this storm, and certainly those in Mississippi, will never again find peace of mind in insurance. Actions do speak loudest. On the Mississippi Gulf Coast, the insurance industry simply failed to act. In the end, it will pay dearly for that decision, as will all of society.

James W. Greer, CPCU, President, Association of Property & Casualty Claims Professionals[4]

There are also adverse implications for consumers because of the use of claims payment software by insurance companies. Insurers have reduced their payouts and maximized their profits by turning their claims operations into "profit centers" by using computer programs and other techniques designed to routinely underpay policyholder claims. For instance, many insurers are using programs such as "Colossus," sold by Computer Sciences Corporation (CSC.)[5] CSC sales literature touted Colossus as "the most powerful cost savings tool" and also suggested that the program will immediately reduce the size of bodily injury claims by up to 20 percent. As reported in a recent book, "...any insurer who buys a license to use Colossus is able to calibrate the amount of 'savings' it wants Colossus to generate...If Colossus does not generate sufficient 'savings' to meet the insurer's needs or goals, the insurer simply goes back and 'adjusts' the benchmark values until Colossus produces the desired results."[6] In a settlement of a class-action lawsuit, Farmers Insurance Company has agreed to stop using Colossus on uninsured and underinsured motorist claims where a duty of good faith is required and has agreed to pay class members cash benefits.[7] Other lawsuits have been filed against most of America's leading insurers for the use of these computerized claims settlement products.[8]

Programs like Colossus are designed to systematically underpay policyholders without adequately examining the validity of each individual claim. The use of these programs severs the promise of good faith that insurers owe to their policyholders. Any increase in profits that results cannot be considered to be legitimate. Moreover, the introduction of these systems could explain part of the decline in benefits that policyholders have been receiving as a percentage of premiums paid in recent years.

Colossus has been bought by most major insurance companies in response to marketing efforts by CSC promising significant savings. McKinsey & Company has also encouraged several companies to use Colossus.[9] "Before the Allstate launched a project in 1992 (called CCPR – Claims Core Process Redesign), McKinsey named its USAA project 'PACE' [Professionalism and Claims Excellence]. At State Farm, McKinsey named its project 'ACE' [Advanced Claims Excellence]."[10]

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4 "Your Own Worst Enemy, Continued," Blog of Sam Friedman, Editor, National Underwriter Magazine, www.property-casualty.com, February 21, 2007. Posted on January 31, 2007 23:06. The blog has other interesting posts on this subject.

5 Other programs are also available that promise similar savings to insurers, such as ISO's "Claims Outcome Advisor." These are bodily injury systems but other systems, such as Exactimate, "help" insurers control claims costs on property claims.

6 "From Good Hands to Boxing Gloves – How Allstate Changed Casualty Insurance in America," Trial Guides, 2006, Berardinelli, Freeman and DeShaw, pages 131, 133, 135.

7 Bad Faith Class Actions, Whitten, Reggie, PowerPoint Presentation, November 9, 2006.

8 Ibid.

9 "...Mc Kinsey & Co. has taught Allstate and other insurance companies how to deliver less and less." Berardinelli, Freeman and DeShaw, page 17.

10 Ibid. Page 57.

When McKinsey introduced Allstate to Colossus, "McKinsey already knew how Colossus worked having proved it in the field at USAA."[11] This quote was footnoted as follows: "See McKinsey at (PowerPoint slide number) 7341: "The Colossus sites have been extremely successful in reducing severities with reductions in the range of 10 percent for Colossus-evaluated claims."[12]

I have been a witness in some of the cases against insurers using the Colossus product and I am covered by a protective order in these cases. (I could go on at length about why these protective orders are bad public policy, particularly coupled with secrecy provisions in settlements, in that the abusive practice that was uncovered often continues to harm people). I am, therefore, limited in this testimony to what is in the public domain. However, as I describe above, there is public information about the use of common consultants and vendors by insurance companies that have adopted Colossus and similar systems. I strongly urge this Committee to probe the question of whether these vendors and consultants have been involved in encouraging and facilitating collusive behavior by insurance companies with these claims systems. I also urge you to investigate whether a similarity in Hurricane Katrina claims payment procedures and actions (or non-actions), as mentioned above, could indicate collusive activity by some insurers.

The use of these products to cut claims payouts may be at least part of the reason that consumers are receiving record low payouts for their premium dollars as insurers reap unprecedented profits. As is obvious in the following graph, the trend in payouts is sharply down over the last twenty years, a period during most state insurance regulators have allowed consumer protections to erode significantly and when Colossus and other claims systems were being introduced by many insurers.[13]

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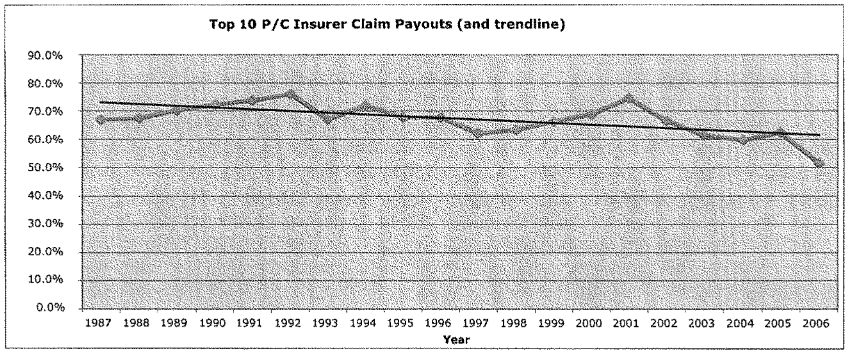
[11] Ibid. Page 132.
[12] Ibid.
[13] CFA tested this drop in benefits related to premiums to see if it could be attributed to a drop in investment income. Over the time frame studied, there was a three percent drop in investment income. Since insurers typically reflect about half of investment income in prices, CFA believes that the drop in investment income accounts for only 1.5 points of the 15-point drop. That is, declining investment income explains only about one-tenth of the drop in benefit payouts to consumers per dollar expended in insurance premium.



It is truly inappropriate for property/casualty insurers to be delivering only half of their premium back to policyholders as benefits.[14]

State insurance departments have been sound asleep on the issue of the negative impact that Colossus and other such products have on policyholder rights, and even on the right to good faith claims settlements. The Federal Trade Commission (FTC) should be empowered to undertake investigations and other consumer protection activities to help stop the insurers from engaging in such acts on a national basis.

Insurance Availability: Some insurance is mandated by law or required by lenders to complete financial transactions, such as mortgage loans. In a normal competitive market, participants compete by attempting to sell to all consumers seeking the product. However, in the insurance market, participants compete by attempting to "select" only the most profitable consumers. This selection competition leads to availability problems and redlining.[15] Regulation exists to limit destructive selection competition that harms consumers and society.

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[14] Insurers contend that the loss adjustment expense is a benefit to consumers. Obviously, this is a "benefit" that is not provided to the consumer or repair cars, doctor bills, etc. But even the loss and LAE ratio itself is at a record low for many decades, at under 70 percent.

[15] The industry's reliance on selection competition can have negative impacts on consumers. Insurance is a risk spreading mechanism. Insurance aggregates consumers' premiums into a common fund from which claims are paid. Insurance is a contractual social arrangement, subject to regulation by the states.

The common fund in which wealth is shifted from those without losses (claims) to those with losses (claims) is the reason that the contribution of insurance companies to the Gross National Product of the United States is measured as premiums less losses for the property-casualty lines of insurance. The U.S. government recognizes that the losses are paid from a common fund and thus are a shift in dollars from consumers without claims to those with claims, not a "product" of the insurance companies.

Competition among insurers should be focused where it has positive effects, e.g., creating efficiencies, lowering overhead. But rather than competing on the basis of the expense and profit components of rates, the industry has relied more on selection competition, which merely pushes claims from insurer to insurer or back on the person or the state. States have failed to control against the worst ravages of selection competition (e.g. redlining).

Some of the vices of selection competition that need to be addressed include zip code or other territorial selection; the potential for genetic profile selection; income (or more precisely credit report) selection; and selection

Lawsuits brought by fair housing groups and the Department of Housing and Urban Development (HUD) over the past 15 years have revealed that insurance availability problems and unfair discrimination exist and demonstrate a lack of oversight and attention by many of the states. NAIC had ample opportunity after its own studies indicated that these problems existed to move to protect consumers. It retreated, however, when, a few years ago, insurers threatened to cut off funding for its insurance information database, a primary source of NAIC income.

Serious problems with home insurance availability and affordability surfaced this spring along America's coastlines. Hundreds of thousands of people have had their homeowners' insurance policies non-renewed and rates are skyrocketing. As to the decisions to non-renew, on May 9, 2006 the Insurance Services Office (ISO) President and CEO Frank J. Coyne signaled that the market is "overexposed" along the coastline of America. In the *National Underwriter* article, "Exposures Overly Concentrated Along Storm-prone Gulf Coast" (May 15, 2006 Edition), the ISO executive "cautioned that population growth and soaring home values in vulnerable areas are boosting carrier exposures to dangerous levels." He said, "The inescapable conclusion is that the effects of exposure growth far outweigh any effects of global warming."

Insurers started major pullouts on the Gulf Coast in the wake of the ISO pronouncement. On May 12, 2006, Allstate announced it would drop 120,000 home and condominium policies and State Farm announced it would drop 39,000 policies in the wind pool areas and increase rates more than 70 percent.[16] Collusion that would be forbidden by antitrust laws in most other industries appears to be involved in the price increases that have occurred. (See section below entitled "Where Have All the Risk Takers Gone?")

One obvious solution to discrimination and availability problems is to require insurers to disclose information about policies written by geo-code, and about specific underwriting guidelines that are used to determine eligibility and rates. Such disclosure would promote competition and benefit consumers; but state regulators, for the most part, have refused to require such disclosure in the face of adamant opposition from the industry. Regulators apparently agree with insurers that such information is a "trade secret" despite the absence of legal support for such a position. In addition, though insurance companies compete with banks that must meet data disclosure and lending requirements in underserved communities under the Community Reinvestment Act ("CRA"), insurers refuse to acknowledge a similar responsibility to communities.

Reverse Competition: In certain lines of insurance,[17] insurers market their policies to a third party, such as creditors or auto dealers, who, in turn, sell the insurance to consumers on behalf of the insurer for commission and other compensation. This compensation is often not disclosed to the consumer. Absent regulation, reverse competition leads to higher -- not lower --

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based on employment. Targeted marketing based solely on information such as income, habits, and preferences, leaves out consumers in need of insurance, perhaps unfairly.

[16] "Insurers Set to Squeeze Even Tighter," *Miami Herald*, May 13, 2006.
[17] Such as credit insurance, title insurance and force-placed insurance.

prices for consumers because insurers "compete" to offer greater compensation to third party sellers, driving up the price to consumers.

The credit insurance market offers a perfect example of reverse competition. Every few years, consumer groups issue reports about the millions of dollars that consumers are overcharged for credit insurance. Despite the overwhelming evidence that insurers do not meet targeted loss ratios in most states, many regulators have not acted to protect consumers by lowering rates. Title insurance is vastly overpriced due to rampant reverse competition in that line of insurance.

The markets for low value life insurance and industrial life insurance are characterized by overpriced and inappropriately sold policies and a lack of competition. This demonstrates the need for standards that ensure substantial policy value and clear disclosure. Insurers rely on consumers' lack of sophistication to sell these overpriced policies. With some exceptions, states have not enacted standards that ensure value or provide timely, accurate disclosure. Consumers continue to pay far too much for very little coverage.[18]

Information for Consumers: True competition can only exist when purchasers are fully aware of the costs and benefits of the products and services they purchase. Because of the nature of insurance policies and pricing, consumers have had relatively little information about the quality and comparative cost of insurance policies. Regulation is needed to ensure that consumers have access to information that is necessary to make informed insurance purchase decisions and to compare prices.

While the information and outreach efforts of states have improved, states and the NAIC have a long way to go. Some states have succeeded in getting good information out to consumers, but all too often the marketplace and insurance regulators have failed to ensure adequate disclosure. Their failure affects the pocketbooks of consumers, who cannot compare adequately on the basis of price.

In many cases, insurers have stymied proposals for effective disclosure. For decades, consumer advocates pressed for more meaningful disclosure of life insurance policies, including rate-of-return disclosure, which would give consumers a simple way to determine the value of a cash-value policy. Today, even insurance experts can't determine which policy is better without running the underlying information through a computer. Regulators resisted this kind of disclosure until the insurance scandals of the 1990s, involving widespread misleading and abusive practices by insurers and agents, prompted states and the NAIC to develop model laws to address these problems. Regulators voiced strong concerns and promised tough action to correct these abuses. While early drafts held promise and included some meaningful cost-comparison requirements, the insurance industry successfully lobbied against the most important provisions of these proposals that would have made comparison-shopping possible for normal consumers. The model disclosure law that NAIC eventually adopted is inadequate for consumers trying to understand the structure and actual costs of policies.

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[18] My April 26, 2006, testimony before the House Committee on Financial Services on title insurance, detailing the reverse competition impact on that vastly overpriced product, can be found at: http://www.consumerfed.org/pdfs/Title_Insurance_Testimony042606.pdf.

California adopted a rate of return disclosure rule a few years ago for life insurance (similar to an APR in loan contracts) that would have spurred competition and helped consumers comparison-shop. Before consumers had a chance to become familiar with the disclosures, life insurance lobbyists persuaded the California legislature to scuttle it.

Are the Reasons for Insurance Regulation Still Valid?

The reasons for effective regulation of insurance are as relevant, or in some instances even more relevant, today than five or ten years ago:

- Advances in technology now provide insurers access to extraordinarily detailed data about individual customers and allow them to pursue selection competition to an extent unimaginable ten years ago.
- Insurance is being used by more Americans not just to protect against future risk, but as a tool to finance an increasing share of their future income, e.g., through annuities. We already know that many consumers have been hurt by improper claims practices by some of these insurers.
- Increased competition from other financial sectors (such as banking) for the same customers could serve as an incentive for misleading and deceptive practices and market segmentation, leaving some consumers without access to the best policies and rates. If an insurer can't compete on price with a more efficient competitor, one way to keep prices low is by offering weaker policy benefits (i.e., "competition" in the fine print).
- States and lenders still require the purchase of auto and home insurance. Combining insurer and lender functions under one roof, as allowed by the Gramm Leach Bliley Act, could increase incentives to sell insurance as an add-on to a loan (perhaps under tie-in pressure) – or to inappropriately fund insurance policies through high-cost loans.
- Insurers are gutting coverage provided by homeowners insurance policies in ways that are difficult for consumers to understand or overcome.[19]

As consumers are faced with these changes, it is more important than ever that insurance laws are updated and the consumer protection bar is raised, not lowered.

Given that Regulation is Important for Consumers, Who Should Regulate -- the States or the Federal Government?

Consumers are not concerned with who regulates insurance, but they are concerned with the ability of the regulatory system. Consumer advocates have been (and are) critical of the current state-based system, but we are not willing to accept a federal system that guts consumer protections in the states and establishes one uniform but weak set of regulatory standards.

I am one of the very few people who have served as both a state and federal insurance regulator.[20] My experience demonstrates that either a federal or state system can succeed or fail

[19] See the discussion of the anti-concurrent causation clause below.
[20] I was Texas Insurance Commissioner and Federal Insurance Administrator when the Federal Insurance Administration (FIA) was in HUD and had responsibility for the co-regulation of homeowners insurance in the

in protecting consumers. What is critical is not the locus of regulation, but the quality of the standards and the effectiveness of enforcement of those standards.

Both state and federal systems have potential advantages and disadvantages:

Item	Federal	State
Experience overseeing all aspects of insurance regulation?	No	Yes
Responsive to local needs?	No	Yes
Handle individual complaints promptly and effectively?	No	Some States
Limited impact if regulatory mistakes are made?	No	Yes
Not subject to political pressure from national insurers?	No	No
Not subject to political pressure from local insurers?	Yes	No
Efficient solvency regulation?	Yes	Yes
Effective guarantee in event of insolvency?	Yes	No
Adequately restricts revolving door between regulators and industry?	Maybe	No
More uniform regulatory approach?	Yes	No
Can easily respond to micro-trends impacting only a region or a state?	No	Yes
Can easily respond to macro-trends that cross state borders?	Yes	No
Has greater resources, like date processing capacity?	Yes	No

Despite many weaknesses that exist in state regulation, a number of states do have high-quality consumer protections. States also have extensive experience regulating insurer safety and soundness and an established system to address and respond to consumer complaints. The burden of proof is on those who for opportunistic reasons now want to shift away from 150 years of state insurance regulation to show that they are not asking federal regulators and American consumers to accept a dangerous "pig in a poke" that will harm consumers.

CFA agrees that better coordination and more consistent standards for licensing and examinations are desirable and necessary – as long as the standards are of the highest – and not of the lowest – quality. We also agree that efficient regulation is important, because consumers pay for inefficiencies. CFA participated in NAIC meetings over many months helping to find ways to eliminate inefficient regulatory practices and delays, even helping to put together a 30-day total product approval package. Our concern is not with cutting fat, but with removing regulatory muscle when consumers are vulnerable.

Top Six Problems Facing Insurance Consumers Today:

1. Insurers Are Increasingly Privatizing Profit, Socializing Risk and Creating Defective Insurance Products by Hollowing out Insurance Coverage and Cherry Picking Locations in Which They Will Underwrite.

FAIR Plans, as well as flood and crime insurance duties. The White House had also tasked FIA with keeping abreast of all insurance issues, so we worked on auto insurance issues with DOT, health insurance with HHS, medical malpractice insurance with HHS and DOC, and many other major insurance matters.

There are two basic public policy purposes of insurance. The first is to provide individuals, businesses and communities with a financial security tool to avoid financial ruin in the event of a catastrophic event, whether that event is a traffic accident, a fire or a hurricane. Insurers provide this essential financial security tool by accepting the transfer of risk from individuals and by spreading the individual risks through the pooling of very large numbers of individual risks. The pool of risks is diversified over many types of perils and many geographic locations.

The second essential purpose of insurance is to promote loss prevention. Insurance is the fundamental tool for providing economic incentives for less risky behavior and economic disincentives for more risky behavior. The insurance system is not just about paying claims; it is about reducing the loss of life and property from preventable events. Historically, insurers were at the forefront of loss prevention and loss mitigation.[21] At one point, fire was a major cause of loss. This is no longer true, in large part due to the actions of insurers in the 20th century.

Left to a "competitive" or deregulated market, insurers are undermining these two core purposes of insurance. They have hollowed out the benefits offered in many insurance policies so they no longer represent the essential financial security tool required by consumers and have pushed the risk of loss onto taxpayers through federal or state programs. The most glaring example of these two actions is demonstrated by insurer actions in the wake of Hurricane Katrina. Losses covered by insurance companies were a minority fraction of the losses sustained by consumers because insurers had succeeded in shifting exposure onto the federal government through the flood insurance program,[22] onto states through state catastrophe funds and onto consumers with higher deductibles and sharply reduced coverage inside of the homeowners insurance policy. Despite the worst catastrophe year ever in terms of dollars paid by the private insurance industry, the property-casualty industry realized record profits in 2005.[23] The trend toward shifting risk away from the primary insurance market has clearly gone too far when the property-casualty insurance industry experiences record profits in the same year as it experiences record catastrophe losses.

The critical conclusion here is that what the insurance industry calls "competition," which is essentially a completely or virtually deregulated market in which price collusion is not prevented by the application of antitrust law, will not protect consumers from unfair or unreasonable classification, policy form or coverage decisions by insurers. The overwhelming

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[21] Through such innovations as the creation of Underwriter's Laboratory.

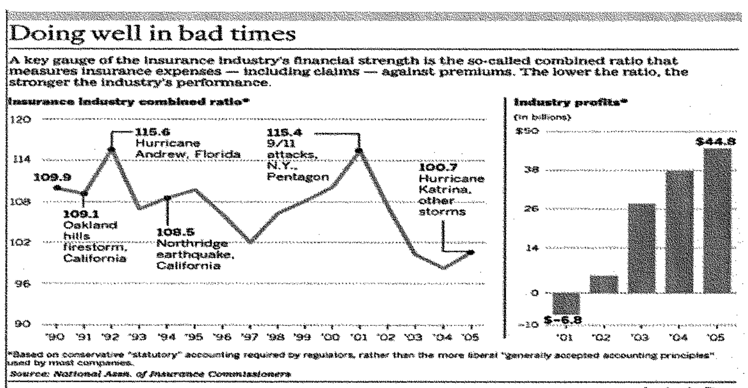
[22] The National flood Insurance Program has been in place since 1968 because insurers could not price or underwrite the risk. Insurers have since developed the technological capacity to create the data necessary for such pricing and underwriting. Consideration should be given by Congress to returning some of this risk to private insurance control. The federal program has had excessive subsidies and has been ineffective in mitigating risk in coastal areas as well as private insurers could.

[23] Indeed, they enjoyed record profits in 2004 ($38.5 billion), 2005 ($44.2 billion), and 2006 ($63.7 billion). That three-year net income of $146.4 billion represents profits of almost $500 per person in America, an astonishing sum. (See "Property/Casualty Insurance in 2007: Overpriced Insurance, Underpaid Claims, Declining Losses and Unjustified Profits," Americans for Insurance Reform, Center for Insurance Research, Center for Economic Justice, Center for Justice and Democracy, Consumer Federation of America, Consumers Union, Foundation for Taxpayer and Consumer Rights and United Policyholders, January 8, 2007 at http://www.consumerfed.org/pdfs/2007Insurance_White_Paper.pdf.

evidence is that a market failure regarding policy forms and coverage has triggered a need for greater regulatory oversight of these factors to protect consumers.

Where Have All the Risk Takers Gone? Unaffordable Home Insurance Covers Less and Less Risk

In 2004, four major hurricanes hit Florida, but the property-casualty insurance industry enjoyed record profits of $38.5 billion. In 2005, Hurricane Katrina resulted in the highest hurricane losses ever, but the insurance industry also had another record year of profits, which reached $44.2 billion. Below is a chart from a *Los Angeles Times* article on the subject:[24]



Doing well in bad times

April 5, 2006

Since the article was published, the property-casualty industry has reported the largest annual profit in its history in 2006, as cited above.

[24]Gosselin, Peter, "Insurers Show Record Gains in Year of Catastrophic Losses," *Los Angeles Times*, April 5, 2006.

Insurers often contend that such large returns are justified given the enormous financial risks undertaken by the insurance industry. Although it may be true that reinsurance is a high-risk industry,[25] it is certainly not true for the primary market. In fact, primary insurers have succeeded in eliminating much risk. This is not an opinion, but a simple fact.

If one purchases a property-casualty insurance company's stock, with few exceptions, one has bought into a business that is lower in risk than the market in general, hurricanes notwithstanding. This is shown in any Value Line publication, which tests the risk of a stock. One key measure is the stock's Beta, which is the sensitivity of a stock's returns to the returns on some market index, such as the Standard & Poor's 500. A Beta between 0 and 1, such as utility stocks, is a low-volatility investment. A Beta equal to 1 matches the index. A Beta greater than 1 is anything more volatile than the index, such as a "small cap" fund.

Another measure of a shareholder's risk is the Financial Safety Index, with 1 being the safest investment and 5 being least safe. A third measure of risk is the Stock Price Stability reported in five percentile intervals with 5 marking the least stability and 100 marking the highest.

Consider Allstate. At the same time the company has taken draconian steps to sharply raise premiums and/or reduce coverage for many homeowners in coastal areas, it has presented shareholders with very low risk: Beta = 0.90; Financial Safety = 1, and Stock Price Stability = 95.[26]

ValueLine posts results for 26 property/casualty insurers.[27] The simple averages for these carriers are: Beta = 0.97; Financial Safety = 2.4; and Stock Price Stability = 83.

By all three measures, property/casualty insurance stocks are of below-average risk, safer than buying an S&P 500 index fund. Therefore, long-term below-average returns for insurers should be expected given the low-risk nature of this investment. The low returns demonstrate that the capital market is performing efficiently by awarding below-average returns to a below-average risk industry.

Another measure of how property/casualty insurers have insulated themselves from risk is the extraordinary profits they have earned in recent years. In 2004, insurers posted their largest dollar net (after tax) profit in history ($38.5 billion) despite the fact that four major hurricanes caused significant damage in Florida. Insurers achieved another record of $44.2 billion in 2005, despite the unprecedented losses caused by hurricanes Katrina, Rita, and Wilma. In 2006, profits were the highest ($63.7 billion) yet because of low hurricane activity, excessive rates, the use of programs to systematically keep payments to policyholders low and other reasons discussed in this testimony.

[25] CFA is still researching this question.
[26] ValueLine, December 22, 2006 edition.
[27] The stocks are ACE Ltd., Alleghany Corp., Allstate Corp., American Financial Group, W.R. Berkley Corp., Berkshire Hathaway, Inc., CAN Financial, Chubb Corp., Cincinnati Financial, Everest Re Group, HCC Insurance, Hanover Insurance Group, Markel Corp., Mercury General, Ohio Casualty Corp., Old Republic International Corp., PMI Group, Inc., Partner Re, Ltd., Progressive Corp., PLI Corp., Safeco Corp., St. Paul/Travelers Group, Selective Insurance, Transatlantic Holdings, 21st Century Insurance Group and XL Group, Ltd.

How did insurers do it? Some of the answers are clear:

First, insurers did make intelligent use of reinsurance, securitization, and other risk spreading techniques. That is the good news.

Second, after Hurricane Andrew, insurers modernized ratemaking by using computer models. This development was a mixed blessing for consumers. While this caused huge price increases for consumers, CFA and other consumer leaders supported the change because we saw insurers as genuinely shocked by the scope of losses caused by Hurricane Andrew. Insurers promised that the model, by projecting either 1,000 or 10,000 years of experience, would bring stability to prices. The model contained projections of huge hurricanes (and earthquakes) as well as periods of intense activity and periods of little or no activity.

In the last two years, however, Risk Management Solutions (RMS) and other modelers have moved from using a 10,000-year projection to a five-year projection, which has caused a 40 percent increase in loss projections in Florida and the Gulf Coast, and a 25-30 percent jump in the Mid-Atlantic and Northeast. As a result, the hurricane component of insurance rates has sharply increased, resulting in overall double-digit rate increases along America's coastline from Maine to Texas. The RMS action interjects politics into a process that should be based solely on sound science. It is truly outrageous that insurers would renege on the promises made in the mid 1990s. CFA has called on regulators in coastal states to reject these rate hikes.

It is clear that insurance companies sought this move to higher rates. RMS's press release of March 23, 2006 states:

> 'Coming off back-to-back, extraordinarily active hurricane seasons, the market is looking for leadership. At RMS, we are taking a clear, unambiguous position that our clients should manage their risks in a manner consistent with elevated levels of hurricane activity and severity,' stated Hemant Shah, president and CEO of RMS. 'We live in a dynamic world, and there is now a critical mass of data and science that point to this being the prudent course of action.'

The "market" (the insurers) sought leadership (higher rates), so RMS was in a competitive bind. If it did not raise rates, the market would likely go to modelers who did. So RMS acted and other modelers are following suit.[28] It is simply unethical that scientists at these modeling firms, under pressure from insurers, appear to have completely changed their minds at the same time despite having used models for over a decade that they assured the public were scientifically sound. RMS has become the vehicle for collusive pricing.

Almost two years after CFA warned the coastal states and the NAIC about the problems with RMS new methods, little protection for consumers has been put in place. Consumers and

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[28] According to the *National Underwriter's* Online Service on March 23, 2006, "Two other modeling vendors—Boston-based AIR Worldwide and Oakland, Calif.-based Eqecat—are also in the process of reworking their hurricane models."

businesses in coastal areas have suffered significant harm in the form of unjustified rate increases because the NAIC took no action to end collusion and the retreat from science by the modelers. In fact, the sum total of NAIC's response on an issue that is vital to millions of Americans who live and work near the nation's coastlines was to hold a hearing on whether modeling companies should be regulated. Florida, Georgia, and Louisiana, to their credit, did not allow the new model to be used by primary insurers. New York and Massachusetts have also taken some steps to prevent unjustified rate hikes or policy non-renewals. In the meantime, residents in the other states along the coast have been paying rates up to 50 percent higher solely because of the changes adopted by RMS and other modelers. At the same time, it has become more and more obvious that those who questioned the scientific legitimacy of the modeling changes were correct.

Consider the series of investigative articles on this topic that ran in the *Tampa Tribune* earlier this year indicating that the scientists consulted by RMS on their model no longer support the methodology that was used. "On Saturday, one of the scientists whom Risk Management Solutions consulted, Jim Elsner, a professor of geography at Florida State University, told the Tribune that the company's five-year model 'points to a problem with the way these modeling groups are operating' and that the results contain assumptions that are 'actually unscientific.'... Thomas R. Knutson, a research meteorologist with the National Oceanic and Atmospheric Administration in Princeton, N.J., and another Risk Management expert panelist, said Saturday the five-year timeline didn't come from the experts. 'I think that question was driven more by the needs of the insurance industry as opposed to the science,' he said."[29]

Scientists not employed by RMS are also speaking out: " 'It's ridiculous from a scientific point of view. It just doesn't wash well in the context of the way science is conducted,' said Mark S. Frankel, director of the Scientific Freedom, Responsibility & Law Program at the American Association for the Advancement of Science, in Washington... Charles Watson, an engineer who specializes in numerical hazard models, said RMS acted irresponsibly. 'Especially for something with trillions of dollars in property value, and peoples' lives and livelihood are literally at stake in these decisions. It is irresponsible to implement before peer review. There are tremendous policy implications.'"[30]

Even RMS's competitors are stating that the methodology for the 5-year model does not represent good science. In an article in *Contingencies*, the magazine of the American Academy of Actuaries,[31] AIR's Senior Vice President, David A. LaLonde, said, "We [AIR] continue to believe, given the current state of the science, that the standard base model based on over 100 years of historical data and over 20 years of research and development remains the most credible model." AIR's entire premise in the article is that short-term projections, like five years, are not appropriate. Since AIR followed RMS's lead in using the 5-year model despite their misgivings, LaLonde acknowledged that policyholders have experienced rate increases of "as much as 40 % higher than the long-term average in some regions." AIR also seems to confirm the possibility of collusion between modelers and insurers, stating that, "...many in the industry challenged catastrophe models and called for a change."

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[29] New Speaker Challenges Insurance Risk Projections, *Tampa Tribune*, January 10, 2007.
[30] Ethicist Questions Insurance Rate Data; *Tampa Tribune*, January 12, 2007.
[31] What Happened in 2006? *Contingencies*, March/April 2007.

In a third major development, insurers have not only passed along gigantic price increases to homeowners in coastal areas, but they have also sharply gutted coverage. Hurricane deductibles of two to five percent were introduced. Caps on home replacement costs were also added. State Farm has a 20 percent cap. Other insurers refuse to pay for any increased replacement costs at all, even though demand for home rebuilding usually surges in the wake of a hurricane driving replacement costs up sharply. Insurers also excluded coverage for laws and ordinances, so that if a home has to be elevated to meet flood insurance standards or rewired to meet local building codes, insurers no longer have to pay.

But the most egregious change was the introduction into homeowners' insurance policies of the anti-concurrent causation ("ACC") clause. It removes all coverage for wind damage if another, non-covered event (usually a flood) also occurs, regardless of the timing of the events. Under this anti-consumer measure, if a hurricane of 125-miles-per-hour rips a house apart but hours later a storm surge floods the property, the consumer would receive no reimbursement for wind losses incurred. The use of ACC clauses is intellectually ambiguous, even if the language is found by the courts to be clear.

At a hearing held by the House Financial Services Oversight Subcommittee on February 28th, 2007, Mississippi Attorney General Jim Hood testified that a number of insurance companies operating on the Gulf Coast had tried to escape paying legitimate homeowners' claims after Hurricane Katrina through the use of ACC clauses. Although the ACC clauses were invalidated by a Mississippi judge, insurers intended to refuse to pay wind damage caused by the hurricane if flooding occurred at about the same time, even if the flood hit hours after a home was damaged by wind. The court ruling only affected insurers in Mississippi, so insurers may still be using ACC clauses in other states in the region.

In some cases, particularly those involving the complete destruction of a home down to a slab, insurers did not even seriously study or "adjust" the claim, instead declaring the wind coverage to be trumped by the flood. Such cases often lead to the payment of full flood coverage by the NFIP, even if all or some of the losses paid were really caused by wind damage that should have been paid by insurers under a homeowner's policy.

Consider a $200,000 home that is covered by just a homeowners' policy, with no flood insurance protection. Assume that hurricane winds strike the home for several hours, causing $150,000 worth of damage. Two hours later a flood hits, causing an additional $25,000 in damage for a total damage of $175,000. If the insurer of the home has an ACC, the policyholder would get nothing. If the policyholder had, in addition to the homeowners policy, a flood policy for $200,000, the wind claim would be denied and taxpayers would likely pay $175,000 when they should only pay $25,000. Insurers who get paid handsomely to service the flood insurance program, the Write Your Own ("WYO") companies, should be prohibited from having policy language that has the effect, as ACC does, of shifting insurer losses onto the taxpayers. Congress must make sure that the flood program is not being used by private insurers as a place to lay off their obligations.

Finally, insurers have simply dumped a great deal of risk by not renewing the policies of tens of thousands of homeowner and business properties. Allstate, the leading culprit after

Hurricane Andrew, is emerging as the "heavy" once more in the wake of Katrina[32]. After Hurricane Andrew, Allstate threatened to not renew the policies of 300,000 South Floridians, provoking a state moratorium on such action. Today, Allstate is not renewing policies even in places like Long Island and not writing in entire states, like Connecticut. Yes, you heard me right, all of Connecticut, even in places many miles from the coast!

These actions present a serious credibility problem for insurers. They told us, and we believed, that Hurricane Andrew was their "wake up" call because its size and intensity surprised them. This caused them to make massive adjustments in price, coverage, and portfolio of risk. What is their excuse now for engaging in another round of massive and precipitous actions?

Insurers surely knew that forecasters had predicted for decades that an increased period of hurricane activity and intensity would occur from the 1990s to about 2010. They also surely knew a storm of Hurricane Katrina's size, location, and intensity was possible. The *New Orleans Times-Picayune* predicted exactly the sort of damage that occurred in a series of articles more than three years before Katrina hit.[33]

Take Allstate's pullout from part of New York and their refusal to write any new business in the entire state of Connecticut. It is very hard to look at this move as a legitimate step today when no pullout occurred after Hurricane Andrew. Why isn't the probability of a dangerous storm hitting Long Island or Connecticut already accounted for in the modeling – and rate structure – that were instituted after Hurricane Andrew? This type of precipitous action raises the question of whether Allstate is using the threat of hurricane damage as an excuse to drop customers they have had but do not want to retain for other reasons, such as clients in highly congested areas with poorer credit scores. Whether it was mismanagement that started a decade ago or the clever use of an opportunity today, consumers are being unjustifiably harmed. Insurance is supposed to bring stability, not turmoil, into peoples' lives.

2. The Revolution in Risk Classification has Created Many Questionable Risk Characteristics, Generated New Forms of Redlining and Undermined the Loss Prevention Role of the Insurance System.

As discussed above, one of the primary purposes of the insurance system is to promote loss prevention. The basic tool for loss prevention is price. By providing discounts for characteristics associated with less risky behavior and surcharges for characteristics associated with more risky behavior, the insurance system provides essential economic signals to consumers about how to lower their insurance costs and reduce the likelihood of events that claim lives or damage property.

Over the past fifteen years, insurers have become more "sophisticated" about rating and risk classification. Through the use of data mining and third party databases, like consumer credit reports, insurers have dramatically increased the number of rating characteristics and rate levels used.

[32] See "The 'Good Hands Company' or a Leader in Anti-Consumer Practices?," Consumer Federation of America, July 18, 2007 at http://www.consumerfed.org/pdfs/Allstate_Report_07_18_07.pdf.
[33] McQuaid, John; Schleifstein, Mark, "Washing Away," *New Orleans Times Picayune*. June 23-27, 2002.

We are certainly not against insurers using sophisticated analytic tools and various databases to identify the causes of accidents and losses. We would applaud these actions if the results were employed to promote loss prevention by helping consumers better understand the behaviors associated with accidents and by providing price signals to encourage consumers to avoid the risky behaviors surfaced by this sophisticated research.

Unfortunately, insurers have generally not used the new risk classification research to promote loss prevention. Rather, insurers have used new risk classifications to undermine the loss prevention role of insurance by placing much greater emphasis on risk factors unrelated to loss prevention and almost wholly related to the economic status of potential policyholders. The industry's new approach to risk classification is a form of redlining, where a host of factors are employed that are proxies for economic status and sometimes race.

For example, although federal oversight of the impact of credit scores in insurance underwriting and rating decisions has been quite poor,[34] it is well-documented in studies by the Texas and Missouri Departments of Insurance that credit scoring has a disproportionately harmful effect on low income and minority consumers.[35] And recently, GEICO's use of data about occupation and educational status has garnered the attention of New Jersey legislators.[36] But other factors have not received similar visibility. Several auto insurers use prior liability limits as a major rating factor. This means that for two consumers who are otherwise identical and who are both seeking the same coverage, the consumer who previously had coverage of only the minimum required under law will be charged more than the consumer who previously was able to afford a policy with higher limits. As with credit scoring and occupation/educational status information, this risk classification system clearly penalized lower income consumers.

Once again, deregulated "competition" alone will not protect consumers from unfair risk classification and unfair discrimination. Once again, this market failure demands close regulatory scrutiny of the use of risk classification factors when underwriting, coverage and rating decisions are made.

Let me present one more example of the illegitimate use of risk classification factors to illustrate our concern. Insurers have developed loss history databases – databases in which insurers report claims filed by their policyholders that are then made available to other insurers. Insurers initially used the claims history databases –Comprehensive Loss Underwriting Exchange (CLUE) reports, for example – to verify the loss history reported by consumers when

[34] Federal agencies with potential oversight authority paid virtually no attention to the possible disparate impact of the use of credit scoring in insurance until Congress mandated a study on this matter as part of the Fair Access to Credit Transactions (FACT) Act (Section 215). Unfortunately, the agency charged with completing this study, the Federal Trade Commission, has chosen to use data for this analysis from an industry-sponsored study that cannot be independently verified for bias or accuracy, resulting in a study that offers an unreliable and incomplete description of insurance credit scoring and its alternatives.

[35] "Report to the 79th Legislature: Use of Credit Information by Insurers in Texas," Texas Department of Insurance, December 30, 2004; "Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri," Missouri Department of Insurance, January 2004.

[36] Letter from Consumer Federation of America and NJ CURE to NAIC President Alessandro Iuppa regarding GEICO rating methods and underwriting guidelines, March 14, 2006.

applying for new policies. However, in recent years, insurers started data mining these loss history databases and decided that consumers who merely made an inquiry about their coverage – didn't file a claim, but simply inquired about their coverage – would be treated as if they had made a claim. Penalizing a consumer for making an inquiry on his or her policy is not just glaringly inequitable; it undermines loss prevention by discouraging consumers from interacting with insurers about potentially risky situations.

Although insurers and the purveyors of the claims databases – including ChoicePoint – have largely stopped this practice after much criticism, simple competitive market forces without adequate oversight harmed consumers over a long period and undermined the loss prevention role of the insurance system. Moreover, as with the use of many questionable risk classification factors, competitive forces without regulatory oversight can actually exacerbate problems for consumers as insurers compete in risk selection and price poor people out of markets.

3. Insurance Cartels – Back to the Future

The insurance industry arose from cartel roots. For centuries, property-casualty insurers have used so-called "rating bureaus" to make rates for insurance companies to use jointly. Not many years ago, these bureaus required that insurers charge rates developed by the bureaus. (The last vestiges of this practice persisted into the 1990s).

In recent years, the rate bureaus have stopped requiring the use of their rates or even calculating full rates because of lawsuits by state attorneys general. State attorneys general charged in court that the last liability insurance crisis was caused in great part by insurers sharply raising their prices to return to Insurance Services Office (ISO) rate levels in the mid-1980s. As a result of a settlement with these states, ISO agreed to move away from requiring final prices. ISO is an insurance rate bureau or advisory organization. Historically, ISO was a means of controlling competition. It still serves to restrain competition since it makes "loss costs" (the part of the rate that covers expected claims and the costs of adjusting claims) which represent about 60-70 percent of the rate.[37] ISO also makes available expense data to which insurers can compare their costs in setting their final rates. ISO sets classes of risk that are adopted by many insurers. ISO diminishes competition significantly through all of these activities. There are other such organizations that also set pure premiums or do other activities that result in joint insurance company decisions. These include the National Council on Compensation Insurance (NCCI) and National Insurance Services Organization (NISS). Examples of ISO's many anticompetitive activities are attached.

Today the rate bureaus still produce joint price guidance for the large preponderance of the rate. The rating bureaus start with historic data for these costs and then actuarially manipulate the data (through processes such as "trending" and "loss development") to determine an estimate of the projected cost of claims and adjustment expenses in the future period when the costs they are calculating will be used in setting the rates for many insurers. Rate bureaus, of course, must bias their projections to the high side to be sure that the resulting rates or loss costs are high enough to cover the needs of the least efficient, worst underwriting insurer member or subscriber to the service.

[37] A list of activities of ISO is attached as Attachment 3.

Legal experts testifying before the House Judiciary Committee in 1993 concluded that, absent McCarran-Ferguson's antitrust exemption, manipulation of historic loss data to project losses into the future would be illegal (whereas the simple collection and distribution of historic data itself would be legal since that would be a pro-competitive activity). This is why there are no similar rate bureaus in other industries. For instance, there is no CSO (Contractor Services Office) predicting the cost of labor and materials for construction of buildings in the construction trades for the next year (to which contractors could add a factor to cover their overhead and profit). The CSO participants would go to jail for such audacity.

Further, rate organizations like ISO file "multipliers" for insurers to convert the loss costs into final rates. The insurer merely has to tell ISO what overhead expense load and profit load they want and a multiplier will be filed. The loss cost times the multiplier is the rate the insurer will use. An insurer can, as ISO once did, use an average expense of higher cost insurers for the expense load if it so chooses plus the traditional ISO profit factor of five percent and replicate the old "bureau" rate quite readily.

It is clear that the rate bureaus[38] still have a significant anti-competitive influence on insurance prices in America.

- The rate bureaus guide pricing with their loss cost/multiplier methods.
- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust exemption.
- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.
- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

More recently, insurers have begun to utilize new third party organizations (like RMS and Fair Isaac) to provide information (often from "black boxes" beyond state insurance department regulatory reach) for key insurance pricing and underwriting decisions, which helps insurers to avoid scrutiny for their actions. These organizations are not regulated by the state insurance departments and have a huge impact on rates and underwriting decisions with no state oversight. Indeed RMS's action, since it is not a regulated entity, may be a violation of current antitrust laws.

The Senate Judiciary Committee is in the midst of a review of the antitrust exemption. The Chairman and bipartisan members of the Committee have introduced S.618, which would

[38] By "rate bureaus" here I include the traditional bureaus (such as ISO) but also the new bureaus that have a significant impact on insurance pricing such as the catastrophe modelers (including RMS) and other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like Fair Isaac are one example).

repeal the antitrust exemption and provide the FTC with antitrust enforcement authority if insurers engage in anticompetitive behavior not immunized by the state action doctrine. CFA and a number of other national consumer organizations support passage of S.618.[39]

4. Reverse Competition in Some Lines of Insurance

As indicated above, some lines of insurance, such as credit insurance (including mortgage life insurance), title insurance and forced placed insurance, suffer from "reverse competition." Reverse competition occurs when competition acts to drive prices up, not down. This happens when the entity that selects the insurer is not the ultimate consumer but a third party that receives some sort of kickback (in the form of commissions, below–cost services, affiliate income, sham reinsurance, etc.).

An example is credit insurance added to a car loan. The third-party selecting the insurer is the car dealer who is offered commissions for the deal. The dealer will often select the insurer with the biggest kickback, not with the lower rate. This causes the price of the insurance to rise and the consumer to pay higher rates.

Other examples of reverse competition occur in the title and mortgage guaranty lines, where the product is required by a third party and not the consumer paying for the coverage. In these two cases, the insurer markets its product not to the consumer paying for the product, but to the third party who is in the position to steer the ultimate consumer to the insurer. This competition for the referrers of business drives up the cost of insurance – hence, reverse competition.

We know from the investigations and settlements by New York Attorney General Eliot Spitzer that even sophisticated buyers can suffer from bid rigging and other negative consequences of "reverse-competition". Even when unsophisticated consumers purchase insurance lines that don't typically have reverse competition, these buyers can suffer similar consequences if they do not shop carefully. Independent agents represent several insurance companies. At times, this can be helpful, but not always. If a buyer is not diligent, an agent could place the consumer into a higher priced insurer with a bigger commission rate for the agent. Unfortunately, this happens too often since regulators have not imposed suitability or lowest cost requirements on the agents.

5. Claims Problems

Many consumers face a variety of claims problems. Often, their only recourse is to retain an attorney, an option that is not affordable for consumers in many situations. For example, many Gulf Coast residents are in litigation over handling of homeowners claims by insurers after Hurricane Katrina. We have seen many reports from consumers of situations that appear to involve bad claims handling practices, particularly related to policy forms that appear ambiguous.[40]

[39] My testimony on this bill at the Senate Judiciary Committee hearing of March 7, 2007, can be found at http://judiciary.senate.gov/pdf/03-07-07McCarran-FergusonHearing-HunterTestimony.pdf.
[40] Reviews of calls to the Americans for Insurance Reform hotline are available at www.insurance-reform.org.

Some insurers have also adopted practices that routinely "low-ball" claims offers through the use of computerized claims processing and other techniques that have sought to cut claims costs arbitrarily.

See the more detailed discussion of claims problems earlier in this testimony.

6. The Revolving Door between Regulators and the Insurance Industry Results in Undue Industry Influence at the National Association of Insurance Commissioners

Consider this list of recent NAIC Presidents and their current place of employment:

2006: Al Iuppa – moved in mid-term as NAIC President to become chief lobbyist for the insurer Zurich Financial Services Group

2005: Diane Koken – recently resigned as Pennsylvania's commissioner to, as an AP story put it: "Koken… said she has accepted a nomination to the board of a national insurance company. She declined to identify the company but said she expects to be elected in April and decided to step down effective Feb. 19 to avoid potential conflicts of interest."[41]

2004: Ernest Csiszar – moved in mid-term as NAIC President to lobby on behalf of the property-casualty insurers as President of the Property Casualty Insurers Association

2003: Mike Pickens – currently lobbies on behalf of insurers as a private attorney

2002: Terrie Vaughn – currently lobbies on behalf of life insurers as a Board Member of Principal Financial Group

2001: Kathleen Sebelius – currently Governor of Kansas

2000: George Nichols – currently works for New York Life

The revolving door of regulators to industry and of industry to regulators is particularly troubling given the role of the NAIC in state insurance regulation.[42] The NAIC plays a major role in guiding state insurance oversight, yet it is organized as a non-profit trade association of regulators and, consequently, lacks the public accountability of a government agency, like an insurance department. For example, it is not subject to Freedom of Information statutes. In addition, policy decisions are made at the NAIC by allowing each state one vote, not matter the population of the state. This means that the Commissioner of Insurance in South Dakota has equal influence as the California or New York regulator. The result is that regulators in states comprising a minority of the country's population can determine national policy for the entire

[41] "Diane Koken Resigns After Ten Years as PA Insurance Chief," *The Associated Press*, Feb. 13, 2007. *See* http://www.yorkdispatch.com/pennsylvania/ci_5225171?source=sb-google.

[42] Studies over they years show that about half of all commissioners come from and return to the insurance industry. Studies also show that about 20 percent of state legislators serving on insurance committees in state legislatures are actively employed directly or indirectly by the insurance industry.

country. This problem is exacerbated by the inappropriate industry influence resulting from the revolving door between regulators and industry.

Why Have Insurers Recently Embraced Federal Regulation (Again)?

The recent "conversion" of some insurers to the concept of federal regulation is based solely on the notion that such regulation would be weaker. Insurers have, on occasion, sought federal regulation when the states increased regulatory control and the federal regulatory attitude was more laissez-faire. Thus, in the 1800s, the industry argued in favor of a federal role before the Supreme Court in *Paul v. Virginia*, but the court ruled that the states controlled because insurance was intrastate commerce.

Later, in the 1943 *SEUA* case, the Court reversed itself, declaring that insurance was interstate commerce and that federal antitrust and other laws applied to insurance. By this time, Franklin Roosevelt was in office and the federal government was a tougher regulator than were the states. The industry sought, and obtained, the McCarran-Ferguson Act. This law delegated excusive authority for insurance regulation to the states, with no routine Congressional review. The Act also granted insurers a virtually unheard of exemption from antitrust laws, which allowed insurance companies to collude in setting rates and to pursue other anticompetitive practices without fear of federal prosecution.

From 1943 until recently, the insurance industry has violently opposed any federal role in insurance regulation. In 1980, insurers successfully lobbied to stop the Federal Trade Commission from investigating deceptive acts and practices of any kind in the insurance industry. They also convinced the White House that year to eliminate the Federal Insurance Administration's work on insurance matters other than flood insurance. Since that time, the industry has successfully scuttled any attempt to require insurers to comply with federal antitrust laws and has even tried to avoid complying with federal civil rights laws.

Notice that the insurance industry is very pragmatic in their selection of a preferred regulator. They always favor the least regulation. It is not surprising that, today, the industry would again seek a federal role at a time they perceive little regulatory interest at the federal level. But, rather than going for full federal control, they have learned that there are ebbs and flows in regulatory oversight at the federal and state levels, so they seek the ability to switch back and forth at will.

Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last seven years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[43] They have been assisted in this effort by a series

[43] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville, which I witnessed. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the federal option and that their huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem the tide. In a July 9, 2001, *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get

of House hearings under the previous Committee leadership. Rather than focusing on the need for improved consumer protection, the hearings served as a platform for a few Representatives to issue ominous statements calling on the states to further deregulate insurance oversight, "or else."

This strategy of "whipsawing" state regulators to lower standards benefits all elements of the insurance industry, even those that do not support any federal regulatory approach. Even if Congress does nothing, the threat of federal intervention is enough to scare state regulators into acceding to insurer demands to weaken consumer protections.

Unfortunately for consumers, the strategy has already paid off, before the first insurance bill is ever marked up in Congress. In the last few years, the NAIC has moved suddenly to cut consumer protections adopted over a period of decades. The NAIC is terrified of Congressional action and sees reducing state consumer protections as the way to "save" state regulation by placating insurance companies and encouraging them to stay in the fold. This strategy of saving the village by burning it has made state regulation more, not less vulnerable to a federal takeover.

The NAIC has also failed to act in the face of a number of serious problems facing consumers in the insurance market.

<u>NAIC Failures to Act</u>

1. Failure to do anything about abuses in the small face life market. Instead, NAIC adopted an incomprehensible disclosure on premiums exceeding benefits, but did nothing on overcharges, multiple policies, or unfair sales practices.

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people refocused." His remarks were so offensive that I went up to several top commissioners immediately afterward and said that Materra's speech was the most embarrassing thing I had witnessed in 40 years of attending NAIC meetings. I was particularly embarrassed since no commissioner challenged Mattera and many commissioners had almost begged the industry to grant them more time to deliver whatever the industry wanted.

Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds." As a result, other observers of the NAIC see this pressure as potentially damaging to consumers.

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the *National Underwriter* of June 4, 2000. In it he said, "...how long will Congress and our own industry watch and wait while our competitors continue to operate in a more uniform and less burdensome regulatory environment? Momentum for federal regulation appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the nation's capital...NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely...The long knives for state regulation are already out..."

In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control" dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) ... others in the financial services industry – including insurers – will aggressively pursue federal regulation of our business..."

In the NAIC meeting of June 2006, Neil Alldredge of the National Association of Mutual Insurance Companies pointed out that "states are making progress with rate deregulation reforms. In the past four years, 16 states have enacted various price deregulation reforms...(but) change is not happening quickly enough...He concluded that the U.S. Congress is interested in insurance regulatory modernization and the insurance industry will continue to educate Congress about the slow pace of change in the states (Minutes of the NAIC/Industry Liaison Committee, June 10, 2006)."

2. Failure to do anything meaningful about unsuitable sales in any line of insurance. Suitability requirements still do not exist for life insurance sales even in the wake of the remarkable market conduct scandals of the late 1980s and early 1990s. A senior annuities protection model was finally adopted (after years of debate) that is so limited as to do nothing to protect consumers.

3. Failure to call for collection and public disclosure of market performance data after years of requests for regulators to enhance market data, as NAIC weakened consumer protections. How does one test whether a market is workably competitive without data on market shares by zip code and other tests?

4. Failure to call for repeal of the antitrust exemption in the McCarran-Ferguson Act as they push forward deregulation model bills. Indeed, the NAIC still opposes repeal of the antitrust exemption even as they deregulate…effectively seeking to deregulate cartel-like organizations.

5. Failure to do anything as an organization on the use of credit scoring for insurance purposes. In the absence of NAIC action, industry misinformation about credit scoring has dominated state legislative debates. NAIC's failure to analyze the issue and perform any studies on consumer impact, especially on lower income consumers and minorities, has been a remarkable dereliction of duty.

6. Failure to end use of occupation and education in underwriting and pricing of auto insurance.[44]

7. Failure to address problems with risk selection. There has not even been a discussion of insurers' explosive use of underwriting and rating factors targeted at socio-economic characteristics: credit scoring, check writing, prior bodily injury coverage limits purchased by the applicant, prior insurer, prior non-standard insurer, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.

8. Failure to heed calls from consumer leaders to do something about contingency commissions for decades until Attorney General Spitzer finally acted.

9. Failure to even discover, much less deal with, the claims abuses relating to the use of systems designed to systematically underpay claims for millions of Americans.

10. Failure to do anything on single premium credit insurance abuses.

11. Failure to take recent steps on redlining or insurance availability or affordability. Many states no longer even look at these issues, 30 years after the federal government issued studies documenting the abusive practices of insurers in this regard. Yet,

[44] Florida has held hearings on the practice.

ongoing lawsuits continue to reveal that redlining practices harm the most vulnerable consumers.

12. Failure to take meaningful action on conflict-of-interest restrictions even after Ernest Csiszar left his post as South Carolina regulator and President of the NAIC in September 2004 to become President of the Property Casualty Insurers Association of America after negotiating deregulation provisions in the SMART Act desired by PCIAA members.

13. Failure to act to create regional catastrophic pools to spread hurricane risks or to effectively deal with inappropriate short-term, unscientific models which have sharply raised consumers' home insurance prices along the coasts.

NAIC Rollbacks of Consumer Protections

1. The NAIC pushed through small business property-casualty deregulation, without doing anything to reflect consumer concerns (indeed, even refusing to tell consumer groups why they rejected their specific proposals) or to upgrade "back-end" market conduct quality, despite promises to do so. As a result, many states adopted the approach and have rolled back their regulatory protections for small businesses.

2. States are rolling back consumer protections in auto insurance as well. New Jersey, Texas, Louisiana, and New Hampshire have done so in the last three years.

3. NAIC has terminated free access for consumers to the annual statements of insurance companies at a time when the need for enhanced disclosure is needed if price regulation is to be reduced.

4. NAIC is currently actively considering adoption of personal lines (auto and home insurance) regulatory framework guidance to the states that would severely reduce consumer protections.

Can Competition Alone Guarantee a Fair, Competitive Insurance Market?

Consumers, who over the last 30 years have been the victims of vanishing premiums, churning, race-based pricing, creaming, and consumer credit insurance policies that pay pennies in claims per dollar in premium, are not clamoring for such policies to be brought to market with even less regulatory oversight than in the past. The fact that "speed-to-market" has been identified as a vital issue in modernizing insurance regulation demonstrates that some policymakers have bought into insurers' claims that less regulation benefits consumers. We disagree. We think smarter, more efficient regulation benefits both consumers and insurers and leads to more beneficial competition. Mindless deregulation, on the other hand, will harm consumers.

The need for better regulation that benefits both consumers and insurers is being exploited by some in the insurance industry to eliminate the most effective aspects of state insurance regulation such as rate regulation, in favor of a model based on the premise that competition alone will protect consumers.[45] We question the entire foundation behind the assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. First of all, there are many reasons why competition in insurance is weak (see a list of these reasons attached as Attachment 2). The track record of market conduct regulation has been extremely poor. As noted above, insurance regulators rarely are the first to identify major problems in the marketplace.

Given this track record, market conduct standards and examinations by regulators must be dramatically improved to enable regulators to become the first to identify and fix problems in the marketplace and to address market conduct problems on a national basis. From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and provide proper restitution to consumers after the fact.

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[45] If America moves to a "competitive" model, certain steps must first be taken to ensure "true competition" and prevent consumer harm. First, insurance lines must be assessed to determine whether a competitive model, e.g., the alleviation of rate regulation, is even appropriate. This assessment must have as its focus how the market works for consumers. For example, states cannot do away with rate regulation of consumer credit insurance and other types of insurance subject to reverse competition. The need for relative cost information and the complexity of the line/policy are factors that must be considered.

However, if certain lines are identified as appropriate for a "competitive" system, the following must be in place before such a system can be implemented,:

- Policies must be transparent: Disclosure, policy forms, and other laws must create transparent policies. Consumers must be able to comprehend the policy's value, coverage, actual costs, including commissions and fees. If consumers cannot adequately compare actual costs and value, and if consumers are not given the best rate for which they qualify, there can be no true competition.
- Policies should be standardized to promote comparison-shopping.
- Antitrust laws must apply.
- Anti-rebate, anti-group, and other anti-competitive state laws must be repealed.
- Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.
- Consumers must be able to hold companies legally accountable through strong private remedies for losses suffered as a result of company wrongdoing.
- Consumers must have knowledge of and control over flow and access of data about their insurance history through strong privacy rules.
- There must be an independent consumer advocate to review and assess the market, assure the public that the market is workably competitive, and determine if policies are transparent.

Safeguards to protect against competition based solely on risk selection must also be in place to prevent redlining and other problems, particularly with policies that are subject to either a public or private mandate. If a competitive system is implemented, the market must be tested on a regular basis to make sure that the system is working and to identify any market dislocations. Standby rate regulation should be available in the event the "competitive model" becomes dysfunctional.

If the industry will not agree to disclose actual costs (including all fees and commissions, ensuring transparency of policies, strong market conduct rules, and enforcement) then it is not advocating true competition, only deregulation.

The unique nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guarantee, such beneficial price competition.

Front-end regulation should be designed to prevent market conduct problems from occurring instead of inviting those problems to occur. It should also promote beneficial competition, such as price competition and loss mitigation efforts, and deter destructive competition, such as selection competition, and unfair sales and claims settlement practices. Simply stated, strong, smart, efficient and consistent front-end regulation is critical for meaningful consumer protection and absolutely necessary to any meaningful modernization of insurance regulation.

Is Regulation Incompatible With Competition?

The insurance industry promotes a myth: that regulation and competition are incompatible. This is demonstrably untrue. Regulation and competition both seek the same goal: the lowest possible price that is consistent with a reasonable return for the seller. There is no reason that these systems cannot coexist and even compliment each other.

The proof that competition and regulation can work together to benefit consumers and the industry is the manner in which California regulates auto insurance under Proposition 103. Indeed, that was the theory of the drafters (including myself) of Proposition 103. Before Proposition 103, Californians had experienced significant price increases under a system of "open competition" of the sort the insurers now seek at the federal level. (No regulation of price is permitted but rate collusion by rating bureaus is allowed, while consumers receive very little help in getting information.) Proposition 103 sought to maximize competition by eliminating the state antitrust exemption, laws that forbade agents to compete, laws that prohibited buying groups from forming, and so on. It also imposed the best system of prior approval of insurance rates and forms in the nation, with very clear rules on how rates would be judged.

As our in-depth study of regulation by the states revealed,[46] California's regulatory transformation -- to rely on both maximum regulation and competition -- has produced remarkable results for auto insurance consumers and for the insurance companies doing business there. The study reported that insurers realized very nice profits, above the national average, while consumers saw the average price for auto insurance drop from $747.97 in 1989, the year Proposition 103 was implemented, to $717.98 in 1998. Meanwhile, the average premium rose nationally from $551.95 in 1989 to $704.32 in 1998. California's rank dropped from the third costliest state to the 20th.

As of 2005, the average annual premium in California was $844.50 (ranked 18th) vs. $829.17 for the nation.[47] Since California transitioned from relying simply on competition -- as promoted by insurers -- to full competition and regulation, the average auto rate went up by 12.9

[46] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," Consumer Federation of America, June 6, 2000.
[47] State Average Expenditures & Premiums for Personal Automobile Insurance in 2001, NAIC, July 2005.

percent while the national average rose by 50.2 percent -- a powerhouse result for California's consumers! [48] In 1989, California consumers were paying 36 percent more that the national average, while today they pay a mere 2 percent more than the national average price.

How Can Uniformity be Achieved Without Loss of Consumer Protections?

CFA would endorse a more uniform national or multi-state approach if certain rigorous conditions were met. The attached fact sheet, *Consumer Principles and Standards for Insurance Regulation,* [49] provides detailed standards that regulators should meet to properly protect consumers, whether at the state, multi-state or national level. It should be noted that none of recent proposals offered by insurers or on behalf of insurers to Congress come close to meeting these standards.

One obvious vehicle for multi-state enforcement of insurance standards is the NAIC. The NAIC Commission of the Interstate Insurance Product Regulation Compact began operation with a small staff on June 13th of this year. We have favored empowering the NAIC to implement such a multi-state approach only if the NAIC's decision-making procedures are overhauled to make it a more transparent, accountable body with meaningful regulatory powers. These steps would include public access to insurer filings during the review process and formal, funded consumer participation. To date, regulators have refused to take these steps. Moreover, the Commission will be unlikely to carry out its role as a truly independent regulator due to inadequate funding. The Commission will be receiving and reviewing life, annuity and long term care filings for at least 27 states, but its current budget only allows for a total staff of three people. As stated above, recent NAIC failures demonstrate that it is not an impartial regulatory body that can be counted on to adequately consider consumer needs.

Because of its historical domination by the insurance industry, consumer organizations are extremely skeptical about its ability to confer national treatment in a fair and democratic way. It is essential that any federal legislation to empower the NAIC include standards to prevent undue industry influence and ensure the NAIC can operate as an effective regulatory entity, including:

- Democratic processes/accountability to the public, which must include: notice and comment rulemaking; on the record voting; accurate minutes; rules against ex-parte communication; public meeting/disclosure/sunshine rules/FOIA applicability.
- A decision-making process subject to an excellent Administrative Procedures Act.
- Strong conflict of interest and revolving door statutes similar to those of the federal government to prevent undue insurance industry influence. If decision-making members of the NAIC have connections, past or present, to certain companies, the process will not be perceived as fair.

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[48] Insurers have posted excellent profits as well. Over the decade ending in 2004, California insurers enjoyed a return on equity for private passenger auto insurance of 11.1 percent vs. 8.5 percent for the nation (Report on Profitability by Line by State 2004, NAIC).

[49] See Attachment 1.

- Independent funding. The NAIC cannot serve as a regulatory entity if it relies on the industry for its funding. The bill should establish a system of state funding to the NAIC at a set percentage of premium so that all states and insured entities equally fund the NAIC.
- National Independent Advocate. To offset industry domination, an independent, national, public insurance counsel/ombudsman with necessary funding is needed. Consumers must be adequately represented in the process for the process to be accountable and credible.

Regulation by Domiciliary States Will Lead to Unacceptably Weak Standards

When I was Texas Insurance Commissioner, I had to go into another state to seek a court order to declare an insurer, domiciled in the other state, insolvent. The commissioner of that state refused to do so because of local politics (several ex-governors were on the Board of the failed insurer).

CFA opposes allowing a domiciliary state to essentially act as a national regulator by allowing domiciled companies to comply only with that state's standards. This approach has several potential problems, including the following:

- It promotes forum shopping. Companies would move from state to state to secure regulation from the state that has the least capacity to regulate, provoking a "race to the bottom."
- The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state company.
- The resources of states to properly regulate insurance vary widely.
- It is antithetical to states' rights to apply laws from other states to any business operating within their borders. If such a move is made, however, it is imperative that consumers have a national, independent advocate.
- It promotes a lack of consistency in regulation because companies could change domiciliary state status.
- Residents of one state cannot be adequately represented by the legislature/executive of another. If a resident's state consumer protections did not apply, the resident would be subject to laws of a state in which they have no representation. How can a consumer living in Colorado influence decisions made in Connecticut?
- Rather than focusing on protecting consumers, this system would change the focus to protecting itself and its regulatory turf, as has happened in the bank regulatory system. State and federal banking regulators have competed to lower their consumer protections to lure banks to their system.
- We would be particularly concerned with proposals to give exclusive control of market conduct exams to a domiciliary state. Unscheduled exams by a state are very important for that state's ability to protect its consumers from abuse. States must retain the ability to act quickly based on complaints or other information.

"One-Stop" Policy Approval Must Meet High Standards

Allowing insurers to get approval for their products from a single, unaccountable, non-state regulatory entity would also lead to extremely weak protections unless several conditions are met:

- An entity, such as the NAIC's Coordinated Advertising, Rate and Form Review Authority (CARFRA), that is not subject to authorizing legislation, due process standards, public accountability, prohibitions on ex-parte communications, and similar standards should not have the authority to determine which lines would be subject to a one-stop approval process or develop national standards. It also must have funding through the states, not directly from insurers. Independent funding ensures that the regulatory entity is not subject to unfair and detrimental industry influence.
- Any standards that apply must be high and improve the ability of consumers to understand policies and compare on the basis of price. Consumers do not want "speed—to-market" for bad policies.
- Any entity that serves as national standard setter, reviewer and/or approver needs federal authorizing legislation. An "interstate compact" or "memorandum of understanding" is unworkable and unaccountable.
- Giving the regulated insurer the option to choose which entity regulates it, is an invitation to a race to the bottom for regulatory standards.
- Standardization of forms by line has the potential to assist consumers if done in such a way to enhance understanding of terms, benefits, limitations, and actual costs of policies.
- Public/consumer input is essential if the entity makes decisions that ultimately affect information provided to and rates charged consumers.
- We support the concept of an electronic central filing repository, but the public must have access to it.
- To retain oversight of policies and rates affecting their residents, states must have the ability to reject decisions of the entity.
- Any national system must include a national, externally funded consumer-public advocate/counsel to represent consumers in standard setting, development of forms, rate approval, etc.

Recent Federal Proposals

Given the extremely sorry state of state regulation, it is hard to believe that a federal bill could be crafted that would make matters worse. Yet, insurers have managed to do it – not once, but twice! Their bills not only do not provide the basic standards of consumer protection cited above, they would undermine the extremely low standards of consumer protection now extant in many states.

Greater resistance in Congress and extremely low public opinion of insurers in the wake of their poor performance after Hurricane Katrina, which occurred as the insurers rolled to three years of record profits in a row, has led insurers to temporarily step back from regulatory "reform." As one insurance lobbyist told me, "We are not pushing in this atmosphere – we do not want to risk having a bill that actually might enhance regulation, our goal all along has been deregulation, not uniformity." Nonetheless, it is important to reflect on how harmful to consumers these proposals would be.

<u>Insurer Dream Bill #1: Optional Federal Insurance Charter</u>

The bills that have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers would create a federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market for a particular line of insurance might be. (This bill has been introduced in the House as H.R. 3200 by Representatives Bean and Royce and in the Senate as S. 40 by Senators Johnson and Sununu.) The bills also offer little improvement in consumer protection or information systems to address the major problems cited above. Insurers would be able to choose whether to be regulated by this weak federal regulator or by state regulators.

Consumer organizations strongly oppose an optional federal charter that allows the regulated company, at its sole discretion, to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections. Indeed the industry drafters of such proposals have openly stated that this is their goal. If elements of the insurance industry truly want to obtain uniformity of regulation, "speed to market" and other advantages through a federal regulator, let them propose a federal approach that does not allow insurers to run back to the states when regulation gets tougher than they want. We could all debate the merits of that approach. CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

<u>Insurer Dream Bill #2: SMART Act</u>

The State Modernization and Regulatory Transformation (SMART) Act was proposed by former House Financial Services Chairman Michael Oxley and Representative Richard Baker as a discussion draft in 2005. Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would override important state consumer protection laws, sanction anticompetitive practices by insurance companies and incite state regulators into a competition to further weaken insurance oversight. It is quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen, with absolutely no protections for consumers. The consumers who will be harmed by it are our nation's most vulnerable: the oldest, the poorest, and the sickest.

For example, the discussion draft would have preempted state regulation of insurance rates. Imagine the impact on the Gulf Coast of that "brilliant" idea! This would leave millions of consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of state controls on territorial line drawing. States would be helpless to stop the misuse of risk classification information, such as credit scores, territorial data, and the details of consumers' prior insurance history, for pricing purposes. The draft approach goes so far as to deregulate cartel-like organizations such as the Insurance Services Office and the National Council on Compensation Insurance, while leaving the federal antitrust exemption fully intact.

What the draft does not do is as revealing as what it does require. It does not create a federal office to represent consumer interests, although the draft creates two positions to represent insurer interests. It takes no steps to spur increased competition in the insurance industry, such as providing assistance or information to the millions of consumers who find it extremely difficult to comparison shop for this complex and expensive product, or eliminating the antitrust exemption that insurers currently enjoy under the McCarran-Ferguson Act. Insurers are not required to meet community reinvestment requirements, as banks are, to guarantee that insurance is available in underserved communities. Nothing is done to prevent insurers from using inappropriate information, such as credit scores or a person's income, to develop insurance rates.

CFA supports the goals outlined in several sections of this draft. As stated above, we are not opposed to increasing uniformity in insurance regulation. Unfortunately, however, in almost every circumstance in which the draft attempts to ensure uniformity, it chooses the weakest consumer protection approach possible. Like the OFC, this approach has no chance in the current Congress, given the outrage over insurer practices and profits.

Insurer Dream #3: Non-admitted Insurance/Reinsurance Regulation

This bill, which was initially only one of 17 titles in the SMART Act, preempts states only in the regulation of surplus lines of insurance and reinsurance. This legislation (H.R. 1065) has passed the House of Representatives this year and has been introduced this year by Senators Martinez and Nelson as S. 929. It provides for a method of collecting state premium taxes for surplus lines and allocating this income to the states. CFA has several concerns with this legislation:

1. Contrary to the stated intent of the authors of this legislation, this bill (Section 107(3)) appears to open the door to the increased sale of poorly regulated, non-admitted personal lines of insurance to individual consumers, not just commercial insurance sold to sophisticated corporations. Moreover, the bill does not exclude non-admitted personal lines of insurance from its provisions. If the bill fosters a sharp growth in under-regulated, non-admitted insurance – as it is intended to do – it could seriously harm consumers.

2. Great regulatory confusion and ineptitude would likely result when the state of domicile for an insured party regulates all parts of that entity's insurance transaction. (Section 103 prohibits any state from overseeing surplus lines of transactions other than the home state of an insured party.) Consider how Michigan might regulate a transaction in which General Motors or another large company based in the state, has purchased a commercial automobile policy for its cars on the West and Gulf Coasts from non-admitted insurers. In all likelihood, Michigan regulators know very little about dealing with earthquake risk in California or hurricane risk in Florida in pricing insurance policies, or in handling claims resulting from such weather events if GM's cars are damaged. Moreover, since Michigan is a no-fault state for auto insurance, regulators there would likely know very little about tort laws in other states and how pricing and claims should be handled. How can 50 regulators each become experts in the laws of all 50 states? This is regulatory super-complexity, not regulatory simplification.

3. The bill is based on the incorrect assumption that the domiciled state of an insured party or reinsurance company will provide adequate oversight. The bill handcuffs states that would have a legitimate interest in acting to protect residents harmed by clearly abusive insurance practices (Section 102). For example, suppose a non-admitted insurer for a company like GM acts in bad faith and refuses to pay legitimate claims regarding unsafe automobiles that harmed drivers in other states? These states would have no ability to investigate or sanction that insurance company while the State of Michigan, with limited resources and very little in-state impact, would have much less of an incentive to get to the bottom of the problem.

Moreover, a "home state" regulator has the greatest interest in pleasing a large insured party – and employer – based in that state. This could lead the regulator to lower insurance standards that protect residents and consumers who use that company's products and services across the country.

The bill (Section 105) would also allow large commercial insured parties to seek coverage from non-admitted insurers without determining whether the same coverage is available from an admitted carrier, which most states now require. It is not in the public interest to foster the growth of a segment of the market that does not have to meet state standards – unless admitted insurance is truly not available. For example, guaranty associations in all states do not cover claims for surplus lines insurers from other states when an insured entity and its insurer become insolvent. This may be a minor problem for the defunct policyholder and the defunct insurer, but it certainly is not minor for the people that the policyholder may have injured who are left without guarantee association protection.

Similarly, the bill (Section 202(a)) only allows the domiciled state of a reinsurance company to regulate that company's solvency. What if insured entities in the state of domicile are covered by only one percent of the reinsurance written by a particular company but entities in another state are covered by seventy-five percent of the reinsurance? Moreover, allowing a domiciliary state to essentially act as a national regulator promotes forum shopping by insurers to secure the most favorable regulatory environment. The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state insurer. As stated above, when I was Insurance Commissioner of Texas, I had to investigate an insolvent insurer in another state because the commissioner of that state refused to do so.

4. Several deregulatory provisions of the bill are based on the faulty assumption that large buyers of insurance do not need protections that would normally be provided in an insurance transaction, such as prohibitions on deceptive practices and mandated verification of the legality of policy forms. (For example, Section 103 prohibits any state from overseeing surplus lines transactions other than the home state of an insured party.) The investigations and settlements pursued by New York Attorney General Eliot Spitzer refute this assumption. Large, sophisticated corporations were victimized by insurers and brokers through bid-rigging, kickbacks, hidden commissions, and blatant conflicts of interest.

A Pro-Consumer Bill: The Insurance Consumer Protection Act of 2003

Only one recent bill considers the consumer perspective in its design, adopting many of the consumer protection standards cited in this testimony. That was S. 1373 of 2003 introduced by Senator Hollings. The bill would adopt a unitary federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

The bill's regulatory structure requires federal prior approval of prices to protect consumers, including some of the approval procedures (such as hearing requirements when prices change significantly) being used so effectively in California. It requires annual market conduct exams. It creates an office of consumer protection. It enhances competition by removing the antitrust protection insurers hide behind in ratemaking. It improves consumer information and creates a system of consumer feedback.

If federal regulation is to be considered, S.1373 should be the baseline for any debate on the subject.

A Pro-Consumer Bill Whose Time has Come: Amending the McCarran- Ferguson Act to Remove the Antitrust Exemption

Insurers say they want competition alone to determine rates. The best way for Congress to help spur competition in the insurance industry would be to repeal the McCarran Ferguson Act, as proposed by S. 618. This would test the industry's desire to compete under the same rules as virtually all other American businesses.

Wisely, S. 618 also unleashes the Federal Trade Commission to perform oversight of anticompetitive insurer behavior, a key step necessary for effective and efficient consumer protection. We strongly support passage of this legislation.

Another Pro-Consumer Bill: Improving Disclosure to Consumers

One cause of the problems we have witnessed in the settlement of Hurricane Katrina claims is that consumers cannot understand complex insurance policy language. Senator Lott's Bill, S.1061, the "Homeowner's Insurance Noncoverage Disclosure Act," is an essential step to help people know what will not be covered if some calamity occurs to a home. The use of the FTC, an agency too long restrained from helping Americans with insurance problems, is also welcome. CFA supports passage of S.1061.

Conclusion

CFA looks forward to working with the Subcommittee to strengthen consumer protections for insurance, Mr. Chairman. I will be happy to respond to questions at the appropriate time.

ATTACHMENT 1

Consumer Principles and Standards for Insurance Regulation

1. **Consumers should have access to timely and meaningful information about the costs, terms, risks and benefits of insurance policies.**

   - Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
   - Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
   - Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
   - Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or an independent third party.
   - Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
   - A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.
   - Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
   - Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
   - Information on claims policy and filing process should be readily available to all consumers and included in policy information.
   - Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
   - Consumer Bill of Rights, tailored for each line, should accompany every policy.
   - Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). The insurer should give the consumer notice of feedback procedure at the end of the transaction, e.g., form on-line or toll-free telephone number.

2. **Insurance policies should be designed to promote competition, facilitate comparison-shopping, and provide meaningful and needed protection against loss.**

- Disclosure requirements above apply here as well and should be included in the design of policy and in the policy form approval process.
- Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
- Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurance are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
- "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
- Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. **All consumers should have access to adequate coverage and not be subject to unfair discrimination.**

- Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (e.g., mortgage), regulatory intervention is appropriate to assure reasonable affordability and guarantee availability.
- Market reforms in the area of health insurance should include guaranteed issue and community rating and, where needed, subsidies to assure health care is affordable for all.
- Information sufficient to allow public determination of unfair discrimination must be available. For example, geo-code data, rating classifications, and underwriting guidelines should be reported to regulatory authorities for review and made public.
- Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.
- Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
- Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. **All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.**

    - Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
    - Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
    - Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable).
    - In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
    - A regulatory entity, on its own or through delegation to an independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. **Consumers should have control over whether their personal information is shared with affiliates or third parties.**

    - Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
    - Consumers should have access to the information held by the insurance company to make sure it is timely, accurate, and complete. They should be periodically notified how they can obtain such information and how to correct errors.
    - Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
    - Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect, and or disclose information about the consumer.
    - Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.
    - Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
    - Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.**

- Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.
- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be an independent, fair, and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. **Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.**

- Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers:
  - The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
  - Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
  - Regulators should focus on online monitoring and certification to protect against fraudulent companies.
  - A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
    - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios, and consumer rights with regard to policies and claims.
    - Access to information sources should be user friendly.

    - Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database. (NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.
- Strong conflict of interest, code of ethics, and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be a prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., providing a rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
    - Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.

- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability a national consumer advocate office, with the ability to represent consumers before each insurance department, is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.
- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that are independent, external to regulatory structure, and are empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or "one-stop" approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
- Insurance departments should support public counsel or other external, independent, consumer representation mechanisms before legislative, regulatory, and NAIC bodies.
- Regulatory entities should have a well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., a consumer advisory committee. This is particularly important to ensure that the needs of certain populations in the state and the needs of changing technologies are met.

ATTACHMENT 2

WHY INSURANCE IS AN ESSENTIAL PUBLIC GOOD AND IS NOT A NORMAL PRODUCT THAT CAN BE REGULATED SOLELY THROUGH COMPETITION

1. ***Complex Legal Document.*** Most products are able to be viewed, tested, "tires kicked" and so on. Insurance policies, however, are difficult for consumers to read and understand -- even more difficult than documents for most other financial products. For example, consumers often think they are buying insurance, only to find they bought a list of exclusions.

2. ***Comparison Shopping is Difficult.*** Consumers must first understand what is in the policy to compare prices.

3. ***Policy Lag Time.*** Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy's usefulness may not arise for decades, when a claim arises.

4. ***Determining Service Quality is Very Difficult.*** Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

5. ***Financial Soundness is Hard to Assess.*** Consumers must determine the financial solidity of the insurance company. One can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

6. ***Pricing is Dismayingly Complex.*** Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

7. ***Underwriting Denial.*** After all that, underwriting may result in the consumer being turned away.

8. ***Mandated Purchase.*** Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "free-market", but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.

9. ***Incentives for Rampant Adverse Selection.*** Insurer profit can be maximized by refusing to insure classes of business (e.g., redlining) or by charging regressive prices.

10. ***Antitrust Exemption***. Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it does not matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home or health.

ATTACHMENT 3

COLLUSIVE ACTIVITY BY THE INSURANCE SERVICES ORGANIZATION THAT IS ALLOWED BY THE MCCARRAN-FERGUSON ANTITRUST EXEMPTION

The ISO website has extensive information on the range of services they offer insurance companies. The website illustrates the deep involvement that this organization has in helping to set insurer rates, establishing policy forms, underwriting policies, and in setting other rules.

Some examples:

- The page "The State Filing Handbook," promises 24/7 access to "procedures for adopting or modifying ISO's filings as the basis for your own rates, rules and forms."

- The page "ISO MarketWatch Cube" is a "powerful new tool for analyzing renewal price changes in the major commercial lines of insurance…the only source of insurance premium-change information based on a large number of actual policies." This price information is available "in various levels of detail – major coverage, state, county and class groupings – for specific time periods, either month or quarter…"

- "MarketWatch" supplies reports "that measure the change in voluntary-market premiums (adjusted for exposure changes) for policies renewed by the same insurer group…a valuable tool for…strategically planning business expansion, supporting your underwriting and actuarial functions…"

- "ISO's Actuarial Service" gives an insurer "timely, accurate information on such topics as loss and premium trend, risk classifications, loss development, increased limits factors, catastrophe and excess loss, and expenses." Explaining trend, ISO points out that the insurer can "estimate future costs using ISO's analyses of how inflation and other factors affect cost levels and whether claim frequency is rising or falling." Explaining "expenses" ISO lets an insurer "compare your underwriting expenses against aggregate results to gauge your productivity and efficiency relative to the average…" NOTE: These items, predicting the future for cost movement and supplying data on expenses sufficient for turning ISO's loss cost filings into final rates, are particularly anti-competitive and likely, absent McCarran-Ferguson antitrust exemption protection, illegal.

- "ISO's Actuarial Services" web page goes on to state that insurers using these services will get minutes and agendas of "ISO's line actuarial panels to help you keep abreast of ratemaking research and product development."

- The "Guide to ISO Products and Services" is a long list of ways ISO can assist insurers with rating, underwriting, policy forms, manuals, rate quotes, statistics, actuarial help, loss reserves, policy writing, catastrophe pricing, information on specific locations for property insurance pricing, claims handling, information on homeowner claims, credit scoring, making filings for rates, rules and policy forms with the states and other services.

Finally, ISO has a page describing "Advisory Prospective Loss Costs," which lays out the massive manipulations ISO makes to the historic data. A lengthy excerpt follows:

"Advisory Prospective Loss Costs are accurate projections of average future claim costs and loss-adjustment expenses — overall and by coverage, class, territory, and other categories.
Your company can use ISO's estimates of future loss costs in making independent decisions about the prices you charge for your policies. For most property/casualty insurers, in most lines of business, ISO loss costs are an essential piece of information. You can consider our loss data — together with other information and your own judgment — in determining your competitive pricing strategies.

"**The insurance pricing problem** –Unlike companies in other industries, you as a property/casualty insurer don't know the ultimate cost of the product you sell — the insurance policy — at the time of sale. At that time, losses under the policy have not yet occurred. It may take months or years after the policy expires before you learn about, settle, and pay all the claims. Firms in other industries can base their prices largely on known or controllable costs. For example, manufacturing companies know at the time of sale how much they have spent on labor, raw materials, equipment, transportation, and other goods and services. But your company has to *predict* the major part of your costs — losses and related expenses — based on historical data gathered from policies written in the past and from claims paid or incurred on those policies. As in all forms of statistical analysis, a large and consistent sample allows more accurate predictions than a smaller sample. That's where ISO comes in. The ISO database of insurance premium and loss data is the world's largest collection of that information. And ISO quality checks the data to make sure it's valid, reliable, and accurate. But before we can use the data for estimating future loss costs, ISO must make a number of adjustments, including loss development, loss-adjustment expenses, and trend.

"**Loss development ...**because it takes time to learn about, settle, and pay claims, the most recent data is always incomplete. Therefore, ISO uses a process called *loss development* to adjust insurers' early estimates of losses to their ultimate level. We look at historical patterns of the changes in loss estimates from an early evaluation date — shortly after the end of a given policy or accident year — to the time, several or many years later, when the insurers have settled and paid all the losses. ISO calculates *loss development factors* that allow us to adjust the data from a number of recent policy or accident years to the ultimate settlement level. We use the adjusted — or developed — data as the basis for the rest of our calculations.

"**Loss-adjustment expenses** – In addition to paying claims, your company must also pay a variety of expenses related to settling the claims. Those include legal-defense costs, the cost of operating a claims department, and others. Your company allocates some of those costs — mainly legal defense — to particular claims. Other costs appear as overhead. ISO collects data on allocated and unallocated loss-adjustment expenses, and we adjust the claim costs to reflect those expenses.

"**Trend** –Losses adjusted by loss-development factors and loaded to include loss-adjustment expenses give the best estimates of the costs insurers will ultimately pay for past policies. But you need estimates of losses in the future — when your new policies will be in effect. To produce those estimates, ISO looks separately at two components of the loss cost — claim *frequency* and claim *severity*. We examine recent historical patterns in the number of claims per unit of exposure (the frequency) and in the average cost per claim (the severity). We also consider changes in external conditions. For example, for auto insurance, we look at changes in speed limits, road conditions, traffic density, gasoline prices, the extent of driver education, and patterns of drunk driving. For just three lines of insurance — commercial auto, personal auto, and homeowners — ISO performs 3,000 separate reviews per year to estimate loss trends. Through this kind of analysis, we develop *trend factors* that we use to adjust the developed losses and loss-adjustment expenses to the future period for which you need cost information.

"**What you get** – With ISO's advisory prospective loss costs, you get solid data that you can use in determining your prices by coverage, state, territory, class, policy limit, deductible, and many other categories. You get estimates based on the largest, most credible set of insurance statistics in the world. And you get the benefit of ISO's renowned team of actuaries and other insurance professionals. ISO has a staff of more than 200 actuarial personnel — including about 50 members of the Casualty Actuarial Society. And no organization anywhere has more experience and expertise in collecting and managing data and estimating future losses."

ISO's activities extensively interfere with the competitive market, a situation allowed by the provisions of the McCarran-Ferguson Act's extensive antitrust exemption.

THE FINANCIAL SERVICES ROUNDTABLE

Statement of Alessandro Iuppa
Senior Vice President, Government and Industry Affairs
Zurich North America
on behalf of the Financial Services Roundtable

Before a Hearing of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Additional Perspectives on the Need for Insurance Regulatory Reform"

October 30, 2007

Good afternoon, Chairman Kanjorski, Ranking Member Pryce and members of the Subcommittee. My name is Alessandro Iuppa and I am Senior Vice President, Government and Industry Affairs for Zurich North America. I appreciate the opportunity to speak with you on behalf of Zurich and the Financial Services Roundtable on the subject of insurance regulatory reform, a critical issue for insurance consumers, agents and carriers alike.

I have had the honor of appearing before this Subcommittee in 2006 in my role as President of the National Association of Insurance Commissioners, albeit to testify on a different issue, hybrid securities. It is a pleasure to be here again in my new capacity.

Zurich Financial Services Group is an insurance-based financial services provider with a global network of subsidiaries and offices in North America, Europe, Latin America, Asia, and other markets. Zurich was founded in 1872, and in 1912 was the first foreign insurer to enter the U.S. market. Zurich employs approximately 58,000 people worldwide, including approximately 11,000 people in 38 U.S. states, and serves customers in more than 170 countries. We are one of the leading global underwriters of life and personal as well as commercial property and casualty insurance. In the U.S., Zurich is the third largest writer of commercial property and casualty insurance, and we provide insurance and risk management services for many of Fortune's Global 100 companies, as well as for individuals and small and mid-sized businesses. Zurich is also affiliated with Farmers Group, Inc., headquartered in Los Angeles, CA, which manages the member owned Farmers Inter-Insurance Exchanges and their subsidiary companies. Farmers has more than 19,000 employees, 17,000 exclusive agents and 12 million policyholders around the country, and as a Group are the nation's fourth largest personal lines insurer of homeowners and private-passenger auto risks, the fifth largest insurer of small business and one of the largest life insurers in the country.

The Financial Services Roundtable (the Roundtable) represents 100 of the nation's largest integrated financial services companies. Roundtable members provide insurance, banking and investment products and services to millions of American consumers, and its membership includes both commercial and personal lines property and casualty insurers, as well as life insurers, who share Zurich's concerns and support the proposed solutions outlined in my testimony. Member companies account for $65.8 trillion in managed assets, $1 trillion in revenue, and 2.4 million jobs.

I come to the issue of insurance regulatory reform with a perspective different from the other witnesses at today's hearing. Prior to joining Zurich, I was an active member of the regulatory community for over 20 years, serving as Commissioner in Nevada, as Superintendent in Maine, as well as a consultant to insurance departments seeking to rehabilitate financially troubled insurers. During my nine plus years as Maine Superintendent, I was engaged on insurance issues nationally and internationally through the National Association of Insurance Commissioners (NAIC) and the International Association of Insurance Supervisors (IAIS). I had the honor to serve as NAIC President in 2006 and Chairman of the IAIS Executive Committee from 2004 - 2006.

When I concluded my regulatory career, I chose to join Zurich because it is a leader in the global marketplace and a thought leader in the public policy debate on issues such as insurance regulatory reform. We are, I believe, an agent for positive change in the effort to create a regulatory system that protects insurance consumers (our customers) and, at the same time, allows market participants – the carriers, producers and others who provide insurance products to consumers – to thrive.

Introduction

Financial markets in general have undergone extraordinary growth and structural change in recent decades. Much of this change is due to developments such as the worldwide integration of capital markets, the revolution in information technology, and shifting attitudes toward competition and protection in the financial services area. Modernization of the U.S. insurance regulatory structure is a necessary component if we expect to maintain a strong, vibrant insurance sector and is essential to address policyholder needs in the 21st century. Zurich first invested in the U.S. market 95 years ago and now operates throughout the world. Like us, our clients have risks and exposures that transcend state and national boundaries and increasingly are international in scope. This reality differs markedly from the nineteenth century when state regulation of insurance began – and even from two decades ago when I began my career in insurance regulation.

Unfortunately, the current U.S. insurance regulatory structure is not fully equipped to supervise the sophisticated insurance marketplace of the 21st century. The need to operate within the state patchwork of regulation in the U.S. means that insurers with customers with worldwide operations are hindered in their efforts to keep pace with the complex risk issues confronting clients doing business on a national and international basis.

Zurich and the Roundtable are not opposed to regulation of insurance. I would not be here if they were. We support prudent, strong, state-of-the-art insurance regulation that allows insurers to meet the needs of their policyholders and encourages competitive and thriving markets. Although the existing state structure works for some, it impedes our ability to achieve those goals.

We are grateful to Representatives Bean and Royce for drafting and introducing H.R. 3200, the National Insurance Act of 2007, and to you, Mr. Chairman, for your willingness to conduct a comprehensive review of the current regulatory system. This introduction marks a major undertaking with a plethora of issues and interests that will require careful consideration and deliberation. Representatives Bean and Royce and their staffs have crafted legislation that establishes an excellent framework to reach the goal of an optional federal charter for the insurance marketplace. Their bill will provide real choices for all participants – insurance companies and insurance agents and brokers and, most importantly, insurance consumers. Zurich and the entire Roundtable membership support the legislation and look forward to working with the Subcommittee as the work progresses forward.

The State of Insurance Regulation

An exclusively state-based system for the regulation of insurance, codified by the McCarran-Ferguson Act in 1945, made sense when risks and the potential for loss were concentrated in relatively small geographic areas and insurance markets were similarly small. Indeed, state regulation may still make sense for many of the 7,000 insurers currently operating in the United States who operate on a single state or regional basis and serve a customer base with similar interests. Nevertheless, for many insurers and policyholders, the world has changed – and changed dramatically.

Although some risks and insurance markets remain local or state-based, in general, insurance has become a national and international marketplace in which risks and losses are widely spread throughout the world. Rather than encouraging increased availability and improving the affordability of insurance to cover such risks, the state regulatory system does just the opposite. By artificially making each state an individual marketplace, it constrains the ability of carriers to innovate and has a negative affect on the availability and affordability of coverage.

To their credit, the state insurance regulators, individually and through the NAIC, have attempted to institute regulatory reforms and they have made some strides in recent years toward simplifying and streamlining regulatory requirements. We appreciate that and we continue to work with them to make the system more workable in the modern world.

The reality, however, is that today's marketplace demands far more dramatic action than the states alone are able to provide. Large insurers' increasingly global footprint continues to outstrip the pace of reform efforts by state regulators and legislatures. Competition and efficiency in the insurance industry lags behind other financial services sectors due in large part to the regulatory inefficiencies and inconsistencies in the state insurance regulatory system, inefficiencies and inconsistencies that must be addressed if the U.S. insurance sector is to be in a position to match the pace of change in the rapidly-evolving global marketplace and thereby expand the insurance marketplace for the benefit of insurers, producers and consumers. In short, it is not that the states are not trying to adapt, but it is the fact that the state-by-state structure simply does not work efficiently for insurers, producers and consumers that are national and international players. Even at the highest level of competence and cooperation, states have limited options due to their narrow market focus and statutory frameworks.

Broad reform of the insurance regulatory system is necessary to provide insurance consumers with a strong, competitive insurance markets that deliver the best products at the lowest cost, allow the industry to operate more efficiently, and enable the industry to compete in the larger financial services industry and internationally. Reform should be focused on one thing: creating a national marketplace, a market unencumbered by geographic borders.

Let me be clear, we are advocating for a regulatory system that retains prudential oversight, fosters greater transparency, greater efficiency both for the companies and the regulators, more product availability, and more competitive markets. To achieve such a system, we believe that an optional federal charter is the best choice. It will allow those who seek access to broader financial services markets to do so through an optional federal charter. At the same time, those who wish to continue under the state system can continue to do so. The choice should be based on sound business considerations not a singular regulatory system.

State Regulation Hinders U.S. Globally

Over the past several years I spent a great deal of time working on behalf of the U.S. regulatory community – at home and abroad – with our foreign colleagues and the international insurance community. The NAIC has been active for many years in international policy issues, both to protect U.S. consumers who purchase coverage from non-U.S. insurers and for trade purposes – to develop bilateral and multilateral trade, open markets around the world, and maintain the U.S. industry's global competitive position. Despite the best efforts of the U.S. regulatory community, however, its effectiveness on the international stage is constrained – not necessarily in the development of policies and ideas, but in terms of implementing those policies and ideas at home in order to make the international marketplace function more effectively.

Let me give you an example: The IAIS has become the de facto standard setter with respect to international insurance standards commensurate with the Basel Committee for Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) for the securities industry. Since its inception in 1994, the IAIS has adopted 13 Standards, 15 Guidance Papers and a set of Core Principles. U.S. regulators have been and continue to be active participants in the development of those standards and principles, but no matter how much agreement exists among the regulators, the U.S. representatives are not in a position to bind the U.S. regulatory community to adopt those standards. That right belongs to each state – through its legislature – which can, within its sovereign authority, adopt the standards, modify them before adopting them, or refuse to adopt them as they see fit. The ability of a single U.S. regulator to bind its state is questionable at best. Unfortunately, this limitation applies not only to agreements with foreign regulators, but to model laws and other NAIC actions, as well. The fact is, it is difficult to gain a consensus among the state regulators on any one issue, and even when consensus is reached, state-by-state execution makes nationwide uniform adoption and implementation nearly impossible.

A federal presence in insurance would change this dynamic. The National Insurance Commissioner, with the authority to negotiate and bind the federal government, would add immeasurably to the effectiveness of our international endeavors to the benefit of U.S. insurance consumers. I have no doubt the states would remain involved internationally and encourage them to do so. Doing so alongside the National Commissioner will bring a measure of importance absent in today's environment.

State Regulation Unable to Address National Problems

State insurance regulators, through the NAIC, have and continue to construct regulatory reforms with national implications, regrettably with limited success. The NAIC financial accreditation program is a prime example of state regulation and cooperation at its best. But efforts to export the success of the accreditation program to other regulatory initiatives, such as market conduct, have moved slowly. Even the Interstate Insurance Product Regulatory Commission, which is an undisputed success for the states, covers only 30 member states to date.

The reality is that today's marketplace – both national and international – demands faster and far more dramatic action than the states alone are able to provide. As I have mentioned, insurance is no longer the local market it once was. Insurance consumers have exposures across the country and around the globe, so state boundaries no longer match our customers' national and international business models. And the states – with their differing and sometimes conflicting laws and rules, their sometimes widely varying interpretation of those laws and rules, and their inconsistent and sometimes inflexible implementation – are simply not equipped to handle this increasingly complex and sophisticated marketplace.

Although these may seem like small issues – and individually, state to state, the differences may appear inconsequential – taken as a whole, they constitute a significant burden on insurers, to the ultimate detriment of consumers. Moreover, I question the overall consumer protection value of many of the idiosyncratic state rules, and whether significant regulatory differences from state to state really serve to protect national insurance consumers?

Although the tension between state regulation and the modern insurance marketplace is evident across the spectrum of regulation, I would like to briefly address three areas that would benefit from federal regulation: market deficiencies , speed to market, and commercial policyholder issues.

Market Deficiencies

The lack of a sustainable market for terrorism coverage and coverage shortfalls in some coastal regions illustrates a deficiency in the U.S. marketplace. There are many reasons insurers do not cover terrorism or certain property risks, and we should all be clear from the beginning that a federal regulator will not solve every problem that arises in the marketplace; I am not aware of any regulator that has been able to accomplish that. Regulation, however, can play an important role in helping markets operate as efficiently as possible. In some situations, it can amplify problems that already exist in the marketplace, rather than help markets function for the benefit of policyholders and insurers. Artificial limitations on business and barriers to entry distort markets and ultimately do not benefit consumers.

Additionally, by making each state an individual marketplace, the current regulatory structure inhibits the ability of insurers to spread risk and enhance capacity, while at the same time perpetuating an uneven national regulatory system. As we have learned from painful experience, terrorism, floods, hurricanes, earthquakes, wildfires and other natural catastrophes rarely respect state borders. The problems created by mega-catastrophes are regional and national issues.

Over the years, Congress has increasingly acted to address national problems, and congressional actions have envisioned in their underlying premise a significant role for the federal government. We hope that as the federal government continues responding to marketplace problems, Congress will seriously consider creating a single national insurance regulator with the ability to oversee the national market and interact with the legislative branch in a way that will benefit all market participants. As Congress addresses problems in the states, enforcement of congressional actions is typically left to the states, each of which understandably has its own concerns with its local markets. A federal regulator with responsibility for the national insurance market will be better able to respond to national problems.

Speed To Market

A number of states still require the prior approval or the filing of rates and policy forms before those products can be offered for sale in the state. Several states have completely de-regulated the commercial insurance marketplace for rates and forms, meaning that there are no substantive regulatory approval requirements, other states, however, continue to maintain pre-approval requirements. Although the intent of these requirements is to anticipate problems and prevent them before they happen, in practice, this approach hinders the ability of the insurance industry to deal with changing marketplace needs and conditions in a flexible and timely manner by significantly impeding the ability of insurers to get products to market. My experience taught me that of the approximately 1,000 companies licensed to do underwrite insurance products in Maine very few sought to introduce products that did not comply with state laws and regulations. But for those products that did require prior approval the search for the few problems slowed the pace of product introduction to the insurance community.

For insurers functioning in regional or national markets this approach can lead to duplicative requirements among the jurisdictions, and excessive and inefficient regulation, diverting not only the resources of the carriers that are required to comply, but also regulatory resources that may be better utilized elsewhere.

Commercial Policyholders Better Served at Federal Level

By and large, state regulation serves individual consumers well. The states are responsive to their residents and have in place solid consumer protection laws and rules. That is not to say, however, that the states are best able to protect insurance consumers in all cases or that the federal government is not equally – or better – able to protect insurance consumers. It is also important to remember that policyholders are not always individuals. Commercial entities – from the corner dry cleaners, to Starbucks, to Google – constitute a very large segment of the insurance market. These commercial policyholders come in all shapes and sizes, and have their specific risk management requirements.

Our company, for example, works with many of the Fortune 100 companies – large multinational entities with coverage needs that span state and national borders. In our effort to better serve our multinational clients, we developed the Zurich Multinational Insurance Proposition (MIP). With Zurich MIP, our global customers can be confident that their out of territory coverage is aligned with local licensing and premium tax requirements. For our clients indemnifying risks in the U.S. compliance would be much simpler if Zurich had a federal charter. I mention this because compliance in these areas is an important policyholder protection.

Insurance Regulatory Reform: An Optional Federal Charter

Despite recent improvements, the states clearly cannot solve the problems with insurance regulation on their own, so we believe congressional action is necessary. For better or worse, it is clear that many of the states' regulatory modernization efforts have been the direct result of major external threats – either the threat of federal intervention, or the wholesale dislocation of regulated markets. In the absence of such threats, there is no guarantee the state-based system will adopt further meaningful reforms. As I have mentioned, building a consensus among the state regulators is difficult, and enacting uniform nationwide reform almost impossible. Thus, congressional involvement in insurance regulatory reform is entirely in order.

We believe the best solution is enactment of legislation creating an optional federal insurance charter as contemplated in the National Insurance Act. An OFC would give insurers and producers the choice between a single federal regulator and multiple state regulators. It will not dismantle the longstanding state insurance regulatory framework, rather it will complement the state system with the addition of a federal partner. It is likely that many insurers and producers – particularly those who operate in a single state or perhaps a small number of states – would choose to remain state-licensed. Large, national and international companies, on the other hand, would more likely opt for a federal charter, thereby relieving themselves of the burden of compliance with 56 different regulatory regimes.

The National Insurance Act creates an optional federal regulatory structure for both the life and property & casualty insurance industries; that option extends equally to both insurance companies and insurance agents and brokers (producers); and the bill carefully addresses essential elements of insurance regulation including licensure, rate approval, guaranty funds, and state law preemption. The Act preserves the state system for those that choose to operate at the state level, but offers a more sophisticated regulatory structure for insurers and producers that operate on a national and international basis in this increasingly global industry.

- ***H.R. 3200 creates an optional insurance regulatory system for all industry players.*** An OFC would provide insurance companies and producers a choice to operate under federal or state oversight. The Act preserves the ability of insurers and insurance producers to operate under State licenses, while giving both the option of doing business under a single federal license.

- ***H.R. 3200 gives insurance producers a choice between federal and state oversight and in no way increases regulatory burdens on producers.*** Far from creating additional licensure and other regulatory requirements for insurance producers, the Act has the potential of significantly reducing the regulatory burdens producers face. Under the Act, for example, federally licensed producers would be subject to a single set of disclosure and other consumer protection requirements. Insurance producers also can choose to keep their existing state licenses and sell for all insurers – state and national – wherever they hold a state license. Or they can choose a single national license and sell for all insurers – state and national – in all U.S. jurisdictions. An additional benefit for "national producers" is the single set of requirements covering qualifications to do business, testing, licensing, market conduct and continuing education. Although the states have taken some steps in recent years toward uniform and reciprocal producer licensing requirements, it will be many years before they will enjoy such a streamlined system at the state level – if ever.

- ***Insurance consumers, too, have a choice.*** Consumers will retain complete control to choose the insurers and producers with which they wish to do business. If a consumer deems it important that their insurance company be subject to the rules of a particular state or the federal regulator, they can use that as a factor in their purchase decision.

- ***H.R. 3200 will bring consistent consumer protections for insurance policyholders nationwide.*** At present, insurance consumer protections are uneven from state to state. Under the Act, consumers purchasing products from national insurers would have the same protections and rights without regard to their state of residence. Nor would their rights and protections change simply because they relocate across state lines.

- ***The consumer protections in H.R. 3200 are as strong as those in any state.*** The ultimate consumer protection is the financial oversight conducted over licensees, the Act requires a level of financial oversight consistent with the best employed by the states. The Act goes on to require that every insurer to undergo a market conduct examination at least once every three years, creates a Division of Fraud, a Division of Consumer Affairs leaves intact the state guarantee system to insure that policyholders are protected in case of insurer insolvency, and makes the commission of a "fraudulent insurance act" a federal crime and subjects National Insurers to federal antitrust laws.

In closing, as I have discussed above, the state insurance regulatory system is not best suited to oversee the complex, sophisticated, international marketplace that insurance has developed into over the past half century. There remains a role for the states, but a large segment of the business of insurance – and the consumers that business serves – have moved beyond artificial state boundaries. It is long past time that the regulation of that business move beyond those artificial boundaries, as well.

Thank you, again, for your interest in these issues and for your consideration of the views of Zurich and the Roundtable. We look forward to working with the subcommittee as you move forward with this important initiative.

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TESTIMONY

OF

FRANKLIN W. NUTTER
PRESIDENT
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ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM

BEFORE

FINANCIAL SERVICES SUBCOMMITTEE
ON
CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

October 30, 2007

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance. RAA members are licensed, authorized or accredited in all US jurisdictions. Together, RAA members and their affiliates write nearly two-thirds of the reinsurance coverage provided by U.S. property and casualty reinsurers.

I am pleased to appear before you today to provide the reinsurance industry's perspective on the need for insurance reform. I want to commend Chairman Kanjorski and Ranking Member Pryce for their continued leadership in the area of insurance regulatory reform. I welcome the opportunity to address the committee on why the 50-state system for regulating the reinsurance marketplace is in need of reform, particularly in those regulatory areas that affect the ability of the US reinsurance industry to compete in this very global marketplace and attract much needed capacity to the United States. Requiring large international companies conducting highly sophisticated commercial transactions to submit to a 50-state regulatory system is unnecessary. My testimony will highlight how US and foreign reinsurers doing business in the United states are regulated; why the 50-state insurance regulatory system does not work well for the sophisticated global marketplace; and explain RAA's position in support of an optional federal charter for the reinsurance industry or alternatively, federal legislation that streamlines the current state system.

I. BACKGROUND ON REINSURANCE

a. The US Reinsurance Market

Reinsurance is critical to the insurance marketplace. It reduces the volatility experienced by insurers and improves insurers' financial performance and security. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to provide transfer for insurers of major natural and man-made catastrophe risk; and to increase insurance capacity.

I cannot emphasize enough the important role that reinsurance plays in the insurance marketplace. For example, after virtually every major US catastrophe during the past century, reinsurers have assisted in the recovery of insured losses. For natural disasters, typically one-third of the insured losses are passed on to reinsurers; and in the events of September 11, two-thirds of the losses were absorbed by the reinsurance industry. Fifty percent of the 2005 losses associated with Hurricanes Katrina, Rita and Wilma were ultimately borne by reinsurers.

Reinsurance is a global business. This can be best illustrated by the number of reinsurers assuming risk from US cedents. In 2006, more than 2,300 foreign reinsurers assumed business from US ceding insurers. Although most insurers principally engaged as assuming reinsurers are located in a small number of countries, the 2300 reinsurers identified by US ceding insurers were domiciled in more than 95 foreign jurisdictions[1]. Their share of the US market underwritten directly by foreign-based reinsurers has grown steadily to 53% in 2006 from 38% in 1997.

Some foreign reinsurers also establish US subsidiaries. If the amount of US based ceded revenue to these foreign controlled entities were added to the percentages I quoted above, the total non-US share would be 85%. However, these percentages should not be misconstrued.

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market 2005 Data (2006).

Non-US based reinsurers and their US subsidiaries bring much needed capital and capacity to support the extraordinary risk exposure in the US and to spread that risk throughout the world's capital and capacity providers.

b. US Reinsurance Regulation – Direct and Indirect

The US employs two methods of reinsurance regulation: direct regulation of licensed US reinsurers and indirect regulation of the reinsurance transaction ceded by US insurers to unauthorized reinsurers.

States directly regulate reinsurers that are licensed in the US. Although regulators do not impose regulatory requirements relating to the rates that can be charged for reinsurance or the forms that can be used to evidence the contractual terms, reinsurers licensed in at least one US state are subject to the full spectrum of solvency laws and regulations to which a primary insurer is subject.

To fulfill the larger demands of the US-market, there is a need for substantial reinsurance capacity. As a result, US regulators do not prohibit non-US reinsurers from assuming reinsurance business in the US, nor does the system presume that they have the regulatory capability or resources to assess the financial strength or claims paying ability of non-US reinsurers.

Instead, the US has developed a system of indirect regulation whereby the reinsurance transaction is regulated through the credit for reinsurance mechanism. Credit for reinsurance is the financial statement accounting effect given to a ceding insurer if cessions are ceded in accordance with prescribed criteria. If the criteria are met, the ceding insurer may record a reduction in insurance liabilities for the effect of the reinsurance transactions.

The fundamental concept underlying the US regulatory system is that a reinsurer must either be licensed and subject to the full spectrum of multi-state reinsurance regulation, or provide collateral to ensure the payment of the reinsurer's obligations to US ceding insurers.

Capital providers to the reinsurance market in recent years have clearly opted for the later approach to avoid the multi-state licensing approach. Following the 1992 hurricane season, eight new reinsurers were formed reflecting $4 billion of new capital. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of the new capital came from US capital markets. However, other than the US subsidiaries of some of these new companies, no new US-domiciled reinsurer has been formed since at least 1992. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-US jurisdictions contrasted with the cumbersome and protracted nature of getting licensed in multiple US states.

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

The Reinsurance Association of America seeks to change the current regulatory structure, and advocates a modified optional federal charter for reinsurance to allow a reinsurer to choose between a single federal regulator or remain in the current 50-state system. Alternatively, the RAA seeks federal legislation that streamlines the current state based system. There are a number of key problems and inefficiencies with the current state framework for reinsurance regulation, which has led the RAA Board to pursue a federal role.

a. <u>Credit for Reinsurance</u>

US state laws providing for the circumstances under which ceding insurers may take financial statement credit are the cornerstone of state reinsurance regulation. While there are differences among the states, those laws are based in substantial part[2] on the NAIC model law and regulation governing credit for reinsurance.[3]

The NAIC model law and regulation has been the subject of much debate in recent years. Some non-US reinsurers have advocated the reduction of collateral for those reinsurers that choose not to be subject to direct US licensing and reinsurance regulation. Advocates of this reduced security represent that US collateral requirements impede competition and are unnecessary in a business that is becoming increasingly global. US primary insurers have opposed this effort, contending it weakens US regulation and dilutes the financial security of US insurers and their policyholders.

While non-US reinsurers have the option of being licensed to do business in the US, state regulation has attempted to strike a balance between creating and maintaining an open marketplace, while ensuring the financial security of ceding insurers and their policyholders. As the world's largest insurance marketplace, the US is dependent on non-US and US reinsurance capacity. At the same time, 50 state regulators cannot be expected to know, or to learn, the intricacies of accounting systems and regulatory schemes used throughout the world to determine the financial strength of non-US reinsurers. The ceding US insurer is allowed financial statement credit for cessions to such non-US reinsurers, based on state laws that require collateralization of the reinsurer's obligations. Collateralization eliminates the regulator's need to assess the level of regulation in the non-US reinsurer's domiciliary jurisdiction or the financial

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[2] There are significant deviations among the states, particularly in the area of extra-territorial application of state laws as discussed below.
[3] Credit for Reinsurance Model Law, Vol. –785 (National Association of Insurance Commissioners 1996) and Credit for Reinsurance Model Regulation, V-786 (National Association of Insurance Commissioners 1996).

strength of the particular reinsurer. It also reflects the challenges facing 50 state regulators with resource constraints and competing regulatory demands. Unfortunately, initiatives by some states suggest the risk of a patchwork of state laws relating to financial security may be emerging.

The RAA believes that it is essential to maintain a strong, but uniform, regulatory structure in the US. In that regard, the RAA commends the sponsors of HR 3200 for proposing an optional federal charter for insurers. In large part, this will address the RAA's concerns over uniformity of applicable law.

As the Committee proceeds, we urge it to incorporate a strong credit for reinsurance regulatory system, one that reflects and supports reinsurers need for global capital and risk management.

b. Extra-Territorial Application of Law

The RAA believes there is a need for greater efficiency in the regulation of reinsurance. As a result of our 50-state system of regulation, significant differences have emerged among the states with respect to reinsurance regulatory requirements. The cost associated with addressing these differences among the states, in addition to the basic expense of multi-state systems add extra costs to transactions, and these are ultimately reflected in the premiums paid by consumers. While the NAIC and state regulators are to be applauded for their efforts toward greater uniformity in the adoption of model laws and regulations and the creation of the accreditation system, this has not prevented states from pursuing varying and sometimes inconsistent regulatory approaches. One of the best examples of this is the extra-territorial application of state laws.

Thirteen states apply at least some of their regulatory laws on an extra-territorial basis, meaning that the state law not only applies to the insurers domiciled in that state, but to insurers domiciled in other states if the extra-territorial state has granted a license to the insurer. For example, for an insurer domiciled in a state other than New York, but licensed in New York, it will find that New York asserts that its laws apply to the way it conducts its business nationwide. Since most US based reinsurers are licensed in all 50 states, this extra-territorial application of state law results in inconsistencies among state laws. States applying at least some of their laws extra-territorially include: California, Florida, Kentucky, Maryland, Michigan, New Jersey, New Mexico, New York, Pennsylvania, Texas, Utah, Virginia and West Virginia.

As Congress proceeds to review the current regulatory structure and consider a new one for the future, we encourage the Committee to focus on streamlining reinsurance regulation to be more competitive in the global marketplace. Any structure that is adopted should eliminate duplicative and inconsistent regulation like that which is caused by the extra-territorial application of state laws.

c. Mutual Recognition

US states impose a highly structured and conservative level of regulation upon licensed reinsurers. However, it has long been recognized that the level of reinsurance regulation varies substantially in countries throughout the world.

While some countries impose what has been characterized as "equal or nearly equal treatment" of "professional" reinsurers[4] and direct insurers,[5] other countries employ a "reduced regime" of direct supervision.[6] And still others combine some elements of direct supervision

[4] The term "professional reinsurers" is used here only for clarity. It is not typically used in the U.S.
[5] Denmark, United Kingdom, Finland and Portugal.
[6] Id. Austria, Italy, Spain and Sweden.

with indirect supervision.[7] There are several globally recognized methods of conducting reinsurance regulation.[8]

The RAA is encouraged by the inclusion in HR 3200 of a system of mutual recognition among countries. Mutual recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, European reinsurers would be permitted, for example, to assume reinsurance risk from the US without having to obtain a US license and without having a requirement in law to provide collateral for their liabilities to US ceding insurers. In return, such a system would allow US reinsurers to conduct business in the mutually recognized country based on its US regulatory oversight.

A single national regulator with statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of trust and confidence to their counterparts in the US. The foreign regulatory regime need not be identical to the US regulatory system, but one that has substantially equivalent standards and regulatory enforcement.

III. CONCLUSION

The way in which reinsurers do business in the US is changing; the products and services they offer is evolving, and the range and characteristics of their competitors and their clients is expanding. Reinsurers have been in the forefront of advocating greater regulatory efficiencies to expand capacity in a global marketplace.

[7] See id. Germany, France and the Netherlands.
[8] Id.

Technology, global events, convergence of financial markets combine to offer the opportunity to effect fundamental change to the insurance and reinsurance regulatory regimes that have existed in the past. This opportunity carries with it the burden of ensuring that the critical balance between efficiency and financial security is reached.

The goals of effective reinsurance regulation in the United States should be to promote:

1. Financially secure reinsurance recoverables and capacity that protects the solvency of US ceding insurers.
2. A competitive and healthy reinsurance market that provides sufficient capacity to meet ceding companies' risk management needs.
3. Effective and efficient national reinsurance regulation.

The core characteristics of an appropriate reinsurance regulatory structure that would assist in achieving these goals should include:

1. A single regulator or regulatory system for reinsurance with national regulatory oversight and the power to preempt conflicting or inconsistent state laws and regulations in an effective and efficient manner.
2. The single regulator's authority should provide for the recognition of substantially equivalent regulatory standards and enforcement in other competent regulatory jurisdictions.
3. The regulatory structure should support global capital and risk management, taking into account capital adequacy, assessment of internal controls, recognition of qualified internal capital models and effective corporate governance.
4. The regulatory structure should provide for financial transparency that encourages and supports the cedents' ability to assess counter-party credit risk, including

information regarding the reinsurer's financial condition and the reinsurer's performance in paying covered claims.

5. Regulators should have access to all necessary financial information with appropriate provision for the confidentiality of that information, as provided for currently under state law and regulatory practice.
6. The regulatory structure should have an effective transition mechanism between the current system and any future regime that is consistent with these core characteristics. Absent mutual agreement of the parties, any reduction in existing collateral requirements should only apply prospectively.
7. The regulatory structure should utilize principles-based regulation where appropriate.

Changes to the current reinsurance regulatory structure that meet these goals and core characteristics, include but are not limited to: (1) a single state passport system which allows a reinsurer to be licensed in and regulated by one state but with the ability to then "passport" and assume business in all the other states; or (2) an optional federal charter which allows a reinsurer to remain in the 50-state system or obtain a federal charter and be regulated at the federal level pursuant to federal standards; or (3) a modified optional federal charter which allows a reinsurer to choose between a single federal regulator, a single state regulator or remain in the current 50-state system. The RAA has a strong preference for a modified optional federal charter. Whatever structure is pursued, it will be important to preserve the value of the reinsurers' state licenses and to retain the reinsurers' options to move between various regulatory structures.

The RAA thanks Chairman Kanjorski and the Subcommittee for this opportunity to comment on reinsurance regulation and HR 3200, and looks forward to working with all

Members of the House Financial Services Committee as the Committee considers this most important issue.

Statement of
The National Association of Insurance and
Financial Advisors

In Connection with a Hearing of

The House Financial Services Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

Regarding

Additional Perspectives on the Need for Insurance Regulatory Reform

October 30, 2007

The National Association of Insurance and Financial Advisors (NAIFA) appreciates the opportunity to share with the members of the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises our views regarding the need for insurance regulatory reform. We welcome the Subcommittee's continued interest in this issue, which is so important to insurance agents and advisors, and to the insurance consumers whom we serve.

Founded in 1890 as the National Association of Life Underwriters, the National Association of Insurance and Financial Advisors comprises 770 state and local associations representing the business interests of 225,000 members and their employees nationwide. Members focus their practices on one or more of the following: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members. NAIFA's website can be accessed at www.naifa.org.

Insurance Regulatory Reform is Essential for a Strong and Healthy Insurance Marketplace

NAIFA members are long-time supporters of state regulation and remain steadfastly committed to this tradition. Having said that, we recognize that there are serious deficiencies in the state insurance regulatory system and that reform is critical to protect consumers and ensure a strong and healthy insurance marketplace. We believe, as others do, that fixing the problems with the insurance regulatory system will yield a strong and healthy insurance marketplace, ultimately providing better and greater choices for consumers.

In addition to the existing regulatory challenges, the changing dynamics of the financial services industry in the 21st century compel NAIFA to be open to all promising options to improve the regulation of the industry. Insurance producers have been working with state insurance regulators for years to encourage sensible reforms to make the quilt of state insurance laws and regulations more uniform, thus enabling producers to better compete in an increasingly crowded financial services marketplace. Improvements in regulation benefit consumers, as well, who share the heavy burden of paying for the costs of complying with the current system.

Insurance regulation has failed to adapt to changes in the industry and the markets it serves, resulting in the significant regulatory problems that exist today. Unnecessary distinctions among the states and inconsistencies within the states on issues such as licensing, product approval, and consumer protection, thwart competition, reduce predictability and add unnecessary expenses to the cost of doing business. Similarly, these outdated rules and practices do not serve the goals of regulation in today's converging financial services marketplace.

We recognize the challenges facing state regulators in their efforts to achieve reform. It has proved to be very difficult for state regulators and their legislatures to unilaterally correct the identified deficiencies in state insurance regulation. Both practical and political realities dictate that, if identical bills are proposed in 50 state legislatures, 50 different bills will emerge from those 50 separate legislative processes. There are numerous reasons for this lack of success – lack of will, disagreements over substantive details, structural impediments, and the fact that it is simply very difficult to get 50 different jurisdictions to act in a coordinated fashion, and act quickly in a constantly changing global marketplace.

State insurance regulators have made great efforts in the past several years to reform and modernize the system, working through the NAIC to devise regulatory reforms on the national level and institute them state-by-state. Unfortunately, their efforts have met with limited success. The financial accreditation program is an example of state regulation and cooperation at its best. But the wheels of state regulation move slowly, and, beyond the accreditation program, it has proved nearly impossible to achieve consensus on, and uniform implementation of, model laws and rules. Even the life insurance compact, which is an undisputed success for the states, has only been enacted in 30 states to date, and the likelihood that it will be enacted in all 50 states is very slim.

Producer Licensing Reform Illustrates the Difficulty the States Have Achieving Nationwide Results

Here is another example, in an area that is most important to NAIFA members – producer licensing and regulation: NAIFA has worked for years to get the NAIC and state insurance regulators to fix the cumbersome, duplicative state-based system of producer licensing. The NARAB provisions of the Gramm Leach Bliley Act (GLBA) successfully pushed the states to enact reform. In 2000, the NAIC adopted the Producer Licensing Model Act (PLMA), which provides for a system of reciprocal licensing in the states pursuant to the NARAB requirements. The PLMA has been enacted in some form in over 40 states and the District of Columbia.

NAIFA has supported the NAIC's producer licensing reform efforts at every step of the way and we are, in large part, responsible for enactment of the PLMA in the states. NAIFA is a board member of the National Insurance Producer Registry (NIPR), which operates the electronic database of producer information that has made licensing significantly faster and easier, and is an active participant at the national level, working with an NAIC coalition in the development of specific recommendations for achieving true reciprocity and uniformity in producer licensing nationwide.

Although the passage of NARAB gave the states the needed incentive to streamline the insurance producer licensing system, it did not go far enough. Today, there are approximately 40 states that the NAIC has deemed "reciprocal" for NARAB purposes. Although other states have adopted portions of the PLMA, there remain a significant number of states – including major markets such as California and Florida – that are not reciprocal and therefore not in compliance. In addition, reciprocal states sometimes have similar legal requirements but differing standards for licensure – thus creating a patchwork of approaches across the country. Attached to this statement is a letter sent to the NAIC by NAIFA and two other insurance producer trade organizations, The Council of Insurance Agents & Brokers and The National Association of Professional Insurance Agents (Addendum A). The letter details the shortcomings of the state insurance producer licensing system and recommends actions for addressing those problems.

Although we are heartened that the NAIC has taken the initiative to establish the producer licensing coalition and focus their efforts on achieving full reciprocity and uniformity in producer licensing, we are realistic in our expectations. It is unlikely that the states can or will achieve complete producer licensing reform – or complete reform in any other area of insurance regulation – quickly or easily.

NAIFA Supports All Efforts to Fix the Status Quo – Including Congressional Action

Despite the solid efforts made by the states to improve the current regulatory system, it has become increasingly clear that the state system needs help. NAIFA believes it is imperative that the problems and inefficiencies in the state regulatory system be corrected quickly, and supports the active involvement of the Congress in the reform process. To that end, in 2002, NAIFA adopted an official policy position, amended in 2004, that supports congressional action to improve and augment the regulation of insurance, provided such action meets NAIFA's specific guidelines aimed at maintaining fairness to agents and protection for the consumers they serve. The policy highlights our support for the NAIC's regulatory modernization efforts and identifies certain federal proposals that could, if properly crafted, improve the regulation of our industry. A copy of our current Insurance Regulatory Reform Policy is attached as Addendum B.

While our regulatory reform policy continues our century-long support for state regulation of insurance and confirms our commitment to improve the state-based system, we believe the status quo of insurance regulation is detrimental to consumers and NAIFA members. Thus, our policy acknowledges that all regulatory reform options are on the table and that NAIFA is willing to consider a breadth of alternatives in our desire to fix the problems confronting us. As a result, the policy embraces federal initiatives to improve the regulation of insurance. Simply put, NAIFA favors reform, improvement and progress over the status quo.

Thank you for your consideration of our views. We appreciate your strong interest in insurance regulatory reform, and look forward to working with you as your efforts advance.

# # #

August 28, 2007

Commissioner Roger Sevigny
New Hampshire Insurance Department
21 South Fruit St.
Suite 14
Concord, NH 03301

Dear Commissioner Sevigny:

Thank you for your leadership of the NAIC's efforts to jumpstart producer licensing reform. As we discussed at the Coalition meeting in June, this endeavor is critically important. We all agree that despite the progress that has been made over the past several years, we have not fully realized the intent of the Gramm-Leach-Bliley Act or the promise of the Producer Licensing Model Act. Your fellow regulators have often stated that their ultimate goal is full reciprocity and full uniformity. Unfortunately, we remain a long way from those goals. We hope that with you and other commissioners engaged in the issue, we can make real progress in the near term.

At the June meeting, we discussed many of the challenges producers continue to face, and they range broadly – from pre-licensing education and examination requirements, to interpretation of statutory language, to uniformity standards, to reciprocity and NARAB compliance. Although there may be some differences with respect to the details, the undersigned trade associations – the Council of Insurance Agents & Brokers (The Council), the National Association of Insurance and Financial Advisors (NAIFA), and the National Association of Professional Insurance Agents (PIA) – are in agreement as to what the major problems are and their relative importance.

1. Full Reciprocity:

The most important goal – and the one that the NAIC and the states should attack immediately and forcefully – is achieving full reciprocity for non-resident licensure in every state. The NAIC and the states successfully fended off the creation of NARAB when a majority of the states were certified as having reciprocal licensure requirements for non-residents. Today, the number of NAIC-certified states is somewhere in the mid 40s. The last official list of certified states, from 2005, names 42 states as NARAB-compliant. In addition to those 42, the NAIC website lists several additional states as "actively participating in uniform treatment – licensure reciprocity," although it is not clear whether these additional states have been certified by the NAIC as NARAB-compliant. A list of the NAIC-certified states and the additional states can be found on Attachment A.

Despite the certification of "a majority of the states" by the NAIC, full reciprocity remains elusive. Reciprocity comes up short not only because several states are not certified by the NAIC (and appear to have no interest in it), but because many of the certified states have deficiencies in statute, regulation or practice, that impede true reciprocity. So full reciprocity is really a two-fold challenge: (1) get the recalcitrant states to enact the necessary statutory language to join the reciprocity regime and (2) get the certified states to remove all formal and informal obstacles to reciprocity. Both of these are critically important. Obviously, if we can get the 42+ certified states all on the same page, that would provide substantial relief to producers. But we cannot lose sight of the non-certified states, if for no other reason than they include two of the biggest markets in the country – California and Florida.

Certified States: In the certified states, there are a range of problems, some of which are mere nuisance (Utah requires the word "insurance" in entity names), some of which are speculative (Alaska does not require fingerprints, but the insurance commissioner has the authority to do so), and others material (in a dozen states or more, the insurance department will not grant a license without evidence of registration with the secretary of state). Attachment B provides a list of the certified states and brief descriptions of the additional requirements they impose on non-residents. In researching and compiling the list, we attempted to be as comprehensive as possible, relying on state statutes and regulations and the NIPR business rules. We do not believe the list is necessarily complete, however, because of the history of "desk drawer" rules and similar "unofficial" state regulatory requirements, which can be difficult to nail down accurately.

Based on our findings, there is a strong argument that a number of states designated as certified by the NAIC should not be considered reciprocal, potentially threatening the NAIC's overall determination that the states are in compliance with the GLBA reciprocity requirements. At the very least, all these extra requirements do violence to the spirit of the intended reciprocity regime and make non-resident licensure significantly more burdensome than necessary.

The situation can be improved, however. In fact, we believe that if the states take seriously the basic tenet of the reciprocity regime – that is, non-resident state must rely on the producer's home state – then removing many (if not all) of these additional requirements should be non-controversial and relatively easily (and quickly) accomplished. Nonetheless, it is clear that commissioner-level involvement and peer-to-peer communication is going to be necessary to jumpstart this process and get real results.

As stated above, our research indicated a range of additional nonresident licensure requirements. Some are unique to a particular state, while others can be found in multiple states. We recommend that this be attacked state-by-state and issue-by-issue. Start with Alabama and move through each state's idiosyncratic requirements (such as Utah's name requirement). At the same time, address globally the requirements imposed by multiple states, including: secretary of state registration; lines of authority; qualifications for selling variable lines; qualifications for designated producers of agencies; and documentation of background information.

Secretary of State Registration Requirements: In previous correspondence with you, both PIA addressed a number of issues, focusing particularly on the secretary of state registration requirement for producers that are entities. It is, therefore, not necessary to go into the issue in detail, but we note that the registration requirement:

(1) imposes a significant burden on producers;
(2) is unnecessary from a public policy standpoint because the producer is under the regulatory supervision of the insurance department which, through licensure, controls the producer's ability to conduct business in the state and acts as the producer's representative for service of process; and
(3) violates GLBA, the PLMA and any state law with non-resident licensure provisions based on the PLMA.[1]

These points are clearly valid when a state insurance department makes the granting of a non-resident license contingent upon registration with the secretary of state, effectively making corporate registration a requirement for non-resident licensure. We believe they are no less applicable in other states with secretary of state registration requirements.

In June, we requested an opinion from the NAIC regarding the permissibility of the secretary of state registration requirements under GLBA and the PLMA. We are disappointed that we have not seen anything to date and hope that an opinion or at least some dialogue will be forthcoming. In the meantime, we urge the NAIC to: (1) instruct the states that require registration with the secretary of state prior to granting a non-resident license that such requirement violates GLBA and PLMA reciprocity, and inform those states that they will be de-certified if they do not end that practice; and (2) work with the secretaries of state across the country to exempt insurance producers from their registration requirements. Alternatively, we would urge repeal of all state licensure requirements for producers that are entities. As we have discussed, such requirements are not necessary because the state has on-going authority over the individual producers, whom it licenses and regulates. In addition, from a business/legal standpoint, it is unnecessary because section 13(D) of the PLMA clearly provides that individual producers can share commissions with their agencies, so an agency no longer must be licensed to share in its employee's commissions.

Uncertified States: As we mentioned above, there remain a number of states that have not been certified by the NAIC as reciprocal, including California, Florida and Washington. In order to reach full reciprocity, the NAIC must work with these states to bring them into the fold. This is a difficult but absolutely necessary task.

2. Uniform Interpretation of the PLMA

The PLMA has been enacted in whole or part in well over 40 states. Despite this common statutory language, there is a great deal of inconsistency in interpretation and implementation of the PLMA, inconsistency that goes beyond the non-resident reciprocity issues outlined above.

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1 Under the Gramm-Leach-Bliley Act (GLBA) and the NAIC Producer Licensing Model Act (PLMA), a state is reciprocal if it grants licenses to non-resident producers that submit: (1) a request for licensure; (2) the application for licensure that the producer submitted to its home state; (3) proof that the producer is licensed and in good standing in its home state; and (4) the payment of any requisite fee to the appropriate authority.

Specifically, there are three provisions of the PLMA where consistent interpretation and implementation would (1) help the states move toward full reciprocity and uniformity; and (2) give consistent meaning to provisions of the PLMA, enabling their use in multiple states. The three provisions of the PLMA that are most in need of clear, consistent interpretation – and that would most benefit regulators and producers – are the definition of lines of authority, including limited lines (section 2), the multi-state commercial lines exemption (section 4(B)(6)), and the commission sharing provision (section 13(D)).

Previous attempts to get uniform interpretation of these provisions have not worked. The lines of authority definition is one of the uniformity standards that the Producer Licensing Working Group has been working on for some time now. As our research illustrates, differences among the states with respect to lines of authority are a real impediment to achieving full reciprocity. The commission sharing provision was the subject of a working group survey to determine how the states interpret the provision. In the absence of guidance as to the intent and meaning of the provision, the states were, as expected, all over the board on the issue. The states are similarly all over the board with respect to the multi-state commercial lines exemption, making it "essentially useless" according to some producers.

We recommend that the NAIC adopt official guidance as to the meaning of these PLMA provisions (and perhaps others) and encourage the states to adopt the guidance as their official interpretation of their statutory language.

3. Full Utilization of NIPR

NIPR has experienced tremendous growth in the past ten years in the products it offers, the states it serves, and the number of producers it assists. NIPR provides time- and money-saving services that have eased the licensure burden on both the states and producers. Having said that, some states remain "off the grid" of NIPR services. As members of the NIPR Board of Directors, we know the reasons some states do not fully utilize all that NIPR has to offer, but we believe they should – and the NAIC should use its influence and resources to push for full participation in NIPR's services.

4. Uniformity:

Although there is some disagreement in the industry as to the importance of uniformity, it is clear that the carriers and the larger producers with national presence (and resident producers in multiple states) support the NAIC's stated goal of achieving uniform licensure requirements across the states. It is equally clear that none of the trade groups oppose efforts toward uniformity, although some would prefer that it not distract from the immediate drive for full non-resident reciprocity.

We have a couple of observations with respect to the NAIC uniformity standards. First, in response to your request for prioritization of the uniformity standards, we believe that all the standards are, more or less, equal in importance and all are necessary to achieve real uniformity across the states. While we understand the need to focus on attainable goals, we hesitate to rank the uniformity standards for fear that deeming some of them "less important" will effectively kill them in the states.

Second, the standards themselves are not without some problems. Several of them (examinations, E&O coverage, and CE subject matter requirements) leave the standard "to be determined by each state." That is not uniform. Further, a number of the standards refer to one or more provisions of the PLMA as the standard for the states to follow. Our concern is in the interpretation and implementation of those PLMA provisions. As we discussed above, the states could have identical language on their books, but unless those in authority give the language the same meaning, the hope for uniformity is lost.

In summary, we support the NAIC's pursuit of uniformity through the standards. We are concerned, however, that some of the standards are ill-defined and their adoption will not necessarily move us any closer to uniformity. We encourage the NAIC to take a close look at the standards and revise those that may be susceptible to more than one interpretation.

6. Producer Licensing Handbook

Finally, we note that there is support among the regulators and industry to put together a Producer Licensing Handbook that would contain all of the relevant documentation related to producer licensing, including GLBA, the PLMA, FAQs, the uniformity standards, etc. Going forward, new documents would be added to the handbook as they are adopted, including guidance, interpretations or other documents that arise out of the work of this coalition. We are confident that the NAIC can pursue this project at the same time as – and without diluting the resources devoted to – the other activities of the coalition, particularly the push for full reciprocity and uniformity.

Thank you for your consideration of our views. We look forward to meeting with you on Thursday and to working with you going forward to make these goals reality.

Sincerely,

William R. Anderson
Senior Vice President, Law and Government Relations
The National Association of Insurance and Financial Advisors

Patricia A. Borowski
Senior Vice President
The National Association of Professional Insurance Agents

John P. Fielding

Counsel
The Council of Insurance Agents & Brokers

cc: Honorable Walter Bell, Alabama Insurance Department
Honorable Mike Kreidler, Washington State Office of the Commissioner
Honorable Susan Voss, Iowa Insurance Division
Honorable Jim Poolman, North Dakota Department of Insurance
Honorable Julie McPeak, Kentucky Office of Insurance
Honorable Linda Hall, Alaska Division of Insurance
Honorable Joel Ario, Pennsylvania Insurance Department
Honorable Eric Dinallo, New York Department of Insurance
Andrew Beal, NAIC
Brady Kelly, NAIC
Tim Mullen, NAIC

ATTACHMENT A

NAIC CERTIFICATION

As of March, 2005, the following states (jurisdictions) were certified as reciprocal by the NAIC:

1) Alabama
2) Alaska
3) Arizona
4) Arkansas
5) Colorado
6) Connecticut
7) Delaware
8) Georgia
9) Hawaii
10) Idaho
11) Illinois
12) Iowa
13) Kansas
14) Kentucky
15) Louisiana
16) Maine
17) Maryland
18) Massachusetts
19) Michigan
20) Minnesota
21) Mississippi
22) Montana
23) Nebraska
24) Nevada
25) New Hampshire
26) New Jersey
27) North Carolina
28) North Dakota
29) Ohio
30) Oklahoma
31) Oregon
32) Pennsylvania
33) Rhode Island
34) South Carolina
35) South Dakota
36) Texas
37) Utah
38) Vermont
39) Virginia
40) West Virginia
41) Wisconsin
42) Wyoming

The following additional states (jurisdictions) are currently listed on the NAIC website as

"actively participating in uniform treatment – licensure reciprocity:"

1) District of Columbia
2) Indiana
3) Missouri
4) New Mexico
5) New York
6) Northern Mariana Islands
7) Tennessee

The following states (jurisdictions) remain out of compliance:

1) American Samoa
2) California
3) Florida
4) Guam
5) Puerto Rico
6) Virgin Islands
7) Washington

ATTACHMENT B

COMPLIANCE BY NAIC CERTIFIED STATES

Although the following states have been certified by the NAIC as reciprocal, our research indicates that each of these states impose requirements on non-resident applicants in addition to those set forth in GLBA and the PLMA:

Alabama:

Non-resident required to register with the secretary of state before insurance department will issue license;
Affirmative answer on background check requires filing of additional information;
Variable life/annuities applicant must file additional information.

Alaska:

State law gives the state insurance commissioner the power to require the following from non-residents: fingerprints, power of attorney, fiduciary account requirements. Alaska is likely to be in compliance currently because the current commissioner does not require this information. To the extent she were to require it, however, Alaska would likely fall out of compliance.

Arizona:

Non-resident required to register with the secretary of state before insurance department will issue license;
Trade names must be registered;
Affirmative answer on background check requires filing of additional information;
Variable life/annuities applicant must file additional information.

Colorado:

Variable life/annuities applicant must file additional information.

Connecticut:

Variable life/annuities applicant must file additional information and file for both lines of authority;
P&C applicants must file for both lines of authority;
Applicant must present "evidence of good moral character." If this requires more than the applicant's home state good standing certificate, it could cause the state to fall out of compliance.

Delaware:

Non-resident required to register with the secretary of state before insurance department will issue license.

Georgia:

Affirmative answer on background check requires filing of additional information;
Variable life/annuities applicant must file additional information;
Carrier appointment required before license will be granted.

Hawaii:

Non-resident required to register with the secretary of state before insurance department will issue license;
Affirmative answer on background check requires filing of additional information;
The department will deny licenses to all applicants with "serious RIRS."

Idaho:

Non-resident required to register with the secretary of state before insurance department will issue license;
Affirmative answer on background check requires filing of additional information;
Variable life/annuities applicant must satisfy line of authority requirement;
Commissioner may require fingerprinting at his/her discretion.

Iowa:

Variable life/annuities applicant must satisfy line of authority requirement (must hold life license).

Kansas:

Affirmative answer on background check requires filing of additional information.

Kentucky:

Non-resident required to register with the secretary of state before insurance department will issue license;
Trade names must be registered;
Agency's designated producer must hold a carrier appointment.

Minnesota:

Variable life/annuities applicant must file additional information and satisfy line of authority requirement;
Applicant must hold carrier appointment.

Nebraska:

The Nebraska statute is in compliance, and there are no official and enforceable additional requirements. However, Nebraska places a coversheet on the NAIC uniform non-resident application that says Nebraska requires producers to be "competent, trustworthy, [] financially responsible" and maintain "fiduciary capacity."

Nevada:

Affirmative answer on background check requires filing of additional information signed by applicant;
Surety applicant must satisfy line of authority requirement.

New Hampshire:

Non-resident required to register with the secretary of state before insurance department will issue license;
Affirmative answer on background check requires filing of additional information;
Variable life/annuities applicant must satisfy line of authority requirement;
Designated producer must satisfy line of authority requirement.

New Jersey:

Variable life/annuities applicant must satisfy line of authority requirement;
Applicant must notify commissioner if he/she does business in home state under a different name.

North Dakota:

Non-resident required to register with the secretary of state before insurance department will issue license;
Designated producers must be licensed and hold line of authority entity applies for.

Ohio:

Non-resident required to register with the secretary of state before insurance department will issue license;
Designated producers must be licensed and hold line of authority entity applies for;
Entities must submit articles of incorporation or partnership agreement, as applicable.

Oklahoma:

Non-resident required to register with the secretary of state before insurance department will issue license;
Designated producers must be licensed and hold line of authority entity applies for;
State does not accept applications for variable lines.

Oregon:

Title insurance specifically exempt from reciprocity requirement.

Pennsylvania:

Non-resident required to register with the secretary of state before insurance department will issue license;
Designated producers must be licensed and hold line of authority entity applies for;

Requires "name approval" by the insurance commissioner.

Rhode Island:

Variable life/annuities applicant must satisfy line of authority requirement;
Designated producers must be licensed and hold line of authority entity applies for;
Non-residents charged slightly higher fees than residents.

South Dakota:

Non-resident required to register with the secretary of state before insurance department will issue license;
Designated producers must be licensed and hold line of authority entity applies for;
Non-residents charged slightly higher fees than residents.

Texas:

"Business rules" listed on NIPR website indicates criminal background requirement. Texas website, however, indicates that NR licenses "no longer require" fingerprints.

Utah:

Designated producers must be licensed and hold line of authority entity applies for;
Nonresident licensees required to have the word "insurance" in their company names.

Virginia:

No business entity licensure requirement;
Individual applicant must use home address rather than business address.

West Virginia:

Variable life/annuities applicant must satisfy line of authority requirement;
Designated producers must be licensed prior to entity licensure and must hold license in line of authority entity applies for.

Wyoming:

Requires a portion of the electronic application to be faxed to the department.

Addendum B

NAIFA Policy on Insurance Regulatory Reform

NAIFA supports the principles underlying state regulation of the business of insurance and efforts to improve the state-based system of insurance regulation, including support for the National Association of Insurance Commissioners' Action Plan for Regulatory Modernization. NAIFA also supports congressional initiatives to improve and augment the regulation of the business of insurance, such as the creation of a federal insurance regulator, optional federal charters for insurance companies and agencies, a national producer's license for insurance professionals, and other federal efforts to improve the insurance regulatory system. NAIFA supports reform of the insurance regulatory system that meets the following guidelines:

(1) With respect to producer licensing and continuing education requirements:

- All insurance producers must be licensed.
- All duplicative licensing requirements should be eliminated to ensure that each insurance producer will be required to demonstrate to only one regulator that he/she is qualified to receive a license to engage in insurance representing either a state chartered or federally chartered insurer.
- Uniform substantive and procedural licensing requirements should be established for each class of similarly situated producers.
- The uniform licensing requirements should include the mandated performance of a criminal background check on all applicants for licensure.
- A database to which only financial services regulators have access should be established to help ensure that individuals who have committed fraud or engaged in other behavior which should bar their participation in the business of insurance are identified and tracked.
- Each insurance producer should need to satisfy only a single set of continuing education requirements for each line of business for which he/she is licensed.
- Uniform continuing education requirements should be established for each class of similarly situated producers.

(2) With respect to other consumer protection requirements:

- The tax incentives supporting life and other insurance products must be preserved.
- Uniform trade practices and consumer protection requirements should apply to all insurance sales and service activities.
- Adequate solvency requirements for insurers must be in place such as guarantee funds or comparable fail safe mechanisms.
- Regulators' responsiveness and accessibility to consumers must be preserved.

(3) With respect to rate and form filing and approval requirements:

- Duplicative filing and approval requirements should be eliminated.
- Uniform filing and approval requirements should be established.
- "Quality to market" concerns should not be sacrificed for "speed to market."

(4) With respect to changes in regulatory rules, structures and procedures:

- Current regulatory expertise should be preserved to the maximum extent possible as consistent with efficient regulation.
- Any "reform" should be viable for both accumulation and risk-shifting products.
- Submission to the jurisdiction of any additional newly created regulatory authority should be truly optional for all producers.
- Producers should have an institutionalized role in the development and application of all new regulatory rules, structures and procedures.

— Approved by the NAIFA Board of Trustees 1/16/04

O

Question from Representative Barrett:

I see below from your testimony that you represent small businesses. As a former small business owner and state legislator myself, I can attest to the power of relationships, especially in small towns. Are your members concerned that a federal regulator might be less sensitive to their needs than regulators from their states who better understand the local issues they may face?

My response:

First and foremost, thank you for taking time to contact me on this very important issue. I am grateful that you would solicit additional input from me.

While I certainly think that personal relationships are very important, I do not think it would make a difference for me our others in my industry. While my agency and many of the ones in the National Association of Independent Life Brokerage Agencies (NAILBA) are small, we work in an average of 34 different states. This means that we need to pay fees, complete paperwork and renew dues 34 different times a year. This is very time consuming, expensive and cumbersome. We would much prefer to do it one time and use our time more efficiently.

Finally, we have been in business since 1959 and have never had an occasion where we have had to seek the help of our State Insurance Commissioner. In fact, we have never met any of the people in that position. Therefore, relationships have not been a big concern for us.

Thank you once again for contacting me. I appreciate your interest and I would be happy to be of any assistance in the future.

Alessandro Iuppa
Senior Vice President, Government and Industry Affairs
Zurich
1201 F Street NW, Suite 250
Washington DC 20004

The Honorable J. Gresham Barrett:

Please find below answers to the questions that you submitted in connection with the October 30, 2007, hearing in the Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.

1. Where do you see risks – from an over-regulatory standpoint – from the creation of an optional federal charter? Also, is there any chance that the creation of this national insurance regulatory body could actually decrease competition?

Zurich believes that, properly structured, an optional federal regulatory system for insurers, brokers and agents would complement the existing state regulatory structure. While the potential exists for duplicative regulation between 50+ state and federal regulatory systems, we are confident that the existing optional federal charter [OFC] legislation in the House and Senate will not result in regulatory overlap, but rather will streamline and enhance the existing system of insurance regulation in the United States.

The House OFC bill [H.R. 3200], for example, preserves the states' authority to exclusively levy premium taxes on both state and federally chartered insurers and insurance agencies.[1] This is an appropriate role for the states to play, and we support the approach taken in H.R. 3200 that avoids double taxation of business by not creating a federal premium tax.

Further, while H.R. 3200 would create a National Insurance Guaranty Corporation (NIGC) to protect claimants in an insurance company insolvency. The legislation would require national insurers to participate in existing state guaranty funds, and would require national insurers to join the NIGC only in the absence of a state fund in a state in which the national insurer does business.[2]

Unfortunately, over-regulation, particularly in the form of rate and price controls, exists today in many states under the current state-based regulatory system. An optional federal charter and national insurance regulatory system as envisioned in H.R. 3200 would allow national insurers to set actuarially based rates that accurately reflect the risks that insurers underwrite. Such a system would also allow national insurers to respond to market needs by introducing products that are not constrained by state boundaries or parochial policies and would be able to do so under timeframes dictated by market needs rather than waiting to ensure that each state regulator has approved or modified the product before

[1] H.R. 3200, Title II, Subtitle F, Sections 1251-1253
[2] H.R. 3200, Title VI, Section 1601

going to market. This type of regulation serves neither insurers nor our consumers particularly well, and adds to the costs of doing business.

Additionally, we believe that the establishment of a national insurance supervisory framework will facilitate increased competition. Insurers, like competitors in most industries, seek to offer lower cost and higher quality products to existing and potential customers. However, under the current system, an insurance company seeking to do business throughout the US must still be vetted and licensed by each state in which it wants to sell its products. Once licensed, the new company must generally have each of its products approved by state regulators before one policy can be sold. The economic cost associated with this lengthy process of multiple licensing and product approvals can be a barrier to entry. Under the proposed OFC legislation, a company could choose either the multi-state or federal process based on their business model.

Thank you for the opportunity to respond to your questions.

Respectfully,

Alessandro Iuppa