S. HRG. 110–1009

THE STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE CURRENT STATE OF INSURANCE REGULATION, OVERSIGHT AND WAYS TO ENHANCE CONSUMER PROTECTION, PROMOTE COMPETITION AND EFFICIENCY, AND TO ADDRESS WHAT ROLE, IF ANY, THE FEDERAL GOVERNMENT SHOULD PLAY

TUESDAY, JULY 29, 2008

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THE STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

TUESDAY, JULY 29, 2008

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

The Committee met, pursuant to notice, in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. The Committee will come to order. I thank all of you for being here this morning, and let me share some opening comments if I may, and then turn to Senator Shelby. Then I am going to turn to Senator Tim Johnson for some opening comments as well, and we will get to our panel of witnesses—we have two panels this morning—and a full discussion of this very, very important issue, "The State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure."

Let me start off this morning by mentioning, as my colleagues know, that this Committee has spent a significant amount of time in recent months examining and responding to the crisis in our mortgage and financial markets. The culmination of that effort was the overwhelming bipartisan vote which occurred on Saturday morning to pass the Housing and Economic Recovery Act of 2008. I want to also take this time to thank all of my colleagues, in particular, of course, my friend and colleague from Alabama, Senator Shelby, as well as Senator Jack Reed of Rhode Island, for their significant contributions to achieving what we accomplished on Saturday.

Today, the Committee turns its focus to another very important component of our financial system: the insurance market. While insurance issues have not been as central to the public discourse—or as vexing, I might add—as the challenges we faced in the mortgage and financial markets, the insurance industry is, nonetheless, a very critical underpinning of our economy and, as such, no less deserving of the time and attention of this Committee and its Members.

Most of us only think about insurance when things go wrong. In fact, insurance is something that every one of us depends upon every day to provide us with the economic certainty that we need to function in an uncertain world. By protecting people, property, goods, and services from every imaginable risk, insurance provides stability to every sector of America's $14 trillion economy. In short, a robust, vibrant insurance marketplace is crucial to the economic well-being of our Nation and the financial stability of our people.

This morning's hearing will focus on the current structure of insurance regulation and oversight in the United States and consider the impact of this regulatory structure on the insurance marketplace, industry participants, and policyholders. Unlike other participants in the financial services sector, such as banks and securities firms, the primary regulator of insurance is, of course, as we all know, located in our States. The State-based system has been in place since the 19th century and has been a source of important innovation and consumer protection with regard to insurance. At the same time, the insurance industry, like other segments of the financial services sector, is increasingly becoming national and even international in its scope.

The ability of the insurers to spread U.S. risk broadly around the world has enormous benefits for American consumers, as it increases insurance capacity here at home. The European Union, one of our major trading partners with regard to insurance, is currently updating its approach to regulating insurer solvency in recognition of the fact that the insurance companies are now key players in the global capital marketplace.

Given the importance of insurance to our financial markets and to the economy of our Nation as a whole, this Committee has a responsibility, in my view, to consider the current state of the insurance industry and the regulatory framework within which it operates. Insurance regulation has been the subject of hearings in this Committee during the last two Congresses, and I commend Senator Shelby for his attention to this issue when he was Chairman of this Committee. The Committee also has a responsibility to consider proposals intended to modernize and improve the regulation of insurance, and there is no shortage of legislative proposals in this regard. To date, nearly 20 bills have been introduced in this Congress, each of which to varying degrees seeks to reform or modernize our Nation's system of insurance regulation.

I would be remiss if I did not take this opportunity to acknowledge the hard work of Senator Tim Johnson, who has been a leading voice in favor of insurance regulatory modernization. It is my hope that this hearing will help the Committee consider the merits of the initiatives that have been proposed to date. And while I have yet to draw any firm conclusions on the merits or demerits of any particular piece of legislation, in my view consideration of insurance regulatory reform or a modernization initiative rests on three important principles.

The first is strong consumer protection. Purchasers of insurance must understand what they are buying. Then they must be treated fairly and without deception, and they must know that the company insuring them will be there down the road when they have a claim.

Second, our regulatory structure must promote competition in the marketplace, which will drive innovation and growth.

And, third, regulation must be efficient and not place unnecessary burdens on those being regulated.

With that in mind, I want to thank our witnesses this morning who are here, the two panels. I look forward to hearing from them and what they have to offer, some of their ideas. I know from my colleagues that there are many stakeholders not present at the witness table today, some of which have submitted testimony for the record, and I thank them for doing that. We could have had literally a roomful of witnesses who want to be heard on the subject matter. This will not be the only time we consider their voices, and obviously we are going to leave this record open in the coming days for our colleagues to raise additional questions and for others who want to be heard on the matters that we raise here this morning so we will have as much of a full body of testimony about these issues as possible.

With that, let me turn to Senator Shelby, and then I will turn to my colleague Senator Johnson, and I see Senator Menendez has joined us as well this morning.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

It has been 2 years since this Committee last examined our insurance regulatory structure. During this time, developments in our insurance markets as well as regulatory reforms abroad have strengthened the case that our insurance regulatory structure is out of date. If our insurance markets are to remain competitive and innovative, our insurance regulatory structure must keep pace with changes in the marketplace and in the international regulatory landscape.

The most recent development is the crumbling of our bond insurance market. The bond insurance problems appear to stem from their decision several years ago to begin insuring riskier securities. This leads to the question of whether the regulatory regime governing bond insurers was properly calibrated to account for the changes in their activities.

Because the financial problems of the bond insurers have impacted not only federally regulated institutions but also our overall economy, I believe that closer scrutiny of bond insurance regulation by this Committee is warranted. Over the past year, we have seen several insurance companies post sizable losses of investments in mortgage-backed securities. And while no major insurance company has yet failed due to the turmoil in our credit markets, recent economic history suggests that such an insolvency should never be considered outside of the realm of possibilities or probabilities.

To ensure that we are prepared for the worst-case scenario, we need to make sure that our insolvency statutes are up to the task. Unless we have the right regulatory structure in place well in advance of insolvency, I fear that the Federal Government will once again be called upon to hastily organize yet another financial bailout.

Recent regulatory reforms undertaken by other countries also demand that we examine how our regulatory structure interacts with the regulatory structures of other countries. In particular—and Senator Dodd referenced this—the European Union is moving forward with new regulations that will require that the U.S. and the EU determine how and to what degree they will rely on each other's insurance regulators when overseeing insurance companies operating in both the U.S. and in the European Union. The failure of the U.S. to secure such an agreement with the EU could place American insurers at a competitive disadvantage to European insurers.

It is my hope that today's hearing will shed additional light on these and other regulatory issues facing our insurance markets. I look forward to hearing what the States, as the primary regulators of insurance, already are doing and what additional steps need to be done to ensure that the U.S. has the most competitive and modern insurance regulatory regime.

Also, I would like to encourage Senator Dodd, the Chairman, to hold additional hearings on insurance regulation. These are important issues that deserve more attention from this Committee. And I would also like to thank all of the witnesses in both panels for appearing before the Committee today.

Thank you, Senator.

Chairman DODD. Thank you very much.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Chairman Dodd, Ranking Member Shelby, thank you very much for holding today's hearing.

For most of the 110th Congress, the Senate Banking Committee has been busy addressing the housing crisis. Out of this housing crisis has come the need to examine the overall regulatory structure overseeing financial services. I do not believe that insurance should be locked out of this discussion—as a financial service, as an important player in the capital markets, and as an important piece of the international economy.

In 2006, Senator John Sununu and I began a bipartisan discussion about the need to modernize the insurance regulatory structure with the introduction of our National Insurance Act to create an optional Federal charter structure.

The issue of insurance regulation and oversight is an issue of a fundamentally out-of-date system of State regulation that no longer serves the needs of all consumers, companies, and agents. Any efforts to reform this system should be done in a comprehensive manner. I believe that the best solution is the creation of an optional Federal charter and, therefore, a Federal insurance regulator.

I ask that my full statement be submitted for the record.

Chairman DODD. Without objection, it is so ordered.

We have been joined by Senator Hagel as well. Any opening comments, sir?

Senator HAGEL. No, Mr. Chairman.

Chairman DODD. Senator Menendez, any opening comments?

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Very briefly, Mr. Chairman.

First of all, let me take a moment to congratulate you and Senator Shelby on what is—you know, we have pieces of legislation that are desirable, and then we have pieces of legislation that are critical. And I appreciate both of your leadership in moving the housing bill that we passed last Saturday, which I believe is critical to the Nation, and you both worked in an exceptional fashion, and I appreciate your collective leadership.

Chairman DODD. Thank you.

Senator MENENDEZ. I did not get the early St. Patrick's Day message about the ties, so I am sorry that I did not come in.

[Laughter.]

Chairman DODD. We call each other in the morning.

Senator MENENDEZ. Very briefly, Mr. Chairman, let me thank you for holding today's state of the insurance industry hearing. I particularly want to welcome and thank Commissioner Goldman from my home State of New Jersey for testifying today on behalf of the National Association of Insurance Commissioners. Commissioner Goldman is an exceptional public servant. Governor Corzine appointed him approximately a little over 2 years ago, and he has done an exceptional job in our State. He is a long-time veteran of one of the State's most prestigious law firms, earned a master's of law in taxation from NYU, a J.D. from GW, and a degree in political science from Boston University. We recently had a foreclosure prevention clinic where hundreds of people came, and it was incredibly successful. And I appreciate his leadership in this regard going above and beyond.

Finally, Mr. Chairman, gaining insight to where things currently stand with the industry and where we need to make improvements is critical. The industry is a vital aspect of our economy, protecting homes and businesses from wind, fire, and a myriad of other disasters and accidents. Insurance provides financial security for individuals and families when a problem occurs or a disaster strikes. And while each of us hopes we never have to exercise our policy, it provides a sense of security in knowing that it is there. It is a safety net for so many of our families. And whether it is property insurance for one's home, accidental insurance for one's car, or a life insurance policy, Americans rely on the industry to protect their families and assets, and in many cases from the unexpected.

So I am pleased that we are going to have an opportunity I hope not just to continue to listen to debate that—some of the earliest court decisions have gone back a couple centuries now, but at the same time, learn how we can best ensure that the industry has the solvency, the competition, and also how we can enhance consumer protections. I think that is critical as well.

And so we look forward to all of the witnesses, and, once again, welcome to Commissioner Goldman.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

I would note that we have been joined as well by Senator Martinez of Florida. Senator, thank you for joining us. Any quick comments?

Senator MARTINEZ. Thank you, Mr. Chairman. Thank you very much. I will put a full statement in the record, and the only thing I would highlight is the great importance to our State of this industry, particularly as we now approach yet another hurricane season, and how tremendously important this is and how the people of Florida have been tremendously under siege in the last several years with the incredible premium cost to homeowners, which adds to the cost of—when you add it to the cost of gasoline, the problem with mortgages, and everything else, it is creating a real burden to Florida families. So I look forward to hearing from this excellent panel, and thank you.

Chairman DODD. Thank you very much, Senator.

Let me introduce our panel of witnesses. I again thank them for joining us. You have already been introduced to Steven Goldman, who is the New Jersey Commissioner for Insurance, and as pointed out, he has been involved over 2 years in that job and prior to that was a senior member of the firm of Sills, Cummis, Epstein and Gross, a large law firm in New Jersey.

Alessandro Iuppa, we want to thank you for your green tie this morning as well.

[Laughter.]

You got the message this morning.

Mr. Iuppa has been at Zurich Financial Services since 2007, previously served as Maine's Superintendent of Insurance, where he was an active participant on insurance issues at both the national and international level, served as President of NAIC in 2006 as well.

John Pearson—and, John, we thank you for joining us—is the President and Chief Executive Officer of the Baltimore Life Company. Prior to joining Baltimore Life in 1995, Mr. Pearson was President of Utica National Life Insurance Company. He also currently serves on the boards of the American Council of Life Insurers and LL Global, and we thank you for joining us this morning.

Travis Plunkett is no stranger to the Committee. We see him quite frequently here. We thank him for coming again. He directs the Federal legislative and regulatory efforts of the Consumer Federation of America. He previously served as the New York State legislative representative for AARP and the associate legislative director of the New York Public Interest Research Group. We thank you for coming.

I want to ask all of you to keep, if you can, your comments, with two panels and a lot of member interest, if you can keep it to 5 to 7 minutes or so, and then I will take your full statements and make them part of the record, as they will be for all of my colleagues here as well. And then we will also accept any documentation and support you think is essential for us to have.

Mr. Goldman, we will begin with you.

STATEMENT OF STEVEN M. GOLDMAN, COMMISSIONER, NEW JERSEY DEPARTMENT OF BANKING AND INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. GOLDMAN. Good morning, Chairman Dodd. Thank you. Ranking Member Shelby, Members of the Committee, thank you for inviting me to testify today. Senator Menendez, thank you for that very kind introduction. I appreciate it.

My name is Steven Goldman. I am the Banking and Insurance Commissioner for the State of New Jersey, and I am here today to testify on behalf of the National Association of Insurance Commissioners. I am pleased to be here to update the Committee on the current State-based structure of insurance supervision and on our ongoing, successful efforts to improve and strengthen that structure.

State insurance officials are stewards of a vibrant, competitive insurance marketplace. The insurance industry in the United States has grown exponentially in recent decades under State supervision.

Today, over 7,000 companies of various sizes compete to sell a vast array of products across State and national boundaries. The U.S. insurance market generates $1.4 trillion in annual premium volume, and insurance income represents roughly 12 percent of the country's GDP. The industry has handled record claims volumes while earning record profits, and insurer surplus stands at over $500 billion.

When State insurance markets are compared to other national insurance markets around the globe, the size and scope of those States' markets—and, therefore, the responsibility of State regulators—typically dwarfs the markets of entire nations. Four of the top 10 and 26 of the top 50 insurance markets in the world are individual United States States. Mr. Chairman, the market in your home State of Connecticut is larger than the insurance markets in Brazil or Russia. Such a significant market demands a local, accountable, and responsive regulator.

State insurance supervision has a long history of aggressive consumer protection and is well suited to the local nature of risk and the unique services offered by the insurance industry. Risks can change from zip code to zip code, and consumers sometimes just a few miles apart have different insurance needs. As State regulators, we live and work in the communities we serve and can respond accordingly. This kind of consumer-oriented local response is the hallmark of State insurance supervision, an asset that would be lost in any attempt to Federalize insurance oversight.

While State insurance commissioners are strong advocates for consumers, we also strive to provide a stable, efficient regulatory environment for insurers, reinsurers, producers, and other industry participants. Insurance regulation must constantly be reformed and improved, and while those efforts should always start at the State level, we would ask that Congress work collaboratively with us and our colleagues in the State legislatures to appropriately target efforts to strengthen the existing State system where areas necessitating Federal assistance are identified.

Indeed, we have worked to provide input on Federal legislation affecting producer licensing as well as on surplus lines and reinsurance legislation pending before this Committee.

While most in the regulatory community believe such targeted proposals have merit, we all agree on one proposal that remains misguided policy. For over a decade, insurance industry lobbyists have called for the creation of a new Federal bureaucracy via an optional Federal charter that would create a dual system of oversight similar to the banking system. We do not want to repeat for the insurance sector the current climate of instability and insolvency that now plagues the banking sector.

The OFC concept is a thinly veiled attempt to unravel the consumer protections, solvency structure, and oversight that have led to the largest and most successful insurance market in the world. Reforms should start at the State level, and they have.

The NAIC has undertaken a number of initiatives with State insurance regulators in recent years. Insurance regulators have worked successfully to bring more cost-effective and sound insurance products to the market more quickly. Central to this effort is the Interstate Insurance Compact for speed-to-market filing and regulatory review of life, annuities, long-term care, and disability insurance products. This State-based effort creates a single point of filing under one uniform set of standards and is up and running, unlike an OFC, in 32 States and Puerto Rico. Several other States, including my own, are actively engaged in joining the compact.

Due to improvements made by State regulators, there has been a 65-percent reduction in insurer insolvencies since the late 1980s. Ultimately, these improvements have allowed regulators to more easily identify when insurers are potentially troubled and react more quickly to protect policyholders and consumers, thereby avoiding the instability and uncertainty presently plaguing other areas of the financial sector.

We have launched an online fraud reporting mechanism to allow consumers, employees, and others who suspect wrongdoing to report their suspicions anonymously to State enforcement authorities. The NAIC has developed a single point of electronic filing for insurance products, allowing insurers considerably shorter turnaround time than was possible under the traditional paper filing process. By developing and utilizing electronic applications and data bases, State insurance officials have created much greater efficiencies in licensing and appointing insurance producers in those States that require it. State insurance officials remain deeply committed to achieving greater uniformity in the producer licensing process.

The NAIC has also developed an electronic system for company licensing designed to help insurers navigate State-specific requirements and provide a single entry opportunity when filing in all jurisdictions.

State regulators understand that protecting insurance consumers is our first responsibility. We also understand that commercial insurance markets are constantly changing and that modernization of State insurance supervision is imperative.

The NAIC and its members will continue to share our expertise with Congress on insurance issues having a national and global impact, and we welcome congressional interest to help us improve the existing system of effective oversight. We look forward to working with you in this regard, and I look forward to answering your questions.

Chairman DODD. Thank you very much, Mr. Goldman.

Mr. Iuppa.

STATEMENT OF ALESSANDRO IUPPA, SENIOR VICE PRESIDENT, GOVERNMENT AND INDUSTRY AFFAIRS, ZURICH NORTH AMERICA, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

Mr. IUPPA. Chairman Dodd, Ranking Member Shelby, Members of the Committee, good morning. As you have heard, my name is

Alessandro Iuppa, and I am Senior Vice President, Government and Industry Affairs for Zurich North America. And I appreciate the opportunity to speak with you today on behalf of Zurich and the American Insurance Association on the subject of insurance regulatory reform.

Prior to joining Zurich last year, I was an active member of the regulatory community for over 20 years, serving as Commissioner in both Nevada and Maine. In the court of my 9-plus years as the Maine superintendent, I also served as an officer and president of the National Association of Insurance Commissioners and in a comparable position as Chair of the International Association of Insurance Supervisors Executive Committee.

Zurich and the AIA are not opposed to the regulation of insurance. I assure you, 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 both nationally and globally. Although the existing structure works for some, it impedes our ability to achieve these goals.

Financial markets in general have undergone extraordinary growth and structural change in recent decades. Much of this change can be attributed to the integration of capital markets, advances in information technology, as well as shifting attitudes toward competition and protection in the financial services arena.

Unfortunately, the current U.S. regulatory structure is not fully equipped to supervise the sophisticated marketplace of the 21st century. The requirement to operate within the State patchwork of regulation often hinders insurers with clients who operate nationally and internationally.

It is increasingly apparent across the political spectrum that the current regulatory system must be modernized and adapted. Insurance regulation, specifically Federal chartering, is featured prominently in both the Bloomberg-Schumer report and the Treasury Blueprint. Both report recommend the creation of an OFC. Likewise, the National Insurance Act of 2007, S. 40, introduced by Senators Johnson and Sununu, recognizes the OFC as the best approach.

Zurich and the AIA strongly agree that an OFC would play an important role in the new world of integrated financial markets. State insurance regulators have attempted to institute regulatory reforms, but the reality is that the regulatory efficiency in the insurance industry lags behind the other financial services sectors.

As an insurance regulator, I spent a great deal of time working on behalf of the U.S. regulatory community with our international colleagues, and despite our best efforts, our effectiveness was limited. For example, the IAIS has become the standard-setting body for the promulgation of international insurance standards. U.S. regulators have and will continue to be active in the IAIS. But no matter the extent of agreement that may exist among the regulators, the State representatives cannot bind individual States to adopt those standards.

Likewise, the introduction of risk-based solvency requirements in the EU through “Solvency II” will pose enormous challenges to State-regulated insurers. U.S. insurers will not be easily integrated into Solvency II because the U.S. does not provide supervision equivalent to that of the EU.

As was recently stated by Standard and Poor's, and I quote, "in the absence of supervisory equivalence, non-EU insurers may find themselves operating at a competitive disadvantage in Europe."

Two areas that can especially benefit from Federal oversight are market deficiencies and product innovation. The lack of a sustainable market for terrorism coverage and property coverage shortfalls in some regions illustrates a deficiency in the U.S. marketplace. Regulation, however, can play an important role in maintaining the proper equilibrium among suppliers and purchasers through the encouragement of market efficiencies. But by sustaining each State as individual market, we inhibit the ability of insurers to spread risk and enhance capacity.

A number of States still require pre-market regulatory approval or rates and policy forms. Through my experience, I have learned that for those products that did require prior approval, the regulatory search for noncompliance at the beginning substantially slowed the pace of product introduction.

Despite recent improvements, the States are not likely to solve the problems of non-uniformity and inconsistency on their own, so we believe congressional action is necessary. Building consensus among regulators is a very difficult thing to do and, at times, almost impossible. An optional Federal charter will modernize the regulatory environment and enhance consumer choices. The availability of a national charter will not dismantle the longstanding State insurance regulatory framework or the ability of State-chartered insurers or agents to serve local market needs; rather, it will complement the State system with the addition of a Federal partner, one that concentrates on strong solvency oversight, protecting consumers, and speaking with a single unified voice at home and abroad. This will produce a dynamic and healthy national insurance marketplace able to keep pace with the demands of the global economy.

I thank you for the opportunity and look forward to your questions.

Chairman DODD. Thank you, Mr. Iuppa. I appreciate it very much.

Mr. Pearson. And turn that microphone on.

STATEMENT OF JOHN L. PEARSON, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, THE BALTIMORE LIFE INSURANCE COMPANY, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURERS

Mr. PEARSON. Thank you. Thank you, Chairman Dodd and Ranking Member Shelby and Members of the Committee. On behalf of the American Council of Life Insurers, I would like to thank you and the Committee for the opportunity to appear before you today.

In the 2 years since this Committee last held a hearing on insurance regulation, the case for regulatory reform has become even stronger. Despite continued efforts by the States and the insurance industry, transforming State-based regulation into a more uniform and coherent national system has seen only marginal results, with the Interstate Compact for life insurance product filing and approval that has yet to be adopted by a number of States and little other significant progress.

Importantly, domestic operational concerns have been joined by pressing international regulatory and competitive issues which the NAIC has acknowledged fall largely outside the State's authority to address.

The ACLI strongly supports the creation of an optional Federal charter, or OFC, for life insurers. That is why we strongly support Senate bill 40, the National Insurance Act, which was introduced by Senators Johnson and Sununu and which would establish the Office of National Insurance within the Treasury Department to issue charters and oversee and regulate Federal insurers. I want to specifically thank Senator Johnson and Senator Sununu for their strong leadership on this issue and their continuing recognition of the need to modernize insurance regulation.

As the CEO of a small life insurance company, I can testify to the many and varied reasons that the time has come for Congress to enact an OFC bill. Lack of uniformity of State insurance laws, conflict State compliance requirements, the plethora of duplicative and unnecessary regulatory costs, the inability to get new and innovative products to market in a timely fashion, the unlevel regulatory playing field insurers face when competing with other financial services entities, the need for greater Federal Government expertise on insurance issues and the growing pressure of the globalization of the life insurance market all point to an overwhelming need to change the way insurance is regulated.

All these are addressed in greater detail in my written testimony, but I would like to focus my comments today on the most important reason why change is necessary, the effects regulatory modernization will have on U.S. insurance consumers.

The life insurance industry is advocating for an OFC built around strong solvency and strong market conduct oversight patterned after the best State statutes or model laws in existence today. This would necessarily include robust uniform regulation in the areas of capital, reserves, accounting, investments, and other financial areas. And consumers would enjoy a high level of protection under the system regardless of where they live or where their insurance is domiciled or a product is purchased. Anything less is not in the best interest of life insurance companies or their customers.

Providing customers access to the same products and benefits wherever they live would afford them uniform rules regarding sales and marketing practices of companies and agents nationwide. It would ensure strict, frequent, and consistent market conduct and financial examination of national insurers.

It would also give consumers the opportunity to work with a trusted company or agent if the customer moves from one State to another, where today the company or agent may not be licensed in every State.

Moreover, an OFC holds the promise of a significant cost savings. Two recent academic studies have quantified those savings. As noted in the studies, the life insurance market in the U.S. is mature, and price competition is intense. It is entirely reasonable to expect that a meaningful portion of those savings would be realized by customers in the form of lower premiums.

Now, those opposed to OFC would assert that it would be fundamentally inconsistent with the best interest of consumers. But when the facts I have just presented are carefully considered against the opponents' arguments, it becomes evident that nothing could be further from the truth.

Opponents would suggest that an OFC would lead to regulatory arbitrage. We are highly confident, however, that Congress will ensure that any Federal regulatory system is at least on a par with the strongest State systems. The industry is seeking strong, uniform regulation, not weak regulation or deregulation.

Moreover, the potential for regulatory arbitrage already exists today in the current State-based system since insurers can readily change the state of domicile and choose to move to a different State as their primary financial regulator. This is not a problem today. We find it highly doubtful that the introduction of a strong Federal regulator into the mix will change things for the worse.

Opponents also argue that consumers will be hurt by the loss of a local regulator who understands their concerns better than people in Washington. This argument, too, has no merit. First, the bill introduced by Senators Johnson and Sununu requires that at least six regional offices of the Federal regulator be established in addition to its D.C. headquarters. So consumers will not be required to turn solely to Washington for help or information.

Second, consumer issues surrounding life insurance products are simply not local in nature. If anything, the long-term promises to consumers made by life insurers, combined with the mobile character of our society today, requires persons concerned about consumer issues to recognize the truly national nature of insurance products.

In fact, national uniform regulation of life insurance products is much more valuable to consumers than local regulation. This is a point made in the findings of the GAO report issued just last week on long-term care insurance, which cited variations in State laws as the reason some consumers enjoy greater policy protections than other consumers. And, frankly, the lack of an appropriate nationwide uniform consumer protection is an industry concern.

For example, since it was adopted in 1998, the industry has supported the NAIC Annuity Disclosure Model regulation, which requires that companies deliver a buyer's guide and other important disclosure documents to annuity purchasers. Ten years later, only 16 States have seen fit to adopt that model rule, and 25 States still have no law or regulation addressing the issue of annuity disclosure. Contrast this to the fact that under an OFC any annuity disclosure law put into place would immediately affect all national insurance annuity purchasers nationwide. This, as well as other examples of variation in State laws, makes a solid argument that national and uniform regulation holds more value for consumers than local regulation does.

In conclusion, we believe the facts support the belief that insurance regulatory modernization that includes the creation of an OFC will benefit U.S. consumers.

Thank you, Mr. Chairman, for holding this important hearing and allowing me to testify before you and the Committee today. We look forward to working with you and other Committee Members as the issue moves forward, and I will be happy to answer questions.

Chairman DODD. Thank you very much, Mr. Pearson.

Mr. Plunkett, welcome.

STATEMENT OF TRAVIS B. PLUNKETT, LEGISLATIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. PLUNKETT. Mr. Chairman, Senator Shelby, Members of the Committee, my name is Travis Plunkett. I am the Legislative Director of the Consumer Federation of America. I would like to thank you for holding a very timely hearing. Consumers are presently facing a number of serious problems in the insurance market regarding availability, affordability, unfair claims practices, and the hollowing out of insurance coverage.

I appreciate the fact that the focus of the hearing is an overall examination of the successes and failures of regulation rather than just reviewing proposed legislation. Most of the regulatory proposals that have been introduced in Congress to date have been driven by the priorities of the insurance industry rather than a need to help insurance consumers.

The optional Federal charter legislation and others that the insurance industry has conceived promote the myth that regulation, strong regulation, and competition are incompatible. The truth is that the unique and complex nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. Without regulation, insurers can “compete through adverse selection,” which hurts our Nation’s most vulnerable consumers—the oldest, the poorest, and the sickest. Regulation is also necessary to promote price competition and loss mitigation efforts and to deter unfair sales and claims settlement practices.

Consumer groups do not care who regulates insurance. We only care that the regulatory system be excellent. We are critical of the current State-based system, but we are not willing to accept a regulatory regime that undermines consumer protections by pitting Federal and State regulators against each other in a contest to lower standards or a Federal system that establishes one uniform but very weak set of standards. We do agree that coordination and more consistent standards for licensing and examinations are desirable and necessary, as long as the standards are high. However, the burden of proof is now on those who want to shift away from more than 150 years of State insurance regulation to show that they are not asking Congress and the American people to accept a dangerous “pig in a poke.”

There are a number of problems, as I mentioned. Let me give you a little more information about the problems that consumers are dealing with in the insurance market. Six problems.

First, many concerns have been raised in recent years about abusive claims practices by insurers in the wake of natural disasters, especially Hurricane Katrina. Insurers have reduced their payouts and maximized profits by turning their claims operations into profit centers by using computer programs like Colossus designed to systematically underpay policyholders without adequately examining the validity of each individual claim. And in my written testimony, I urge the Committee to examine this problem at length.

The second concern: The study released by CFA earlier this year found that property/casualty insurers in recent years have overcharged consumers and reduced the value of home and automobile insurance policies, leading to profits reserves and surplus that are at or near record levels. The pure loss ratio, the actual amount of each premium dollar insurers pay back to policyholders in benefits, was only 55 cents at the beginning of this year, down from 70 cents 20 years ago. Meanwhile, insurers earned an unprecedented $253 billion in profits over the last 4 years, despite increased hurricane activity.

The third concern: Insurers have hollowed out property coverage by adding insurance deductibles and by making it much more expensive for consumers to get reimbursed for true replacement costs, and they are now cherrypicking the locations in which they will underwrite. They have also become adept at cost shifting some catastrophic claims to Federal programs, like the National Flood Insurance Program.

Fourth, insurers have used new risk classification data such as credit scoring and information about an insured party's occupation and education as a form of redlining. These factors are clearly proxies for economic status, and sometimes race.

Fifth, anticompetitive behavior in the industry allowed by the Federal McCarran-Ferguson antitrust exemption.

Sixth, I have already touched on some of the behavior along the Nation's coastlines regarding rate increases and pullouts.

I urge the Committee to examine proposals that will confront these problems head on rather than starting with the industry-conceived proposals. The experience in the States that have regulated well is that it is possible to improve competition and oversight of the insurance market while increasing regulatory uniformity and protecting consumers. Appropriate regulation enhances competition. It requires insurers to compete fairly and in a manner that benefits consumers, and it results in a generous return for these companies.

CFA released an exhaustive study of automobile insurance regulation over the last two decades this year. We found that the 15 States that require insurers to receive advance approval of rate increases had the lowest rate increases of all the States as a group. They also—and this is a key point. These States performed well in spurring competition and generating significant profits for insurers. California was the top-ranking State in the country in this study.

In closing, I propose a number of other detailed recommendations for achieving the twin goals of improving competition and also improving regulation, and I urge this Committee to look at those recommendations.

Thank you once again.

Chairman DODD. Thank you, Mr. Plunkett, very, very much. We appreciate your testimony.

Let me, if I could, I am going to turn the clock on to about 6 minutes—additional Members have shown up, and I appreciate their presence—so we can give everyone a good chance to raise questions, and we have a lot of panelists. And I will leave the record open, by the way, for Members who want to submit questions as well, if you do not get a chance to raise every one you would like. And I will certainly ask our panelists, in the next week or so if you could get back to us so we can complete the record, so we don't necessarily cover all the ground here.

Let me ask, if I can, all of you, let me—it is kind of a two-part question, and so I will just get the whole question out, then ask you to comment if you would. It has been referenced already—I think maybe Mr. Goldman, or someone talked about drawing the comparisons to the dual banking-like system, in a sense, what this would mean. Several of you alluded to this approach to insurance regulation that models our systems in banking regulation. I would like to sort of bore into that a little bit, if I can.

I wonder if each one of you would share your view on the impact that a dual banking-like approach on insurance regulation would have, positively or adversely, in each of the three areas that I identified in my opening statement, with the areas the three pillars that I see, anyway, we should be examining as we approach this whole idea of modernization or regulatory reform: consumer protection, competition, and regulatory efficiency.

And, second, should different lines of insurance be treated differently? And, again, this is something I think all of us have some appreciation for as evidenced by the fact we have eight witnesses on this panel today. That was not by accident. It was not because we had eight people who wanted to be here. It is because we tried to cover the waterfront on the issues of insurance, which cover a broad array of stakeholders. Insurance is not monolithic. Obviously, to state the obvious to the people gathered in our room today, insurance products cover life, property, liability, health; they cover businesses, public entities, individuals.

It leads me to ask the following question: What would be the most effective approach to this Committee's consideration of insurance regulatory reform proposals? Should we consider changes to the regulatory structure more broadly? And some of you have certainly implied that in your testimony here, as envisioned by the Treasury Blueprint? Or should we focus any efforts on ways to improve the regulation of particular lines of insurance, recognizing there are significant differences in the insurance that is being offered in terms of how—what expectations are of people, life insurance versus property and casualty, for instance? There is an expectation, I think, of how people expect it, and there is an expectation of how we treat these from a national perspective as well.

So would you kind of—we will begin with you, Mr. Goldman, just run down, and, again, I ask you to be relatively brief so everybody can get a chance. It is a large question, but it is one that is important to me.

Mr. GOLDMAN. Thank you, Mr. Chairman. Let me respond first to the question about the banking model and emulating the banking model. I am the Banking and Insurance Commissioner in New Jersey, so I have had experience directly dealing with the existing bifurcated regulatory system in the banking sector. And the experience has been that when the Federal Government decides to exercise its preemptive power, as it has aggressively in the last number of years, the ability of the States to protect their consumers, their local consumers, is dramatically reduced. And the consequence of that I think is partly manifested in some of the problems we have seen in the banking sector over this last year and a half.

I know, for example, in New Jersey, just to give a brief example, we have a statute called HOSA. It is the Home Owners Security Act, and it was designed to prevent some of the more aggressive efforts on mortgage origination and sales. And we attempted to enforce that Act not only with respect to New Jersey-chartered banks but also with respect to the operating subsidiaries of federally chartered banks. And as a result of an OCC preemption effort, we were precluded. And, frankly, a number of the problems that are present now in New Jersey as a consequence and that I think have manifested themselves around the country have resulted from our inability to act on behalf of our consumers to prevent some of these problems. And, frankly, I fear a similar sort of potential problem were we to then bifurcate the regulations of insurance.

I think one of the things the Committee importantly should recognize is that the fabric of insurance regulation, while there are many lines, as you mentioned—and there are—is very much a holistic process. For example, trying to pull out reinsurance, which provides an enormous capacity in the marketplace for direct insurers, and regulate that independently of the rest of the market would have a dramatic impact on the regulatory framework throughout the country.

And so even though the lines are separate, it is important to recognize the holistic nature of the regulatory structure and the way the industry itself and its various components interrelate. Some lines are more distinct than others, yes—life and health, for example, versus property and casualty. But, nevertheless, they are all related in important ways. There are important reinsurance considerations that apply to the life industry. So I think that is an important consideration as we begin to think about these issues to recognize.

With respect to the question of looking at this in a broad reform effort or a narrow reform effort, I think this is a real opportunity for creative federalism. The States, I believe—and as I mentioned to someone earlier today, this is not a world that I come from. I was a mergers and acquisitions lawyer before I took this job. So I did not come to this——

Chairman DODD. It sounds like perfect training.

[Laughter.]

Mr. GOLDMAN. Yes, it was. But I did not come to this job with any preconceived notions about the industry or its constituents. And I have come to believe, after being in this job for about 2.5 years, that the State-based system works quite well. It does not work perfectly. There are problems with it. But those problems can be addressed and should be addressed in the context of what I believe is a very effective operating system today. Some of the statistics I mentioned in my testimony I think evidence that. You have a very vibrant industry here in the United States. It is growing. It is profitable. It is growing as a percentage of the GDP in the country. And each of the States and the U.S. market in the aggregate is far and away the largest insurance market in the world and I think the best regulated insurance market in the world.

And so I think if you look at the problems that have presented themselves in the other financial services areas—in the commercial banks, in the investment banks, in the rating agencies—and you see the failures that have taken place there, you do not see that degree of failure in the insurance industry, and that is not by accident. I think it is because they are a well-regulated group, by and large—not without exception, but by and large.

Chairman DODD. Well, I have already exhausted the time I said I have, and I have to ask three other people. Just quick comments, Mr. Iuppa and Mr. Pearson.

Mr. IUPPA. Yes. With regard to the three pillars, I think with regard to consumer protection—and I spent 20 years as a regulator. The ultimate consumer protection is the solvency and soundness of the companies doing business in my State, that they will be there when a claim comes in and so forth. Below that, you have sort of the market practices, which are also addressed. And I think that certainly with the National Insurance Act proposal, there is a sufficient framework that is in the bill at this point for consumer protection through regional offices, Office of Consumer Protection, and I have every confidence that Congress is not going to put something out there that is not going to provide that type of protection.

With regard to regulatory efficiency, I will use one example. Zurich is the third largest commercial writer of property/casualty insurance in the world and the U.S. We have put together a commercial auto policy that was probably somewhere in the neighborhood of about 30 pages long as a policy that we could deliver to our policyholders.

After going through all the approval processes in the various States, the aggregate number of pages was in excess of 300 in order for us to be able to sell that across the country.

Competition, I think, is very much a possibility under the dual approach. We are not advocating that the State system be eliminated. What we are talking about is providing another choice for some of the 7,000 companies that do business in the U.S. If there is an OFC enacted and when that happens, I do not think you are going to see 90 percent or 95 percent of those companies seek to become licensed at the Federal level. I think you are likely to see probably 5 percent, and that may even be an aggressive number. But either way, the sooner you can get products into the marketplace, the more innovative you can be. You provide choices for consumers, and consumers include not just individuals but the small businesses that do business here in our country, as well as national and multinational companies. So I think we have to keep that balance in mind.

With regard to the different lines of insurance, I think that we are, frankly, best to look at this from a comprehensive perspective. Some of the inefficiencies that we see in the current system are not necessarily limited to the life business or the property/casualty business, so I would encourage you to continue looking at this from a comprehensive perspective. And I will stop there.

Chairman DODD. Mr. Pearson, quickly.

Mr. PEARSON. I will. First of all, I have spoken broadly in my opening comments about consumer protection. Let me talk briefly about efficiency, if I may.

I think we are actually a very good example of a company—we are a small life insurance company, yet we have 50 jurisdictions. Our total assets are just a shade over $1 billion. We have 140 employees in our home office. And yet we have—because of the distribution network that we have, we are forced to deal with 50 different jurisdictions. And, frankly, it is very different than the banking model, obviously, where the banks tend to be a very local fashion.

I guess the other thing I would talk about is different lines of insurance. We are supportive of the surplus lines bill that I believe has come to the Committee. But, again, just as Mr. Iuppa has said, we also believe that a full comprehensive rather than an incremental approach is a better long-term solution.

Chairman DODD. Travis.

Mr. PLUNKETT. Mr. Chairman, real quickly, regarding whether the dual banking system is a good model for insurance regulation, we obviously think it is, especially given recent experience, a very bad model. I have worked now at both the State level in New York and at the Federal level, and I have seen problems from both ends. In New York, I can tell you every single time New York regulators considered placing a new burden on State-chartered banks, they hesitated and were very concerned about State-chartered institutions jumping to a national charter. And, eventually, a very big one, Chase, did. So that slowed consumer protection significantly at the State level.

From the Federal perspective, we have seen a situation where the Office of the Comptroller of the Currency, the primary regulator of national banks, has extended preemption very broadly and very aggressively in a move to keep large financial institutions that fund that agency in their realm, and that is a very bad approach as well because it has reduced consumer protection overall and hurt consumers and weakened State protection.

Chairman DODD. Thank you all very much. I apologize for taking that long, but thanks.

Richard.

Senator SHELBY. Thank you, Mr. Chairman.

I do not see anything fundamentally wrong with establishing an optional Federal charter because I can see the efficiencies of a large company, be it American or European, doing business in 50 States, including my own State, or the inefficiencies of that and the cost. And why couldn't we create an optional Federal charter and have a strong regulator, at the same time legislate protections for the consumer? Because we are all consumers here. Mr. Plunkett raises a good question. He is an advocate for the consumer. That is part of his deal, and he does a good job there. But now he is working with the Federal—of course, there is no Federal charter for insurance now, so he has to work 50 States.

Mr. Iuppa, you had the experience, as Senator Dodd pointed out, as Superintendent of Insurance in the State of Maine. Now you are involved as an executive, a senior vice president of a large international company, Zurich. What would a Federal charter offer, assuming it is done right, a company like yours that is doing business all over the world?

Mr. IUPPA. Well, I think one of the principal things it would offer to us—again, in sort of looking at it from our client base, as a commercial insurer we are doing business, as I said, with small businesses but also multinational businesses. Our clients come to us and tell us, Look, we do business in Asia, we do business in South Africa, we do business in Europe, we are doing business in the U.S. We need to be able to know that we have got the proper coverages and the ability to have a product there. And we can tell them that, yes, we can give you a policy that will cover you for your business in South Africa; we can give you a policy that will cover your business in China. But for your operations in the U.S., we are going to have to deviate from that, and we are going to have to add coverages, perhaps provide you coverages that you would normally not buy, and so forth. So we have—an ability to offer products that match our clients' needs is often constrained.

Senator SHELBY. What if we had—and let's hope it will not happen, but it probably will—what if we had a large American or European or Asian company fail? Let's just say an American company that became totally insolvent, and they were chartered by a State here. Do you believe X State could deal with something of that magnitude? I am talking about a huge insurance company. And what happens to the consumers in that case now as opposed to possibly a——

Mr. IUPPA. You know, I think one of the things you are perhaps referring to here is sort of perhaps a systemic risk that may be generated from a major insurer failing. And the reality—I mean, there is a system in place to provide a basis for policyholder protection that exists today. But, again, it is State-based.

So, for instance, if this large company happened to be based in—let's pick Maryland, it would be the Maryland courts that would have the ability to approve any kind of workouts, any sale of the assets, without regard to perhaps some of the interests in the other States.

Senator SHELBY. This leads me to the bond insurers regulated by States, which are of great concern to a lot of us in the financial industry today. What lessons should the ongoing problems with the bond insurers teach us about the weaknesses in our insurance regulatory structure? Mr. Pearson, do you want to take that?

Mr. PEARSON. We have not been particularly involved. It is not something that affects us directly, and so I really do not have a great answer, quite frankly.

Senator SHELBY. Mr. Iuppa, do you have anything on that?

Mr. IUPPA. Well, I think, you know, when we are looking at systemic risk, the bond market—the bond insurance market is a good example. They have for the most part tended to be based in New York. I think we have at least one in the Midwest. The expertise that perhaps is needed to supervise——

Senator SHELBY. Haven't some of those companies either have failed or are about to fail?

Mr. IUPPA. It is my understanding that some of those companies have had their ratings turned down.

Senator SHELBY. Is that because of a lack of capital and too much risk, too little capital, a combination?

Mr. IUPPA. Well, perhaps that they engaged in putting products in the marketplace that they may not have had the expertise to do. And perhaps, again, they are operating under that State framework. There could be issues with knowledge of the business, both on the part of the regulator and the bond insurer. And I think if you had a bond insurer operating under a Federal charter, for instance, you would be able to bring considerably more resources to the table from the standpoint of drawing on Treasury, drawing on the Fed; the SEC would have an opportunity to weigh in. And you also have the ability to have those Federal agencies perhaps react faster than the States can in terms of coming together to a solution.

Senator SHELBY. Mr. Plunkett, do you have any comment on that, the bond insurers and the problems there? Because that is a real risk to our whole financial system.

Mr. PLUNKETT. Senator, the issue there appears to be regulatory expertise, the ability to assess as a regulatory the financial risks, in this case the risks to the capital markets, of a very complex financial product. And on that issue, so far the Federal Government does not have a very good track record either. So I would not assume that regulatory expertise——

Senator SHELBY. I was not choosing one over the other there. I think they are all flawed.

Mr. PLUNKETT. Yes, well, it has been a problem. It has been a problem.

Senator SHELBY. Sure. Mr. Goldman?

Mr. GOLDMAN. Which question, Senator, would you like—the bond insurers?

Senator SHELBY. The bond insurers, seeing as you are the Insurance Commissioner and the Banking Commissioner. You have a dual role here, so you have some experience here. Go ahead.

Mr. GOLDMAN. None of the bond insurers has failed at this point, as Mr. Iuppa has indicated.

Senator SHELBY. If they have not failed, are they under great stress?

Mr. GOLDMAN. They are under—a number of them are under stress. There have been a couple of new entrants into the market, actually. One of Warren Buffett's companies has decided to start a new one.

Senator SHELBY. Well, that is municipal bonds, isn't it?

Mr. GOLDMAN. That is municipal bonds, not the collateralized——

Senator SHELBY. A lot less risk there than there is in other things.

Mr. GOLDMAN. Well, that is true. And had they stuck with that position——

Senator SHELBY. Buffett is smart, isn't he? [Laughter.]

Mr. GOLDMAN. Had they stuck with that, they wouldn't be, some of them, where they are today. But none of them, in fact, has failed. They have been downgraded, a number are under pressure. As I say, there have been some new entrants into the market, which have been quickly approved—around the country, I might add—by the States. I think all 50 States approved Mr. Buffett's new company within 60 or 90 days. I think 40 States approved it within 30 days to get more capacity into the market.

And if I might, the issue of speed to market, which I think was mentioned with the life insurers, the Interstate Insurance Compact, which the States have put into effect, and which is in effect in 32 States and Puerto Rico, does address that problem and is well on its way, I think, to solving the issues that are raised in that regard.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

And as mentioned by many of us already here, there is no one who has been more active and more involved in these questions on this Committee than Tim Johnson. And so I thank him immensely. As I mentioned, I am sort of agnostic on these questions, anxious to sort of hear the arguments that are being presented here this morning. But I am very grateful to Tim for raising the issues. He has been very coherent and very smart in talking about them, so, Tim, we thank you immensely. The floor is yours.

Senator JOHNSON. Mr. Iuppa, Mr. Pearson, and Mr. Goldman, the surplus lines and reinsurance bill has passed the U.S. House unanimously twice. Where do the trades stand in their support for passage of the surplus lines and reinsurance bill? Are there any reasons why this Committee should not pass the bill? And would it help pave the way for comprehensive reform such as OFC? Mr. Iuppa.

Mr. IUPPA. Thank you, Senator. Yes, I think it is important to recognize that the bill does seek to address some real problems in the marketplace when you are talking about the surplus lines proposal. I think that at this point the AIA is supportive of that legislation, and as I said, we believe it really does address some real concerns that we have. But I guess I would urge you with regard to that to not look at that as solving all the concerns or addressing all the concerns, that we still believe that a comprehensive approach and one that would incorporate some of those measures is probably the prudent way to go. And if the Senate chooses to go unilaterally on that particular bill, we would really ask that you provide some assurance that the comprehensive approach would not be abandoned and still be a topic for discussion.

Senator JOHNSON. Mr. Goldman.

Mr. GOLDMAN. Thank you, Senator. I think the NAIC and the States have been working constructively with the Congress on that bill. We have made a number of suggestions we think would improve the surplus lines portion of that bill. And we are supportive, with those changes, of the surplus lines portion of the bill.

With respect to the reinsurance portion of the bill, I am presently chairing a reinsurance task force for the NAIC, and we are in the process of and I believe making good progress on developing a comprehensive modernization proposal for reinsurance regulation in the United States and answering some of the questions that have been raised about mutual recognition and solvency and some of those questions. So our view has been that we think we are fairly close, and we would rather deal with a comprehensive proposal on the reinsurance regulatory modernization framework that we are working on.

Senator JOHNSON. How close are you?

Mr. GOLDMAN. We are hopeful to have a complete proposal, if we are a little bit lucky, by the end of this year.

Senator JOHNSON. Mr. Pearson.

Mr. PEARSON. ACLI is supportive of the surplus lines bill. We think it is a positive step. But we do see it as addressing very narrow boutique issues, and we concur with Mr. Iuppa that ultimately, if insurance reform is to be done properly, comprehensive reform is the right answer.

Senator JOHNSON. Mr. Iuppa or Mr. Pearson, what is the average time that it takes to bring a new insurance product to market? Isn't product innovation discouraged because of the time that it takes to get a product approved?

Mr. IUPPA. Looking back in my career, one of the things that I saw, there was great variety across the States. In some States, you could get products approved in a fairly short order, within 30 days. In others, there are some products that I am aware of that would take a year or 2 years to perhaps get it approved or even to get a disapproval.

Mr. PEARSON. Our process, generally it is about a year for a product to get full approval in all 50 jurisdictions where we operate, and industry data is suggesting as much as 2 years for some products. And, frankly, in today's fast-moving world, products are outdated within 2 years.

Let me also, just if I may, mention on the compact, we have been very supportive of the NAIC moving the compact along and applaud them for what they have done. But our concern, first of all, is that it is but one issue that needs modernization.

Second, there are 33, I think, States and Puerto Rico, but the big States are not in, and, frankly, we do not think we will ever be in. And it is yet to be proven whether it is going to work. It is a bit too early.

Senator JOHNSON. Mr. Iuppa, some believe that there would be more congressional and industry consensus on OFC legislation if it was life only. Why should P&C be included?

Mr. IUPPA. Well, P&C faces many of the same issues that the life industry faces with regard to the need for an OFC. The other thing is, again, to look at this from the standpoint—and I will go back to some of the earlier comments about the competitiveness of the industry, not only from an insurance perspective but also dealing in the capital markets and competitiveness there. The P&C issues—you know, at one time P&C coverages were very local, especially for things like homeowner's, auto insurance. But I was talking with some folks this morning, and one example that I mentioned is that it seems a bit of an anomaly—I live here in the District. I drive over to Virginia. My insurance coverage comes with me. However, if I move from the District over to Virginia or to Maryland, I have got to start the process again of being able to obtain coverage. And we have heard previously by others who have testified on this that just that single thing alone provides a significant burden, especially for people who are engaged in businesses or perhaps even the military service where there is regular movement because of the deployments or transfers, that sort of thing.

I think, too, from the standpoint of looking at, again, global competitiveness that we are confronted with, again, in the context of the OFC, it is not meant for every company. But it is going to be positive. It is going to be a benefit for those that do business across the country or across the globe.

Senator JOHNSON. I am out of time, but, Mr. Pearson, can you answer the question about why should P&C be included or if it should not?

Mr. PEARSON. First of all, we clearly believe that there is a very strong position for life insurers and the need for an optional Federal charter, and I am here as representing small companies to suggest that it is not just an issue that impacts the very large but, in fact, companies of our size as well.

We are supportive of Senate bill 40, and I think I probably should leave it at that.

Senator JOHNSON. Thank you.

Chairman DODD. Thank you very much, Senator.

Just to clarify, Senator Johnson asked a very important question about the surplus lines, and as I understand it, you are for it, Mr. Goldman?

Mr. GOLDMAN. We have made a number of suggested changes to the bill that we think address the——

Chairman DODD. So you would not support it in its present form here?

Mr. GOLDMAN. Well, we think that the bill addresses a number of important concerns, and we would be supportive of it. We do think some changes are appropriate in the bill. But with those changes, we would be supportive of it, yes.

Chairman DODD. All right. Because this is a matter—I think there is a lot of consensus about it. It passed overwhelmingly in the House, that and the Office of Insurance Information were two pieces of legislation that went through rather handily over there, and we are looking at a package over here of things we might be able to do. And so I want to get some clarity from the witnesses on it. And you are for it, as well, as I understand it, surplus lines?

Mr. IUPPA. Yes. We do support it.

Chairman DODD. And Mr. Pearson as well. Travis, do you have a point on that? You were asked that question.

Mr. PLUNKETT. Senator, we are opposed to it, for a number of reasons. For one, it still applies to personal lines, not admitted personal lines as well. Given the lack of access to guarantee funds, we would like to see that carved out. And there are a number of problems with the State of domicile regulation for both nonadmitted insurers and reinsurers in particular.

Chairman DODD. Did you oppose—the House bill passed overwhelmingly.

Mr. PLUNKETT. We did oppose it.

Chairman DODD. OK. Senator Menendez. Excuse me. I am sorry. Senator Martinez. I apologize.

Senator MARTINEZ. Thank you, Mr. Chairman.

Mr. Goldman, I wanted to ask you about another matter which is very important to many people in my State. New Jersey last

March, I understand, became the 11th State to protect consumers from the practice by some life insurance companies to deny coverage or charge excessive premiums for coverage based on past or future lawful foreign travel. In June, the National Association of Insurance Commissioners approved an amendment to the Unfair Trade Practices Act to address unfair life insurance discrimination on the basis of this lawful foreign travel. Unwarranted denial of coverage by insurance companies affects family members, humanitarian aid workers, and also businesspeople seeking opportunities abroad. So as the Commissioner of the New Jersey Department of Banking and Insurance and the representative of NAIC here, can you tell us why New Jersey acted to address this form of insurance discrimination?

Mr. GOLDMAN. Because we agree with you, Senator, that it is inappropriate for people to be charged an excess premium just because they are going to travel to a particular jurisdiction. And so we felt, the legislature of New Jersey felt it was appropriate to ban the practice, and did so.

Senator MARTINEZ. And I understand you have feelings about State and Federal issues, but would it be helpful, do you think, for us to enact a Federal piece of legislation that would strengthen what has been done in New Jersey and perhaps make it be applicable throughout the country?

Mr. GOLDMAN. Well, I think that, you know, that is one of many issues that I think State Insurance Commissioners around the country do deal with, and I think the cooperation of State legislatures is necessary, as it was in New Jersey, to enact the ban you are mentioning. We obviously agreed in New Jersey that it was appropriate.

I think, you know, given a little bit of time, I think a number of States, if not all States, might come to that same conclusion. So I don't know if it would be necessary on that narrow issue, for example, for the Congress to act. But we certainly agree with the principle.

Senator MARTINEZ. On another note, you and the other commissioners that make up the NAIC in your difficult roles are responsible for facilitating a functioning and a robust insurance marketplace while at the same time keeping consumer safety first and foremost. Are you familiar with the legislation that Senator Nelson and I introduced last year, the Nonadmitted and Reinsurance Reform Act, is regulatory reform of the surplus lines and reinsurance marketplace and seems to have a lot of support in this Committee? And would you share your thoughts on this type of regulatory reform, especially if you believe it could boost the vitality of the insurance marketplace while preserving critical consumer protections?

Mr. GOLDMAN. Yes, Senator. As I indicated, the NAIC would support it, with some changes—I think the Insurance Commissioner in Illinois, Mr. McRaith, has been very active and the lead person on behalf of the NAIC in discussing some changes that the NAIC would like to see in that bill. We think that the simplification of the tax allocation process is helpful. We think that vesting the control of the carrier in the home State is helpful. We think establishment of uniform eligibility standards is equally helpful, and the centralizing of data reporting. So we have a lot of areas of that bill, as I said, that we think make sense, and we are supportive with some of the changes that we have suggested.

Senator MARTINEZ. You have some tweaks that you would like to see made, but on the whole, you are in support of the concept.

Mr. GOLDMAN. That is correct.

Senator MARTINEZ. Mr. Chairman, that is all I have. Thank you very much.

Chairman DODD. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony. Like the Chairman, I do not come to this with a preconceived view, so I appreciate the information flow that is going on here. But let me ask a couple questions.

Mr. Iuppa, when you were the regulator in your State and NAIC's—I think you were the president or one of the officers—were you advocating a Federal optional charter?

Mr. IUPPA. I think to put the proper context on your question, you have to recall that I was a State official at that time representing within the context of the State of Maine the position in Maine. When I was speaking on behalf of the organization, I was doing just that—speaking on behalf of the organization.

I made some reference in my testimony, in my comments, about the difficulty in deriving consensus amongst the commissioners. Of the 56 commissioners that we have here in the U.S., you have some significant egos, and I will leave it at that. And to try to get consensus around an issue like, for instance, an optional Federal charter, one, it would have been, I think, inconsistent for a State-based organization, an association of State-based officials to come forward and advocate for an optional Federal charter.

Senator MENENDEZ. So you are saying—first of all, I assume the answer is no. And, second, before you eat up all my time, and, second, I also assume that what you are saying is that all of our national insurance commissioners would not do the right thing if they honestly thought that a Federal optional charter was the right thing, they would still promote their own narrow State-based interests?

Mr. IUPPA. I think they have done the right thing; they will continue to do the right thing. But I think that they may not have fully the perspective that I have managed to gain over the last couple years dealing with a global insurer that has——

Senator MENENDEZ. I see. Let me ask you another question, both for you and Mr. Pearson. Wouldn't this really be, at the end of the day, about profitability? Clearly, if you go to a Federal optional charter based upon all the things you feel that would be taken care of, your companies would be more profitable, would they not?

Mr. IUPPA. Well, I think the ultimate consumer protection is to be able to purchase products from a company that is going to be profitable.

Senator MENENDEZ. I have no problem with profit. My question is: Would it not increase your profitability?

Mr. IUPPA. That remains to be seen. We could be confronting——

Senator MENENDEZ. You mean you would actually enter into a system where your profitability would be diminished as a result——

Mr. IUPPA. No. We are in the business that insures risks and indemnifies risk. We do not have the ability to know with certainty what that risk is ultimately going to be in any given year.

Senator MENENDEZ. Mr. Pearson, do you believe your profitability would be raised?

Mr. PEARSON. I think that it has the potential for increasing profitability. It also has the potential for increasing a better deal for the consumer from a price standpoint because of greater competition and greater efficiency in our companies that we can then pass along to the consumer, because we are—as I said earlier, it is a fairly intense price-competitive business.

Senator MENENDEZ. Mr. Plunkett, on page 34 of your testimony—there is a lot of stuff in here, but it is—you say, "Notice that the insurance industry is very pragmatic in their selection of a preferred regulator. They always favor the least regulation. . . . 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."

Is that switching back and forth that you suggest is the case or would be the case, is that because—is it about profitability or is it about something else?

Mr. PLUNKETT. Well, first, it is about lower regulatory standards, which I think ensures—believe will lead to greater profitability. I am referencing there, you know, 150 years of history of jumping from approval for first Federal-based regulation to then, at the beginning of the last century, State-based regulation and now back.

Senator MENENDEZ. Well, why would we presume that the lower regulatory standards—why would we not presume, as they suggest, the high watermark of high consumer protections?

Mr. PLUNKETT. Well, I think what we have shown in our testimony and elsewhere is that high regulatory standards are not incompatible with competition and are certainly not incompatible with very strong returns. And we detail in the testimony the fact that the States now have what is considered to be the strongest form of regulation, prior approval, have very healthy rates of return, in some cases better than States that have other forms of rate regulation.

So it is not incompatible. You asked me to speculate about what insurers might think, and that was my speculation.

Senator MENENDEZ. All right. Commissioner, let me ask you a question. We have seen reports of a certain company—I will not name them—not renewing home insurance policies in New Jersey. It is not a new phenomenon, either in New Jersey or in different parts of the country. And there are a lot of families who are furious and frightened that after decades of paying coverage and paying premiums without ever making a claim, they have their coverage dropped. And this is happening as we see insurance industry profits continue to rise even during bad years.

Can you give us a sense of what is happening out there and what are some of the challenges before us?

Mr. GOLDMAN. A number of the companies, based on their catastrophe modeling, have made judgments that they want to lessen the potential risk to themselves in particular geographic areas, particularly along the coasts. As a consequence, they have undertaken a concerted effort in coastal areas around the country to reduce their exposure in order to reduce that risk. And that has been the challenge.

In New Jersey in particular, we have been working with the companies by, frankly, persuading them that it might be the better judgment not to engage in the degree of nonrenewal that they might come in to discuss with us in the first instance. We have given them a couple of opportunities when reinsurance costs for them on coastal risks have increased to pass through some portion of that cost to consumers to persuade them to stay. We have actively engaged in bringing new coastal writers into the marketplace. We are engaged in doing that right now in order to bring more capacity to the market. And we have also seen an increase in surplus lines carriers in that market.

So we have worked on a number of fronts to try to mitigate the problem in New Jersey.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and thanks again for having a great hearing and to all our witnesses, thank you for your professionalism.

I do come at this with a philosophical bent, and that is that I would like to see our insurance industry be able to operate in a streamlined way. I was in a business in my previous life, a construction business, where we were licensed in States across the country. It was, in my opinion, nothing but restraint of trade. It had nothing whatsoever to do with good qualifications, and it was just a way to keep contractors, if you will, out of States so that in-State contractors could flourish. That was what it was all about. So I come with a bent.

On the other hand, after being here in Washington and seeing the way things work here, for instance, Chuck Schumer and I have introduced a bill, a toll-free number for people who have issues with the banking system to be able to call one place. I mean, people have no idea which particular entity oversees whatever banking issue they might have. And after the offices around our States in Tennessee are pummeled with calls regarding people just wanting Government to do what Government has agreed to do, we have to assign caseworkers ad nauseam to deal with those issues.

So it seems to me that there is the issue of streamlining that philosophically I agree with. I will say it does look like the insurance industry is flourishing right now. It looks like they are doing particularly well. But, on the other hand, I would like to have a place for constituents to be able to call the Attorney General or someplace else if they have had advantages taken of them. And I would like for each of you, if you would, to address, if you are for the optional Federal Charter, how we might ensure that constituents do not get taken advantage of and do not get caught up in this

Federal abyss, if you will, that exists here; or if you are on the other side of that, explain how that can never happen.

Mr. GOLDMAN. Senator, I can tell you that our office annually gets about 45,000 to 50,000 calls in a State with roughly 8.8 million people. Now, there are under this system 50 States plus the territories that are available to respond to those concerns. I can tell you under an optional Federal charter with six regional offices for 300 million people, I do not think you are going to have very good consumer protection or a place for consumers to reach out and get help. This is an area—insurance—where people pay for a promise. The promise is that when they need it, it will be there for them. Oftentimes, they have difficulty having that promise fulfilled, and they need help. And I do not think six regional offices for 300 million people is going to help too many people get that promise fulfilled.

So I have serious problems with the idea of changing an effective and healthy system in which consumers are more protected than they would be, I think—and are, frankly—anywhere else in the world. I think the U.S. regulatory system, with whatever warts it may have, is probably the gold standard in the world. To put an overlay on that that will reduce significantly the benefits to consumers would be a dramatic mistake.

Mr. IUPPA. Well, with all due respect to my former colleague Mr. Goldman here, if the few companies that will be federally chartered have 300 million customers, we will be pretty pleased.

The reality under the OFC, what we are talking about is an opportunity for a company, depending on their business, particular business model, to enter into whichever regulatory system they believe best fits that model. And at the same time, consumers, policyholders, existing policyholders or new consumers—and, again, I am talking about individuals, small businesses, large businesses—will have an opportunity—they will have an additional choice. They can choose to stay in the State system and only purchase insurance from State-chartered companies. Or their particular needs may have them gravitate toward a nationally chartered entity.

Senator CORKER. Do you really think consumers ask those questions when they are buying a product? I mean, they buy a product, and at the end of the day, they have no—I guarantee you, I do not ask those questions. Maybe I should. But I do not think they are going to be asking whether they are chartered by Federal or State regulators. And so at the end of the day, they will have a product, they will not know who is overseeing those. Is that correct?

Mr. IUPPA. Well, in my 20 years as a regulator, I think I have heard just about every question. But I think, too, you have to keep in mind that there are also producers and agents who work with their clients as well to provide them guidance as to whether or not a company perhaps is State-chartered or nationally chartered or, you know, is based somewhere else. I mean, the reality is most of us buy insurance from a company that is based somewhere else. But the important thing is to—those companies who are State-chartered can still go to their respective States. For those that will be federally chartered, S. 40 provides a framework for those regional offices, and the Congress, as the policymakers, I believe will not shirk your responsibility to provide for a level of strong consumer protection for those federally chartered companies and their customers.

Mr. PEARSON. First of all, we believe it is less of an issue for our industry than for others. Our records say less than 10 percent of complaints are life insurance and life insurance-related.

Having said that, however, we frankly think the current network does a very good job of handling consumer complaints. We would prefer for more uniformity across States with some of these model laws that have passed. But, frankly, we look at it as something that we could build upon as through the Federal bill that we would expect nothing less than an exemplar customer complaint and recourse.

Mr. PLUNKETT. Senator, that is a very good question, and I would just say that if insurers would like uniformity and efficiency—and consumers do pay for a lack of efficiency—then they should propose, you know, uniformly high national standards, not allowing them to go back and forth between the States and the Federal regulators. Senator Hollings proposed a bill of that kind just before he retired in 2003 and got very little support.

Regarding consumer assistance, some States do a good job and others do not, but the States do have a good argument when it comes to property/casualty insurance in particular because there are regional variations. There are variations in tort laws, no-fault versus tort, and the States have a pretty good argument that they have local expertise when it comes to particular property/casualty problems and claims that result in their areas—you know, hurricane, earthquake, hail damage, things like that.

So I would be worried a little bit about eliminating that regional knowledge. Also, the Federal banking regulators who are often cited as the model for national insurance regulation have a poor track record of consumer assistance. They just do not have the cops on the beat that the States have the potential to have.

Senator CORKER. May I ask one more brief question, Mr. Chairman?

Chairman DODD. Certainly.

Senator CORKER. Mr. Pearson, I understand that—something that I agree with, and that is that what we really want to have is a streamlined process for having products approved. And I understand there is an Interstate Compact that many States are a part of, but there are 20 States that are not a part of, and I wonder why the life insurance industry is not pursuing heavily getting those other 20 States to the table and moving on with that.

Mr. PEARSON. We are. Frankly, we have been working with the NAIC and each State and other jurisdictions to get an OFC passed. I know in Maryland we have worked closely with our Insurance Department as well as the legislature to do so. So it is something that we are actively pursuing. We call it a dual track of regulatory modernization, so we are interested in a Federal charter, but also in improving State-based regulation because we believe even if there is a Federal charter that it will continue to be an option for insurers.

Senator CORKER. Thank you.

Chairman DODD. Thank you very much, Senator, and we will leave the record open here. I don't think if there are additional questions. I was going to make the point, having been on this Committee for quite a while, even the notion not that many years ago of a Federal charter, it would have been met with total opposition from the industry and this subject matter. It was a third rail if you were talking about the insurance industry to be talking about a Federal charter.

Again, I am very interested in the testimony and very interested in the proposals and the ideas and what may work. I think Senator Corker touched on sort of the heart of it, which is for many of us here—I have always sort of felt on the life area you could make a pretty case for it because of the very differences that have been raised in dealing with property and casualty, and Mr. Plunkett raised it, certainly Senator Corker did, too. There are distinctions in terms of local tort law and other matters that come up. And, of course, as you point out, Senator Corker points out, for the consumer this only becomes an issue when you have a claim. I mean, other than that you are buying the stuff, you are looking for price. But at the end of the day, when we get the calls—it is not because of the price you are paying for the policy. When a Senator gets a call about it, it is because I am not getting my claim answered. That is when it hits us. And so guaranteeing somehow at the Federal level on property and casualty particularly you are going to get that response is something that I am troubled by. How do you get that response?

But I am very interested in this subject, and clearly we have got to do something. We have got to reform in these areas. So I appreciate immensely the testimony. We literally could just keep this one panel here for the day with the questions I have alone. I am sure my colleagues do as well. So we will leave the record open. But I want to get to the second panel, if we can. So thank you all very, very much for being with us this morning. Very, very helpful.

Let me introduce our second panel as the first panel is stepping down. Our next panel consists of George Steadman, who is President and Chief Operating Officer of Rutherfoord Inc. Mr. Steadman was recently appointed the 2008 Chairman of the Council of Insurance Agents and Brokers. He is also a member of the Board of Managers of Assurex Global Reinsurance Company.

Thomas Minkler is currently the President of the Clark-Mortenson Agency. He also serves as Chairman of the Government Affairs Committee of the Independent Insurance Agents and Brokers of America.

And, third, we have Frank Nutter, who is President of the Reinsurance Association of America, currently serves on the Board of the International Hurricane Research Center, the Advisory Board of the Center for Health and Global Environment, the Governing Council of the American Meteorological Association, the Board of the University Center for Atmospheric Research, and the Advisory Board of OECD's International Network for Financial Management of Large-Scale Disasters.

What's the weather going to be like, Frank, tomorrow?

Mr. NUTTER. I will let you know.

[Laughter.]

Chairman DODD. With all those, you have got to know whatever is going on with the weather.

Richard Bouhan has been Executive Director of the National Association of Professional Surplus Lines Offices since 1987. Previously, Mr. Bouhan was NAPSLO's Director of the Government and Industry Affairs Council.

And we thank all four of you for being here. We heard the issues raised about surplus lines in the last panel, and obviously this panel I know has some particular expertise in that area as well, so we will come back and talk about those questions here. But let me thank all of you for being with us, and, again, I am going to ask you, if you can, to be relatively brief in your opening statements so we can get to some questions.

We will begin with you, Mr. Steadman.

STATEMENT OF GEORGE A. STEADMAN, PRESIDENT AND CHIEF OPERATING OFFICER, RUTHERFOORD INC., ON BEHALF OF THE COUNCIL OF INSURANCE AGENTS AND BROKERS

Mr. STEADMAN. Thank you, Mr. Chairman, Senator Shelby, Members of the Committee. My name is Shad Steadman. I am President and Chief Operating Officer of Rutherfoord, Incorporated, a regional brokerage based in Roanoke, Virginia. Rutherfoord is the 38th largest U.S. insurance brokerage firm, and we have offices from Philadelphia to Atlanta. My testimony is on behalf of The Council of Insurance Agents and Brokers, whose members sell more than 80 percent of all business insurance in the U.S. and a growing share of the international marketplace. I am currently chairman of the council.

Like other witnesses here, we greatly appreciate this opportunity to speak to you today. This Committee has worked constructively and productively on a number of issues that are critical to our industry and to this country. We similarly hope that bipartisan consensus can be found on the complicated but critical issues of insurance regulatory reform.

Let me say at the outset that our organization supports the National Insurance Act, which would create a truly optional insurance regulatory system for all industry players. We are grateful to Senators Johnson and Sununu for their efforts on this front. We believe the Act provides for comprehensive, rigorous oversight of the industry that protects insurers and policyholders in the case of insolvency and bolsters, rather than diminishes, current protections for insurance consumers.

We believe that the current regulatory structure is simply not equipped to handle an insurance marketplace that today is not just national but international in scope and also is increasingly complex and sophisticated. My firm serves clients in 50 States and multiple countries, and our clients have risks and exposures that transcend State boundaries. Regulation of this business must move beyond those artificial State boundaries, and the optional Federal charter is the best ultimate framework for regulatory restructuring.

Political reality dictates that the achievement of the OFC will not be an easy process, nor will it be quick. In order to better serve our policyholders and clients, we need practical solutions to real marketplace problems. That is why I respectfully implore the Committee to pass one measure this year that would address a fundamental flaw in the State-based system of insurance regulation and for which a solution is readily at hand. I am speaking about the Nonadmitted and Reinsurance Reform Act, so-called the surplus lines legislation, that has been introduced by Senators Martinez and Nelson of Florida.

This legislation has been unanimously approved by the House, and its surplus lines provisions constitute the only piece of Federal insurance regulatory reform where all major stakeholders, commercial consumers who are represented solely by REMs, regulators, small insurers, large insurers, large brokers and independent agents agree.

Let me describe very briefly what surplus lines products are and what this legislation would do.

Surplus lines insurance provides coverage for unique, unusual, or very large risks for which insurance is unavailable in the admitted market. It is universally recognized as an important component of the commercial property and casualty marketplace. There are multiple sets of requirements in each State with regard to the steps that must be taken before the nonadmitted marketplace can be accessed, and there are different premium tax requirements in each jurisdiction. When surplus lines activity is limited to a single State, compliance issues are minimal because there is a single set of rules.

When activity encompasses multiple States, which is normal, full regulatory compliance is difficult, if not impossible, because the laws of every State in which an exposure is located may technically apply to the transaction. This is a real problem.

The surplus lines legislation would dictate that the rules and regulations only of the insured's home State would apply to any multi-State surplus lines transaction. This would have an immediate positive impact on the marketplace and consumers and would complement the adoption of the regulatory reform envisioned by the National Insurance Act.

Again, this is an issue on which we agree even with the NAIC, but the optional Federal charter supporters and opponents agree on this legislation. Obviously, we urge the Committee to seize the opportunity to enact it this year due to the extraordinary consensus that has emerged around the basic tenets. And looking toward next year, we believe that the National Insurance Act is the best and ultimate solution to the many competitiveness issues that impact our industry.

Thank you very much.

Chairman DODD. Thank you very much.

Mr. Minkler.

STATEMENT OF THOMAS MINKLER, PRESIDENT, CLARK–MORTENSON AGENCY, INC., ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Mr. MINKLER. Thank you and good morning, Chairman Dodd and Ranking Member Shelby, and Members of the Committee. My name is Tom Minkler, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America and our 300,000 individuals to provide our perspective on insurance regulatory reform. I am the President of Clark Mortenson, a New

Hampshire-based independent insurance agency with 51 employees that offers a broad array of insurance products to consumers and commercial clients.

As you know, States carry out the essential task of regulating the insurance marketplace to protect consumers. State insurance regulators have done an excellent job in the area of financial solvency, thereby ensuring that insurance consumers receive the insurance coverage they need. However, there are some problems with the State-based system, and focused reform is warranted.

When considering such limited reform, we must remember that during the recent turmoil in various sectors of the financial services industry, the insurance industry has remained healthy and stable. Unlike other financial services markets, there is no crisis in the insurance industry that requires a risky, massive overhaul of the current regulatory system.

The State system has proven that it best protects consumers and can be modernized to work effectively and efficiently for the entire insurance marketplace with the right legislative pressures from Congress. Therefore, when considering any reform, we must recognize that the current system does have great strengths, particularly in the area of consumer protection and solvency regulation.

Additionally, when considering reforms to the State regulatory system, we believe that two overarching principles should guide our efforts. First, Congress should attempt to fix only those components of the State system that are broken. Second, no actions should be taken that in any way jeopardize the protection of the insurance consumer. We believe that the effective solvency regulation and disciplined guaranty system that does not require the potential support of Federal tax dollars are essential to such protection.

To speak from a personal perspective, the most serious regulatory challenges facing insurance agents today are the redundant and costly requirements that arise when seeking licenses on a multi-State basis. These requirements hinder the ability of insurance agents to effectively address the needs of consumers. The average independent insurance agent today operates in more than eight States, and many are licensed in 25 to 50 States. We strongly support targeted Federal legislation to streamline nonresident insurance agent licensing. This legislation would be deferential to States' rights. Day-to-day State insurance laws, such as those regarding consumer protection, would not be preempted. By modernizing the NARAB framework passed as part of the Gramm-Leach-Bliley Act of 1999, Congress can help policyholders bring increasing marketplace competition and consumer choice. The NARAB Reform Act incorporates these principles and has had strong bipartisan congressional and industry support. This has led to quick action being taken on this reform measure in the House.

Another area where targeted Federal legislation is necessary is in the nonadmitted market, and we support legislation that would apply single-State regulation and uniform standards to the surplus lines industry.

I also want to mention briefly our strong opposition to another suggested method to achieve insurance regulatory reform—the proposed creation of an optional Federal charter. We are very concerned about this risky proposal for full-blown Federal regulation of the insurance industry and believe that it would not reform the current system but would supplant it. The best characteristics of the current State system from the consumer perspective would be lost if some insurers were able to escape State regulation completely in favor of wholesale regulation from the Federal level. Current Federal legislative proposals to allow for such a Federal insurance charter would not be optional for our members. Independent agents represent multiple insurance companies, and we would be forced to deal with the Federal Government irrespective of any licensing reform that may be accompanying it. Even more importantly, optional Federal charter would not be optional for the consumer. The insurance company, not the insurance consumer, would make that decision.

Current OFC proposals would also create a confusing patchwork of solvency and guaranty regulations. It would not replicate the significant structural improvements that were made in the banking model in the aftermath of the S&L failures and the banking crises of the 1980s and 1990s. The dual structure proposed under the current OFC measures could have disastrous implications for solvency regulation by dividing this key regulatory function from guaranty fund provisions.

Proponents of OFC assert that a Federal regulator is important if the U.S. is to remain a global financial services leader. We believe that the purported decline of U.S. capital markets' competitiveness for insurance does not stem from State-based regulation but from other concerns such as different tax treatment and the costs of excessive litigation. In the end, we feel that a massive overhaul of the insurance regulatory system along the lines of an OFC carries great risk and is unnecessary as there is no crisis in the insurance market.

There is a more practical alternative. We believe that targeted Federal legislation to improve the State-based system is a pragmatic, middle-ground approach, and the solution is achievable. We encourage the Senate Banking Committee to consider this approach specifically in the area of agent licensing reciprocity. It is the only approach that can bring the marketplace together to achieve reform.

Thank you.

Chairman DODD. Thank you very much.

Mr. Nutter, thank you.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Thank you, Mr. Chairman. My name is Frank Nutter, and I am President of the Reinsurance Association of America. The association represents property and casualty insurance companies that specialize in assuming reinsurance.

I am pleased to appear before the Committee today to provide the reinsurance industry's perspective on regulatory reform and welcome this opportunity.

Reinsurance is critical to the insurance marketplace, as has been mentioned by several witnesses. It reduces the volatility experienced by insurers and improves insurers' financial performance and security. It is the insurance of insurance companies.

Reinsurers have assisted in the recovery from every major catastrophe over the past century in this country. By way of example, 60 percent of the losses related to the events of September 11th were absorbed by the global reinsurance industry, and 61 percent of the 2005 hurricanes Katrina, Rita and Wilma were ultimately borne by reinsurers.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential to providing the much needed capacity in the U.S. for property and casualty risks. While nearly 70 foreign jurisdictions are reflected among the ceding companies' preferences for reinsurers, the majority of U.S. premiums ceded offshore are assumed by reinsurers domiciled in about a dozen countries. Foreign reinsurers now account for 56 percent of the U.S. premium ceded directly to unaffiliated reinsurers—a figure that has grown steadily from 38 percent in just 1997.

While the current State-based insurance regulatory system is primarily focused on regulating market conduct, contract terms, rates and consumer protection, as has been discussed before the Committee today, reinsurance regulation focuses on ensuring the reinsurer's financial solvency and to see that reinsurers meet their financial obligations.

The fundamental concept underlying the U.S. regulatory system is that a reinsurer must either be licensed here in the United States and subject to the full spectrum of regulation as insurance companies are or provide collateral through trust funds, letters of credit, and other forms of security to see that their obligations are met.

In recent years, capital providers to the reinsurance market have opted for establishing a platform outside the United States and conducting business through a U.S. subsidiary or by providing financial security through a trust or collateral. My testimony notes that since 1992, after Hurricane Andrew, there have been 38 new reinsurance companies formed, providing nearly $35 billion of new capital serving this market. Nearly all of this capital came from U.S. capital markets, yet no new reinsurer was formed in the United States. Other than the U.S. subsidiaries of some of these new companies, the last reinsurance company formed in the United States was in 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-U.S. jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in the United States.

The RAA advocates a modified optional Federal charter for reinsurance to allow reinsurers to choose a Federal regulator or remain in the current 50-State system. Alternatively, the RAA seeks Federal legislation that streamlines the State-based system. We reference in the statement the Treasury Blueprint as providing examples of why the State-based system does not serve well a global marketplace like reinsurance.

As the rest of the world seeks to work toward regulatory harmonization and international standards, the U.S. is disadvantaged by the lack of a Federal entity with authority to make decisions for the country and to negotiate international insurance agreements or federally enabling legislation which empowers a single state regulator to do so.

It has been long recognized that the level of reinsurance regulation varies throughout the world. A system of mutual recognition whereby the U.S. or a State could recognize the regulatory system in another non-U.S.-based jurisdiction is one which we support, and we are pleased to see that it has been incorporated in S. 40, the National Insurance Act of 2008.

It is also noted in our statement that while non-U.S. reinsurers have the option of being licensed in the U.S., 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 U.S. is dependent on non-U.S. and U.S. reinsurance capacity. On the other hand, it is difficult to see how 50 State regulators can be expected to know, or to learn, the intricacies of the accounting systems and regulatory schemes used throughout the world to determine the financial strength of non-U.S. reinsurers.

The RAA commends the sponsors of S. 40, the National Insurance Act, for proposing an optional Federal charter for insurers, and in large part, we think that would address this concern about uniformity. Frankly, we are also encouraged by the ongoing efforts of the NAIC, under Steve Goldman's leadership, to develop a framework for reinsurance regulation which seeks to streamline regulation through a national system for U.S. reinsurers, a port of entry for non-U.S. reinsurers, and a system of trans-border regulatory recognition. We have encouraged the NAIC to seek Federal legislation to achieve this system rather than hope that all 50 States' laws will be amended on a uniform basis. Our 50-State system of regulation has significant differences among the States with regard to their requirements. We believe that any structure that is adopted by the Congress or Federal legislation which addresses State streamlining should eliminate duplicative and inconsistent regulation. Again, we applaud the sponsors of S. 929, the Non-admitted and Reinsurance Reform Act, for proposing legislation that will eliminate extraterritorial application of laws.

Finally, Mr. Chairman, we believe that changes in the current regulatory system are necessary. We believe the options include an optional Federal charter, as proposed in S. 40, or a modified optional Federal charter which allows a reinsurer to choose among a single Federal regulator or a single State regulator or Federal legislation that streamlines the current system.

I would like to commend the NAIC for its progressive efforts to adopt a framework that seeks to achieve many of the goals that we have set forth, but we have recommended to the NAIC that they work with us and with the Congress to pass legislation that would enable them to achieve the uniformity that they seek.

Thank you, Mr. Chairman and Senator Johnson, for your attention and support in this area.

Chairman DODD. Thank you very much, Mr. Nutter.

Mr. Bouhan.

STATEMENT OF RICHARD BOUHAN, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF PROFESSIONAL SURPLUS LINES OFFICES

Mr. BOUHAN. Chairman Dodd, Senator Johnson, I want to thank you and Ranking Member Shelby for holding this hearing on some very, very important insurance reform issues. My name is Richard Bouhan, Executive Director of the NAPSLO, the National Association of Professional Surplus Lines Offices. I am pleased to be here today to testify on the state of the insurance industry with a focus on its current regulatory structure and oversight. As my association's name implies, the surplus lines marketplace will be the focus of my comments.

The surplus lines market is an indispensable and fast-growing sector of our Nation's insurance industry, a marketplace established to serve consumers by providing coverage when the traditional markets fail to do so. Unlike other components of the insurance sector, surplus lines is not simply a type of coverage; instead, it is an entire insurance marketplace that provides virtually all types of coverage to both commercial and personal customers. Our customers include doctors, lawyers, architects, and other professionals; manufacturing concerns; public infrastructure, like hospitals and airports. Ultimately, perhaps the market is best known as the "safety net" that provides coverage when crises like 9/11 or Hurricane Katrina restrict the capacity of the standard market. Given this wide range of service, there is simply no one in this room who is not in some way impacted by the surplus lines market.

With $40 billion in annual premiums, the surplus lines industry represents nearly 15 percent of the commercial insurance marketplace. This is a fourfold increase from just a decade ago. The primary reason for this rapid growth is the transition of our economy from a manufacturing and industrial base to a complex and diverse array of industries that require a flexible and dynamic insurance marketplace.

Unfortunately, while our sector has evolved to meet ever changing consumer demand, our regulatory system is outdated, inefficient, and in dire need of reform to better serve market participants and consumers. Our major problems are caused by a patchwork of inconsistent and, at times, conflicting State-based regulations. These problems have been further exacerbated by the dramatic expansion of multi-State surplus lines coverage in recent years. Currently, about a third of all surplus lines policies have multi-State exposure, creating a regulatory compliance challenge that is costly and burdensome to all.

While attempts have been made to harmonize these laws, history has proven that the States are unable to create an efficient, uniform, and rational regulatory system for this unique market. Consequently, NAPSLO believes the only solution is Federal legislation that clearly resolves the problems I will now review.

As a result of this patchwork system, licensed surplus lines brokers have no way to determine how much tax would be paid to the States on a multi-State risk and face multiple compliance requirements. This is because the States have inconsistent and sometimes conflicting rules to allocate exposure and calculate taxes. The result is a marketplace replete with confusion and acrimony between

States and brokers as to whether the correct amount of tax has been paid, with consumers at times facing double taxation and, thus, bearing the brunt of these regulatory and financial burdens.

Another significant problem lies in the licensing of nonresident brokers. Nearly a decade ago, Congress attempted to resolve this problem when it created a reciprocal nonresident licensing program as part of Gramm-Leach-Bliley. Despite these efforts, we remain to this day without an efficient system for multi-State licensing contrary to the intent of the law.

While the challenges before us are significant, thankfully solutions are well within reach. The Nonadmitted and Reinsurance Reform Act is now before the Senate. This legislation has twice been unanimously agreed to by the House and has earned the support of the industry stakeholders. Furthermore, the bill recognizes the dramatic changes and the growth in the surplus lines market and puts forth common-sense solutions to streamline the regulatory system to benefit all affected parties. We are most grateful to Senators Bill Nelson and Mel Martinez for introducing S. 929, the Senate version of the Nonadmitted and Reinsurance Act.

Given the broad range of support behind this bill, NAPSLO urges the Senate to promptly pass S. 929 because it will provide consumers with more efficient access to the marketplace, harmonize today's costly patchwork of inconsistent State laws and regulations, and repeal the inefficiencies of duplicative broker licensing requirements.

Again, I want to thank Chairman Dodd and Ranking Member Shelby and the rest of the Committee for holding these important hearings and for giving NAPSLO, on behalf of our Nation's insurance safety net, the opportunity to voice our concerns.

Chairman DODD. Well, thank you very, very much, and we thank all of you for being with us and being patient this morning, having to listen to the first panel. That is an advantage if you look at it in those terms. Let me pick up on the surplus lines issue, if I can, and to you, Mr. Steadman or Mr. Bouhan, if you can. One of the arguments advanced for streamlining surplus lines regulation is that it will enhance access to the surplus lines market for consumers. And I am interested in gaining a better understanding of what that would mean for consumers. Surplus lines, as all of you know, is generally a less regulated marketplace than the admitted market. And as I understand it, surplus lines companies do not participate in State insurance guaranty funds, meaning that consumers would not be protected if a surplus line company were to become insolvent.

What would be the benefits for consumers of expanding the surplus lines market, Mr. Steadman?

Mr. STEADMAN. Mr. Chairman, I think that the problems with the admitted marketplace oftentimes is that there is a lack of product available to consumers, and I think that if we encourage nonadmitted carriers to practice in States and ease regulation on them, it actually provides more creative solutions coming in, additional capacity flowing in. I think it was mentioned earlier in the previous panel that some of the solutions that are coming to the coastal areas now, where there is a lack of product available to insurers, is being taken care of by the nonadmitted market. And I think that we need to provide access to all those areas with these types of products to these consumers, these types of products that will solve a market need.

Chairman DODD. Mr. Bouhan, you kind of addressed this, but let me give you another chance to.

Mr. BOUHAN. I would agree with Mr. Steadman's comments.

Chairman DODD. Put your microphone on there.

Mr. BOUHAN. I would agree with Mr. Steadman's comments. The surplus lines market offers the consumer the opportunity to get the products that are not available in the licensed marketplace by creating a more efficient system of taxation. By creating a system of compliance with the regulatory rules, you gain the opportunity for the system to be overall more efficient, which gives better opportunity for consumers to access the marketplace and brokers to access the marketplace on their behalf. So I think that would be one thing that would happen.

I want to comment on the guaranty fund question. Surplus lines companies are not guaranty funds. But the vast majority of surplus lines business is commercial business, and the guaranty funds have limits. I think $300,000 is the more common limit. Some are as low as $150,000 in terms of caps on the claims payments. And most insurance commercial policies far exceed that. So I am not sure the guaranty fund issue is a significant one, at least in the context of the commercial business that the surplus lines mostly writes.

Chairman DODD. I think you addressed this, or Mr. Minkler did, but on the surplus lines issue, where the bill has gone to the House, the one that is pending here, have you taken a position on that? Are you in favor of it? You indicated in your comments you were, but I want to give both of you a chance to comment on this.

Mr. NUTTER. Mr. Chairman, we would strongly prefer an optional Federal charter legislation. But to your question, and if the Committee and the Senate were to address the more narrow approach to the excess surplus lines and reinsurance bill, we are supportive of the bill, but it does fall somewhat short of what we think would be appropriate.

Chairman DODD. I understand you would like more. I am just trying to get——

Mr. NUTTER. Well, let me comment on something you raised earlier. The legislation that is reflected in the Treasury Blueprint as in Mr. Kanjorski's legislation in the House does create a Federal advocate, an Office of Insurance Information, and also addresses this question of the constitutional authority of the Federal Government to enter into trade agreements with foreign countries. That would address the question of recognition of companies doing business in the United States.

Those two provisions added to the excess surplus lines and reinsurance bill would make it a much stronger piece of legislation and, frankly, address most of our concerns.

Chairman DODD. OK. Mr. Minkler.

Mr. MINKLER. Mr. Chairman, we are in favor of the surplus lines bill, and as you indicate, there is a lot of traction right now for the bill, as there is for the NARAB bill that has come out with broad bipartisan support. So we would support this bill.

Chairman DODD. Thank you very much.

As has been discussed, since Gramm-Leach-Bliley a large majority of States have adopted reciprocity laws with regard to agent and broker licensing. Mr. Minkler, let me start with you and ask Mr. Steadman as well. Could you explain specifically why you believe those reciprocity laws are insufficient? And let me anticipate. If you say it is the fault of the NAIC, which some are apt to, if the problem lies there, how they made their certifications, what efforts have you made to address the issue at the NAIC?

Mr. MINKLER. Thank you, Mr. Chairman. The tenets of Gramm-Leach-Bliley to introduce across-State-border licensing reciprocity were noble goals. They have fallen short. The new NARAB bill, reform act, takes it a next step and introduces Federal tools to be able to coax those States that may not have the reciprocity now.

We have worked closely with the NAIC over the months and years preceding this to come up with an agreement as to a model that would work, both at the regulatory level and at the practitioner level, which is my level. We believe that NARAB II is the answer to that, and we look forward to its passage.

Chairman DODD. Mr. Steadman.

Mr. STEADMAN. Our organization was one of the earliest supporters of licensing reform, and we were big supporters of Gramm-Leach-Bliley when it came about, and we think it did do quite a bit to improve the licensing environment.

However, I have to tell you, it needs a lot more work. There are still 20-odd States that do not have reciprocity.

I can tell you just as an example, my firm—not that large—we have 300 employees, but we maintain in our firm—we actually have full-time people doing nothing more than tracking licenses. And we maintain thousands of licenses and appointments in our organization, and I personally have hundreds.

So it is a very, very difficult, time-consuming, burdensome task for agents and brokers.

Chairman DODD. I did not get a chance to ask Mr. Goldman, because there were obviously a lot of Members here and a lot of questions, but is there any likelihood those remaining States are going to join in this? Or are you optimistic or not optimistic about it? I heard one of my colleagues, I think, or at least someone suggest there are a couple of large States that will never join. At least, that is the impression.

Enlighten Senator Johnson and me as to the possibility of a significant majority of those extra 20 States joining in this effort, or all of them. What is your assessment of that?

Mr. STEADMAN. Mr. Chairman, I think that, absent some type of Federal pressure, I don't think that there will be complete compliance. I think that when we were looking for reforms around counter-signature, yes, we were able to get most States to come into compliance. But ultimately we were forced to file suit in many States in order to get all States to drop these protectionist policies they had in place regarding counter-signature.

So if that is any example of what we could expect as far as licensing reciprocity, I think that there will be some States that never will come into compliance without some sort of Federal pressure.

Chairman DODD. What is your view on that, Mr. Minkler?

Mr. MINKLER. Mr. Chairman, I think it is probably accurate that there are a couple States that will be tough to come into the fold. But the fact that the NAIC has endorsed this proposal I think speaks volumes to its chances of success.

Chairman DODD. Tim. Senator Johnson.

Senator JOHNSON. Mr. Steadman and Mr. Bouhan, you have already discussed the surplus lines marketplace to ensure against risk like terrorism and extreme weather. But I would call to the Chairman's attention, over 20 percent of all property and casualty placements are accounted for by surplus lines.

Mr. Nutter, you talk about many problems the U.S. reinsurance industry and fund reinsurers face with 50 different U.S. insurance regulators and sets of State laws. You mentioned that this patchwork of regulation has caused tensions with foreign officials, and these result in U.S. reinsurers being disadvantaged overseas. Can you elaborate? Is there anything that this Congress can do to make sure that the U.S. reinsurers are not discriminated against because of our regulatory system?

Mr. NUTTER. Certainly, Senator Johnson. The global reinsurance market is, in fact, a very international one. I cited statistics largely to demonstrate that this is in many ways an offshore market serving U.S. capacity needs through U.S. subsidiaries and collateral. The 50-State system is an awkward and cumbersome system to deal with which is why I endorsed the idea of a Federal insurance office as well as constitutional legal authority for that office to enter into international trade agreements. Such agreements would provide reciprocal recognition for U.S. insurers and reinsurers doing business in foreign countries and for their insurers doing business in the United States.

That feature, together with the excess surplus lines and reinsurance bill's features, would go a long way toward moderating this conflict and tension between the capacity needs being served by non-U.S. entities in the U.S. and U.S. insurers and reinsurers being able to do business on a global basis based upon a system here.

Senator JOHNSON. Currently, what is done? Is there a negotiation required by all 50 States?

Mr. NUTTER. Well, currently it is not done, I think is the answer to that. The NAIC itself is struggling with that issue. Just last week, Commissioner Goldman chaired a meeting where a legal opinion was reviewed about the problems of States or the NAIC, which is really a trade association, entering into global negotiations that are, in fact, trade matters. Federal legislation, as is incorporated in the optional Federal charter bill, and is addressed in the Kanjorski bill in the House would provide the legal authority to deal with that.

It is really a matter of dialog at this point without the legal authority to enter into binding agreements to secure the capacity, but also to make certain that the obligations are met by U.S. and non-U.S. companies.

Senator JOHNSON. Mr. Minkler, recognizing that licensing reform is a top priority for insurance agents, do you agree with the licensing reform initiative contained in my legislation, the National Insurance Act, which streamlines the process so that an agent only needs one instead of multiple licenses?

Mr. MINKLER. We do endorse agent licensing reform through NARAB II, Senator. I may have missed your question in there.

Senator JOHNSON. The question was, Do you endorse the provision which is contained in my legislation, the National Insurance Act, which streamlines the process so that an agent only needs one instead of multiple licenses?

Mr. MINKLER. If you are referring to the NARAB portion——

Senator JOHNSON. Yes.

Mr. MINKLER [continuing]. We are in favor of that. We think NARAB II will greatly streamline the process. Today, I have to apply in multiple States, and it is very burdensome. And we think the targeted reform that we are talking about is the best way to accomplish that.

Senator JOHNSON. Thank you.

Chairman DODD. Well, thank you very much.

Let me ask just one—I am going to ask you just quickly, if you will, the second question I asked the first panel involving whether or not different lines of insurance should be treated differently, the issue. And, again, pointing out that the fact we have had eight witnesses and a multiple of issues that are on the table, I wonder if you just might, each one of you, quickly share just some quick thoughts on this. You have generally already in your comments, but I wonder if you would just comment on that. Mr. Steadman.

Mr. STEADMAN. Mr. Chairman, it is a little difficult for me to address the question as far as multiple lines of insurance. I principally deal in the property/casualty arena, and I am very, very supportive of that, of an optional Federal charter, and also for the reinsurance and surplus lines reform. It is, again, extremely burdensome for us, and we are very supportive.

Mr. MINKLER. Mr. Chairman, while there are certainly differences between the property and casualty side of the aisle and the life side of the aisle, our position on regulatory intervention at the Federal level is just that: just targeted. There are certain lines that obviously need immediate attention. Flood insurance comes to mind.

Chairman DODD. Right.

Mr. MINKLER. That needs attention post haste.

Chairman DODD. We are going to deal with, by the way, Senator Shelby—we have passed it out of here. We need to work out the differences with the House. My hope is we are going to get that done. But we are going to get it done, in fact, in my view, before we adjourn.

Mr. MINKLER. Excellent. Excellent. But as far as a distinction between lines of business for the type of reform we are talking about, yes, there is a difference between life and P&C, but our overall proposal is that a Federal regulator is not going to solve the issues that are involved in the differences between the lines of business.

Chairman DODD. Frank, your thoughts.

Mr. NUTTER. Very briefly, Mr. Chairman. We certainly have endorsed an integrated approach as is contained in the optional Federal charter legislation. However, I think the fact that the excess surplus lines and reinsurance bill passed unanimously in the

House twice and is being actively considered here does suggest that at least those two lines of insurance, as distinguishable from the consumer-based issues that you often deal with, says a lot about the value of moving on that legislation.

Mr. BOUHAN. Surplus lines is exclusively really property/casualty, and we have not given a lot of thought to the life issues in comparison to the property/casualty business. But I want to agree with my colleague Mr. Nutter that I think the surplus lines reinsurance bill, the NRRA, is a bill that could move forward and solve some problems in those marketplaces directly today, and I would like to see that happen.

Chairman DODD. Well, I thank you for that, and this has been very, very helpful, both panels on the surplus lines issue, because I had—we are running out of time around here. We have only got a few days left. We end up either this week or next week, and then back for a few days in September before we adjourn for the election, and whether we come back for a lame-duck session or not is completely up in the air. And my hope would be, I want to talk to my colleagues here as well about this, but I am concerned, obviously, that we try and bite off more than we can chew. And I know that people see something moving around here they want to get onto it if they can, put everything onto it. And I would just say with a roomful of people here who have a lot of interest in what may move forward, I would be very interested in moving something along the lines here that would be narrower, that may not—because once I get into a larger picture here, I could end up with just nothing moves. As you can see, it does not take much to stop things in the Senate. And with a limited amount of time left, that 101st Senator begins to emerge, and that is the clock. And once that 101st Senator shows up, things get very, very difficult to move forward on.

But I appreciate the importance of a couple of these issues that I think there is some consensus on, and, again, I cannot speak for the Committee, obviously, but I would like to do a survey of my colleagues here to find out what they are interested in moving. My sense is they may be willing to move on some of this that we have talked about here this morning.

So I will have to get back to you all on that as I ask my staff to review their colleagues, the possibility of trying to get something done here before we adjourn in September. So I thank all of you.

Let me also point out, we have got—it does not always happen here, but we have—there is a wonderful member of the staff who is going to be moving on. Sarah Kline today staffs the Committee mostly on transit issues, and she is going to be moving to another call of public service and working for the Washington Mass Transit—is that the WMATA, is that how you pronounce it? Metro. And the transit riders of the D.C. metropolitan area are going to be advanced substantially when Sarah moves over here. But for 9 years she has served on this Committee and done just a remarkable job for all of us—the SAFETEA Act, the Terrorism Risk Insurance, National Transit System Security Act, the recent housing bill passed on Sunday. It is not an overstatement at all. People do not often get the credit here. There are people who sit behind the dais here and who most of you probably never get to know and wonder who they are. But one of them is named Sarah Kline, and America is a safer and a better place because of her. We thank you.

[Applause.]

Chairman DODD. The Committee will stand adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Chairman Dodd, Ranking Member Shelby, thank you very much for holding today's hearing on "The State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure."

For most of the 110th Congress, the Senate Banking Committee has been busy addressing the Housing crisis; a crisis that has harmed the American consumer, rattled the fundamentals of our financial markets, and has affected all sectors of the economy. Out of this housing crisis has come the obvious need to examine the overall regulatory structure overseeing financial services; an examination, I believe, will take front row in the coming months and years. I do not believe insurance should be left out of this discussion—as a financial service, as an important player in our capital markets, and as an important piece of the international economy.

In 2006, Senator John Sununu (R-NH) and I began a bipartisan discussion about the need to modernize the insurance regulatory structure with the introduction of our National Insurance Act to create an optional federal charter structure. In 2006, the Banking Committee held two hearings on insurance regulation reform and modernization, and I greatly appreciate the continuation of that conversation with today's hearing.

I continue to believe that the current state of insurance regulation and oversight is not well; that the current system negatively affects competition and efficiency in the U.S. insurance marketplace, and more important, that the current system is not benefiting nor fully protecting the consumer.

I am also troubled that little has changed in way of our nation's insurance regulatory structure over the past few years, despite mounting criticisms, and now, perhaps somewhat unexpectedly, new criticism from international insurance market players and regulators who do not want to, and cannot, deal with the United States' regulatory structure.

There are a variety of good reasons, including choice, stability, consumer protection, and efficiency, that I support the creation of an optional federal charter for insurance. But this isn't just about making the industry more efficient or benefiting the insurance companies; the lack of a central insurance regulator affects matters of importance to our economy. There is no federal department for insurance to monitor economic and risk trends in financial markets. There is no national regulator to coordinate federal financial regulatory policy; and no one to represent national insurance interests in international forums and at international trade negotiations. There is also no federal insurance regulator to serve as a source of federal competency to understand and respond to international regulatory and market developments.

Can anyone even imagine what the reaction to the Housing crisis would have looked like if there were no federal regulators and actions were taken to stem the crisis on a state-by-state basis? Can you imagine if there was no Federal Reserve to help coordinate the purchase of Bear Stearns by JPMorgan Chase? No flexibility for the Federal Reserve to open the discount window to primary dealers across the nation? No Treasury to coordinate efforts for loan modifications by the regulated institutions? We should not wait until an insurance sector crisis to realize the need for federal risk management.

In addition, an Optional Federal Charter and a federal insurance regulator would make it possible to address a number of other national insurance issues on a uniform, national basis including: reinsurance; surplus lines; consumer protection; travel underwriting, and many other issues. Having life insurance regulated by the federal government would also allow a national strategy to deal with the retirement security crisis we face as baby boomers retire. It is imperative that the U.S. have a federal insurance regulator with the expertise to help inform Congress when issues like these arise, and after the last year's financial sector's struggles, I feel even more strongly that the absence of a federal regulator for insurance is increasingly risky.

While I believe the best solution is the creation of an optional federal charter and, therefore, a federal insurance regulator, the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises recently passed a bill to establish an Office of Insurance Information in the Department of Treasury. While this legislation would not create an optional federal insurance regulatory system, it would establish federal policy on international insurance matters and ensure that state insurance laws are consistent with agreements between the United States and a foreign government or regulatory entity; and advise the Secretary on major domestic and international insurance policy issues. I applaud this effort as something that is vitally needed. That said, the issue of insurance regulation is really an issue of a fundamentally out-of-date system of state regulation that no longer serves the needs of all consumers, companies and agents. Any efforts to reform this system should be done in a comprehensive manner.

I look forward to continuing to work with my colleagues on the Banking Committee to reform and modernize our insurance regulatory system.

Testimony of the
National Association of Insurance Commissioners

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

Regarding:
"State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure"

Tuesday, July 29, 2008

The Honorable Steven M. Goldman
Commissioner of Banking and Insurance, New Jersey
On behalf of

National Association of Insurance Commissioners

Testimony of the National Association of Insurance Commissioners

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to testify today. My name is Steven Goldman. I am the Banking and Insurance Commissioner for the State of New Jersey, and I am here today behalf on of the National Association of Insurance Commissioners (NAIC). I am pleased to be here to update the Committee on the current State-based structure of insurance supervision and on our ongoing, successful efforts to improve and strengthen that structure.

Having served as the front line of U.S. insurance regulation for over 150 years, State insurance officials have a record of consumer protection and industry oversight that is second to none. We take seriously our responsibility to ensure that the safety net of insurance is there when people need it most. We are a powerful advocate for insurance consumers and an objective regulator of the largest insurance market in the world, leveraging the strengths of local, accountable oversight with technology and collaboration to streamline regulatory efficiency. The current U.S. insurance regulatory scheme is strong, and our track record is regarded internationally as the benchmark by which other supervisory systems are measured.

State insurance regulation in 2008 builds on this effective legacy, but at the same time constantly evolves, innovates and improves to meet the needs of consumers and insurers. In my testimony today I will focus on State efforts to improve insurance regulation, and attempt to dispel notions that a dual regulatory system for insurance, like that of banks, is necessary or prudent. At the outset, we must make clear that any reforms to the system should start and end with the States. To the extent that Federal assistance is necessary, it should be targeted to improve the current system and not supplant a century and a half of successful and effective supervision.

States Oversee a Vibrant, Competitive Insurance Marketplace

In addition to successfully protecting consumers, State insurance officials have proven to be adept stewards of a vibrant, competitive insurance marketplace. The insurance industry in the United States has grown exponentially in recent decades in terms of the amount and variety of insurance products and the number of insurers. There are more than 7,660 domestic insurers currently operating in the United States, with more than 2,000 new companies formed since 1995.

Combined premiums now top $1.4 trillion. As a share of the U.S. economy, total insurance income grew from 7.4 percent of gross domestic product in 1960 to 11.9 percent in 2000. In 2005, while insurance companies were absorbing record losses, they were also making record profits. Profits and surplus have continued to increase each year since. Insurance company surplus is now over $500 billion for the first time ever.

Clearly, this is not an industry that has suffered under State insurance supervision. In light of the record profits just cited, one should look skeptically at claims by some in the industry that appropriate rate regulation is harming their ability to compete. In reality, State regulators' modernization efforts have led to a competitive, profitable market for insurers and lower costs for consumers.

Today, companies of various sizes sell a vast array of products across State and national boundaries, reflecting the growing national economy and diversity of buyer needs, and the demand for insurance protection and investment products. Industry changes caused regulatory institutions to evolve, and State supervisory evolution, in turn, has contributed to the development of the insurance industry. This has resulted in a nimble regulatory environment that clearly has served insurance consumers well.

Insurance Regulatory Modernization: A Dynamic Process

Insurance supervision in recent years has been subject to increasing external and internal forces, to which the States have responded. Fundamental changes in the structure and performance of the insurance industry have complicated the challenge. Insurance companies have become increasingly national and international in scope and have widened the boundaries of their operations. One constant, however, remains: the local nature of insurance markets and the perils consumers face.

Each State, and in some cases, even each zip code, represents a distinct market, with varying risks, products and prices. Tort laws, court systems, workers' compensation laws, and the perils for which individuals and businesses buy insurance differ widely from State to State. Critics of State insurance regulation somewhat disingenuously point to the fact that a consumer moving to a different State must obtain new insurance policies for auto, homeowners, etc.; however, that is a reflection of our nation's vast differences in geography, demographics, and risk, and is not a phenomenon that would change under a Federal regulatory scheme.

When State insurance markets are compared to other national insurance markets around the globe, the size and scope of those States' markets – and therefore the responsibility of State regulators – typically dwarfs the markets of whole nations. Four of the top ten and 26 of the top fifty insurance markets in the world are U.S. states. For example, Mr. Chairman, the insurance market in your home State of Connecticut is larger than the insurance markets in Brazil or Sweden. Likewise, the markets in California, New York and Florida are each larger than the markets in Canada, China or Spain, and the markets in Ohio and Michigan are each larger than the markets in India, Ireland or South Africa. Each of these markets demands a local, accountable and responsive regulator.

The States have enhanced the resources devoted to insurance supervision, and the NAIC through its members has played a central role in State efforts to strengthen and streamline oversight of the insurance industry. These are not one-time silver bullet solutions, but rather represent a dynamic, ongoing process that changes and evolves along with the business of insurance that we oversee. The modern system of State-based insurance supervision builds on over 150 years of State insurance commissioners acting as stewards of a healthy, vibrant insurance marketplace founded upon a bedrock of comprehensive policyholder and consumer protection. But it also demands that State insurance officials be ever vigilant to anticipate and respond to the changing needs of consumers, the industry and the modern marketplace.

Optional Federal Charter – A Misguided Solution

One of the questions underlying this hearing is what should be the role of the Federal government in regulating insurance. We can start by addressing what that role should not be. For over a decade, insurance industry lobbyists have called for the creation of a new Federal bureaucracy via an optional Federal charter ("OFC") that would create a dual system of oversight, similar to the banking system. This concept was a bad idea then, and the current climate of instability and insolvency in the banking sector illustrates that it is an even worse idea now.

The OFC concept is a thinly veiled attempt to unravel the consumer protections, solvency structure and oversight that have led to the largest and most successful insurance market in the world. It was less than ten years ago that Congress reaffirmed, through the passage of the

Gramm-Leach-Bliley Act, that the States are the appropriate regulators for the unique business of insurance, and indeed it was Congress that compelled the States to strengthen and tighten solvency standards in the wake of numerous insurance company insolvencies in the late 1980s. We heeded your concerns and have developed a single, national system of solvency oversight that has allowed the industry in recent years to benefit policyholders and shareholders alike, by sustaining and paying claims presented to them while earning record profits.

Some OFC proponents also argue for U.S. implementation of unfinished, untested solvency standards of foreign regulators in an effort to relax capital and surplus requirements. We are continually working with our foreign colleagues to review and consider the merits of their concepts, but it would be imprudent for us to abdicate our solvency responsibility to our foreign colleagues, particularly when the broader financial sector is struggling.

Avoid a Race to the Bottom – Keep Solvency Protections in Place

We would urge careful analysis of any proposal to achieve modernization of insurance supervision in the United States by applying global standards. Even well intended and seemingly benign "equivalence" standards can have a substantial adverse impact on existing State protections for insurance consumers.

The "Solvency II" directive currently under consideration by the European Union has been held up by some as the beacon of global insurance regulatory reform. We should be careful what we wish for. There is no question that the lower reserve requirements under Solvency II would be appealing to a large insurer. Less money in reserve means more to spend, perhaps on risky but potentially lucrative new ventures. But this type of thinking is exactly what got us into the recent subprime mess and the ongoing banking instability, and what led to the great banking and stock market crises of past years. If there is anything we have learned, it is that an industry hungry for profits does not always have the consumer's best interests at heart.

But on top of that, Solvency II is nowhere near ready to go into effect. Under the current timetable, the Directive is not scheduled to be implemented by the various member countries until 2012. Several smaller EU States have expressed reservations about its effect on their own insurance consumers. The Solvency II concept is far from a reality, even where it originated. Now is certainly not the time for the U.S. to jump onto the Solvency II bandwagon. Instead the

Federal government should be supporting State regulators who are carefully considering aspects of Solvency II and principles-based regulation for potential application within the State system of solvency regulation.

Systemic Risk – A Place for State/Federal Partnership

Earlier this spring, the U.S. Treasury Department released its "Blueprint for a Modernized Financial Regulatory Structure." While we disagree with the Department's ultimate solution for insurance regulation – namely, an optional Federal charter – we do believe that the report's recommendation for increased knowledge and expertise in insurance at the Federal level is a good one. For that reason, the NAIC has offered its conditional support for H.R. 5840, which would establish an Office of Insurance Information within the Department of the Treasury to gather data and advise the Secretary on key international and domestic insurance issues. We have stressed our willingness to continue working with the House Subcommittee that is currently shaping the legislative language, and have expressed our concern that the bill should not be expanded to more broadly preempt State regulatory authority or detrimentally affect our consumer and solvency protection functions.

We recognize that insurance is part of a far larger financial services picture. In the 21st Century, risk in one sector can easily affect others. The recent bond insurance crisis in the United States, and the subprime mortgage crisis now reverberating worldwide, are clear examples. We need a way to address systemic risk, and the NAIC believes that a Federal office utilizing the expertise and knowledge base of the State insurance regulatory system would be a positive step forward.

State Insurance Supervision Has Been Strong and Effective

State insurance supervision has a long history of aggressive consumer protection, and is well suited to the local nature of risk and the unique services offered by the insurance industry. State regulators live and work in the communities they serve, and can respond accordingly. When Hurricane Dolly came ashore last week as a Class Two storm, the Texas Department of Insurance was on the ground with several teams of specialized staff ready to assist policyholders in the affected areas. The Department utilized a Consumer Help Line to assist consumers with filing claims, contacting agents, or understanding coverage. It also issued several emergency bulletins to insurers addressing the situation and indicated that it is "inappropriate for insurers to re-rate, cancel, nonrenew, or refuse to provide coverage due solely to an individual's status as a victim or evacuee of Hurricane Dolly. Further, it is not reasonable to change policyholders' rating classifications or increase their insurance rates solely because they are a victim or evacuee of Hurricane Dolly." This kind of consumer-oriented local response is the hallmark of State insurance supervision, an asset that would be lost in any attempt to federalize oversight of insurance.

While State insurance commissioners are strong advocates for consumers, we also strive to provide a stable, efficient regulatory environment for insurers, reinsurers, producers and other industry participants. We work collectively, through the NAIC, to streamline oversight, stimulate competition and eliminate redundancies between the jurisdictions. These efforts are constantly evolving and we welcome the scrutiny of Congress to assist in finding ways to better serve consumers and the industry. Insurance regulation must constantly be reformed and improved, and while those efforts should always start at the State level, we would ask that Congress work collaboratively with us and our colleagues in the State legislatures to appropriately target efforts to strengthen the existing State system where areas necessitating Federal assistance are identified.

As an example of this commitment, we have worked with the producer community on legislation to streamline non-resident licensing, and we have offered guidance to improve legislation pending before this Committee that would simplify the tax collection and allocation of surplus lines, while implementing uniform eligibility standards for surplus lines carriers. We play an integral role in the development of Federal health insurance policy, establishing standards based on our expertise and experience. We have also held extensive discussions with the Securities and Exchange Commission on the issue of equity indexed annuities. We look forward to continuing to work with Congress on these important issues.

Reforms should start at the State level, and they have. While our critics use the sheer number of States as a false argument to imply redundancy, we would argue that we have made great strides to reduce those redundancies and harmonize supervision from State to State. The NAIC has undertaken a number of initiatives with State insurance regulators in recent years, which are set out in Appendix 1 of this testimony. We have been the face of regulatory reform, coupling an aggressive enforcement mindset with advanced techniques to protect American consumers in times of peril. My testimony will cover a number of major areas where we have taken the initiative and successfully strengthened the State insurance regulatory process, such as:

- Interstate Compact;
- Solvency oversight;
- Consumer assistance and education;
- Fraud detection;
- Turnaround on rate and form filings;
- Producer licensing;
- Company licensing; and
- Uniform transmittal of documents

Interstate Insurance Compact – Speed to Market

Some life insurance companies have petitioned Congress in recent years for a Federal regulator to increase their products' speed to market. They claim that having different standards from State to State is unnecessary for this coverage, and argue that the State by State approval process puts them at a competitive and costly disadvantage. We have not taken that criticism lightly.

Insurance regulators have worked successfully to bring more cost-effective and sound insurance products to the market more quickly. Central to this effort has been the Interstate Insurance Compact ("the Compact") for speed-to-market filing and regulatory review of life, annuities, long-term care and disability insurance products. The States have heard the call for a more competitive framework in the insurance sector, and have responded.

The Compact is a key, successful State-based initiative that modernizes insurance regulation to keep pace with global demands, while continuing to uphold strong consumer protections. Under the Compact, insurers may make one central filing under one set of rules, resulting in one approval in under sixty days that is valid in all Compact Member jurisdictions. This vital reform has allowed insurers to quickly bring new products to market nationally according to strong uniform product standards, while preserving a State's ability to address front-line problems related to claims settlement, consumer complaints, and unfair and deceptive trade practices.

States have overwhelmingly embraced the Compact, as to date 32 States and Puerto Rico have passed the necessary legislation to adopt it. This represents over one-half of U.S. nationwide premium volume. More States are expected to come on board in the near future, including my State of New Jersey, fifth in premium volume nationwide, which is currently considering membership. Other large States, such as New York and California, also are considering membership.

As a cooperative partnership between State regulators and legislators, the initial start-up success of the Compact has proven that the States are proactively meeting the challenges of the global marketplace without sacrificing direct responsiveness to consumers – the bedrock upon which the stability of the insurance sector has been based for over a century.

Solvency Oversight

Since 1989, when the NAIC adopted a solvency agenda designed to enhance the ability of State regulators to protect insurance consumers from the financial trauma of insurer insolvencies, State insurance departments have made continual improvements to protect their consumers. At the very core of those improvements is the NAIC's accreditation program, which requires each State to have numerous laws in place to further strengthen the solvency of the industry. Many of these laws are designed to increase regulators' ability to identify and take action on a company when the financial condition of that company has weakened to a point where conditions are potentially hazardous to the consumer. These laws are therefore all designed to be proactive in how the industry is regulated.

In an international arena currently pushing to have regulation be more principles-based, U.S. insurance regulators understand the need to balance such an approach with prudence. In fact, the prudent standards adopted years ago by insurance regulators have somewhat sheltered insurance companies from the woes of today's market situations, which have clearly resulted from inadequate regulation in the mortgage and securities industries. For example, the various investment holding limitations and disclosure requirements have limited the insurance industry's exposure to the instability in the debt and equity markets today and have also resulted in the industry maintaining higher levels of capital to withstand these types of market struggles.

Due to improvements made by State regulators, there has been a 65% reduction in insurer insolvencies since the late 1980s. Ultimately, these improvements have allowed regulators to identify more easily when insurers are potentially troubled and react more quickly to protect policyholders and consumers. At a minimum, the NAIC urges Congress not to create a system that will allow regulatory arbitrage of the very standards that State insurance regulators have created to protect consumers. An optional Federal charter would weaken the insurance markets and result in more systemic risk. The Federal government should learn from the actions taken by State insurance regulators to protect the solvency of insurance companies and use the State insurance regulatory systems as a blueprint for how consumers in other financial service industries can be protected.

Consumer Assistance and Education

With the many changes taking place in the financial services marketplace, consumer protection poses significant challenges to a regulator. State insurance regulators have risen to the challenge.

Insurance is a unique and complex product that is fundamentally different from other financial services, such as banking and securities. Unlike banking products, which provide individuals up-front credit to obtain a mortgage or make purchases, or securities, which offer investors a share of a tangible asset, insurance products require policyholders to pay premiums in exchange for a legal promise. Insurance is a financial guarantee to pay benefits, often years into the future, in the event of unexpected or unavoidable loss that can cripple the lives of individuals, families and businesses. The cost to insurers to provide those benefits is based on a number of factors, many of which are prospective assumptions, making it difficult for consumers to understand or anticipate a reasonable price. Unlike most banking and securities products, consumers are often *required* to purchase insurance both for personal financial responsibility and for economic stability for lenders, creditors and other individuals. Most consumers find themselves concerned with their insurance coverage, or lack thereof, only in times of crisis – such as illness, death, accident or catastrophe. State officials have responded quickly and fashioned effective remedies to respond to local conditions in the areas of claims handling, underwriting, pricing and market practices.

The NAIC has been proactive in ensuring that State insurance regulators have the very latest and best tools to educate consumers on important insurance issues. These have included outreach campaigns, public service announcements and media toolkits. With its landmark *Insure U – Get Smart about Insurance* public education program, (www.insureuonline.org), the NAIC has demonstrated its deep commitment to educating the public about insurance and consumer protection issues. Insure U's educational curriculum helps consumers evaluate insurance options to meet different life stage needs. Available in English and Spanish, the Insure U website covers basic information on the major types of insurance – life, health, auto and homeowners/renters insurance. It also offers tips for saving money and selecting coverage for young singles, young families, established families, seniors/empty nesters, domestic partners, single parents, grandparents raising grandchildren and members of the military.

Fraud Detection

In January 2005, the NAIC launched an online fraud reporting mechanism to allow consumers, employees, or others who suspect wrongdoing to report their suspicions anonymously to State enforcement authorities. Since business practices in one State may be connected to problems in other States, the system allows for focused fraud detection where problems arise. Continued regulatory collaboration avoids duplicative and excessive data requests that delay responses from the producer and insurer industries and hinder appropriate State regulatory action.

Turnaround on Rate and Form Filings

The NAIC's System for Electronic Rate and Form Filing ("SERFF") provides a single point of filing for insurance products. Insurers choosing to file electronically have experienced a considerably shorter turnaround time than was possible under the traditional paper filing process, which SERFF has effectively made obsolete. SERFF is currently being used by all fifty States, the District of Columbia, Puerto Rico and over 3,000 insurance companies.

Producer Licensing

By developing and utilizing electronic applications and databases, State insurance officials have created much greater efficiencies in licensing and appointing insurance producers in those States that require it. State insurance officials remain deeply committed to achieving greater uniformity in the producer licensing process.

We are currently working with the Independent Insurance Agents and Brokers of America (the "Big I") to craft final legislative language to amend H.R. 5611 in a way that is satisfactory to State regulators, insurance producers and consumers. The bill is designed to achieve the non-resident licensing uniformity goals of the 1999 Gramm-Leach-Bliley Act. We are close, and are confident that our negotiations will produce a measure that will move quickly to enactment.

We trust that these efforts demonstrate our commitment to work to achieve the best possible insurance regulatory system. Insurance consumers need to know that the agent or broker selling them insurance is properly licensed, and not a rogue who has slipped through the regulatory cracks in another State – which sadly was not always the case in the past. Producer licensing is an area that cries out for uniformity nationwide, and we are not averse to Federal government involvement to achieve such uniformity when consumer protection hangs in the balance.

Company Licensing

To simplify insurers' application process for State licenses to write insurance, the NAIC has developed an electronic system and support designed to help insurers navigate State-specific requirements and provide a single entry opportunity when filing in all jurisdictions. The uniform application system is being applied by all jurisdictions, and has greatly eased application requirements for companies wishing to write insurance in multiple jurisdictions. Using this streamlined licensing system in a collaborative effort to stem the recent crisis in the bond insurance industry, forty States approved Berkshire Hathaway Assurance Corporation's application in less than a month, a number that increased to 49 shortly thereafter.

Conclusion

The system of State insurance supervision in the United States has worked well and has continuously evolved for over 150 years. State regulators understand that protecting America's insurance consumers is our first responsibility. We also understand that commercial insurance markets have changed, and that modernization of State insurance standards and procedures is needed to facilitate more streamlined, harmonized and efficient regulatory compliance for insurers and producers.

The NAIC and its members – representing the citizens, taxpayers, and governments of all fifty States, the District of Columbia and U.S. territories – will continue to share our expertise with Congress on insurance issues having a national and global impact, and we welcome Congressional interest in our modernization efforts. We look forward to working with you to continue to modernize insurance regulation and protect consumers.

Thank you for this opportunity to address you, and I look forward to your questions.

Appendix 1:

State Insurance Regulatory Reform Efforts

Area of Reform	States Response	Status
Life Insurance – Speed-to-Market: Life companies want to get products approved under one set of rules and into the market quickly to keep pace with global demands and to compete with banks.	The Interstate Compact: Creates a single point of speed-to-market filing for life, annuity, long-term-care, and disability insurance. Products are approved by the Compact under Uniform Standards in under 60 days and can be rolled out in every participating State.	33 Jurisdictions have adopted the Compact to date: Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina (1/1/09), Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.
Solvency Oversight and Accreditation Program	Dramatically enhanced statutory & regulatory authority over the last 15 years through the NAIC accreditation program to ensure strong, harmonized solvency oversight. All accredited States must pass numerous common laws/rules to ensure consistency nationwide.	49 States are now accredited by the NAIC. Reforms have led to a 65 % reduction in insurer insolvencies. Investment holding limitations and disclosure requirements have limited the insurance industry's exposure to the instability in the debt and equity markets today. Standardized accounting and reporting allow for comparability and advanced financial analysis techniques to identify potentially troubled insurers at an earlier date.
Consumer Assistance & Education	Establishment of proactive consumer education program: www.insureuonline.org Bilingual advice about life, health, auto, and homeowners/renters ins. Assistance for families, seniors, military service-members, singles, & domestic partners	Over 850 million impressions since the launch in March of 2006. The program won the American Society of Association Executives' Award of Excellence and was a finalist for a 2007 SABRE Award.
Fraud Detection	Developed online fraud reporting mechanism to allow for interstate coordination Minimized industry data requests & increased collaboration	System has allowed for focused fraud detection where problems arise. Continued regulatory collaboration avoids duplicative and excessive data requests that delay responses from the producer and insurer industries and hinder appropriate State regulatory action.
Rate Form & Filing	NAIC developed the System for Electronic Rate and Form	Used by 50 States, D.C., Puerto Rico, and 3000+ insurance companies and third

	Filing (SERFF). SERFF offers a decentralized point-to-point, web-based electronic filing system. The system is designed to improve the efficiency of the rate and form filing and approval process and to reduce the time and cost involved in making regulatory filings.	parties. • 2001 – 3,694 Filings • 2002 – 25,528 Filings • 2003 – 76,932 Filings • 2004 – 143,818 Filings • 2005 – 183,362 Filings • 2006 – 269,101 Filings • 2007 – 381,377 Filings
Producer Licensing	Conducted nationwide on-site State producer licensing assessment to evaluate State practices for resident and non-resident licensing. Worked with interested parties and Congress on legislation to improve non-resident licensing.	State regulators are committed to non-resident producer licensing reciprocity in all States.
Company Licensing	NAIC established the Uniform Certificate of Authority Application, an electronic system and support designed to help insurers navigate State-specific requirements and provide a single entry opportunity when filing in all jurisdictions	Using the UCAA, Berkshire Hathaway was licensed by 49 States in less than 3 months.

American Insurance Association

STATEMENT OF
THE AMERICAN INSURANCE ASSOCIATION

BEFORE THE

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

ON

STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

JULY 29, 2008

Alessandro Iuppa
Senior Vice President, Government and Industry Affairs
Zurich North America

Good morning, Chairman Dodd, Ranking Member Shelby and members of the Committee. 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, the American Insurance Association ("AIA"), and its more than 350 members, on the subject of insurance regulatory reform. This is a critical issue for insurance consumers, agents, carriers, and the overall strength of the U.S. economy.

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, 15,000 exclusive agents and 10 million policyholders around the country, and as a Group are the nation's third 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.

I come to the issue of insurance regulatory reform with a perspective different from some of 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 of serving 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. Indeed, in 2007 Zurich published a White Paper titled *Regulation and Intervention in the Insurance Industry – Fundamental Issues*. 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.

Zurich and the AIA are not opposed to regulation of insurance. I would not be here if we 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 nationally and globally. Although the existing state structure works for some, it impedes our ability to achieve those goals.

Introduction

The issue of insurance regulation, once thought to be the province of isolated industry practitioners and regulators, is now central to many of the critical public policy debates over the direction of the financial services sector and the U.S. economy. More than one hundred bills relating to insurance have been introduced in this Congress, many of them within the jurisdiction of this Committee. Insurance regulation, specifically Optional Federal Chartering ("OFC"), is featured prominently in both the Bloomberg/Schumer report on U.S. Global Financial Services Leadership and the Treasury Department's Blueprint for a Modernized Financial Regulatory System. Both reports recommend the establishment of a federal insurance regulatory structure to provide for the creation of an OFC system. We agree strongly that an OFC would play an important role in the new world of integrated and interconnected financial markets, and would address the increasing cost and efficiency burdens that our disjointed state insurance regulatory system imposes on insurers and consumers alike.

Underlying this activity is recognition of the important role that the insurance industry now plays in our new financial world. 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 necessary if we expect to maintain a strong, vibrant insurance sector. It also is essential to address policyholder needs in the 21st century. Zurich first invested in the U.S. market 96 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-by-state patchwork of regulation in the U.S. means that insurers with customers with worldwide operations are hindered in their efforts to manage complex risk issues as they seek to do business on a national and international platform. Moreover, the turmoil that has recently roiled the financial services sectors highlights the interconnectedness of our financial system and the importance of insurance to the proper functioning of that system. This is precisely the time to enact regulatory reforms that strengthen solvency oversight for insurers at the federal level in order to mitigate problems that may cause policyholders to suffer in time of loss.

We are grateful to you for your willingness to conduct a comprehensive review of the current regulatory system. This marks a major undertaking with a plethora of issues and interests that will require careful consideration and deliberation. We also wish to commend Senators Johnson and Sununu for their introduction of the National Insurance Act of 2007 (S. 40). The bill establishes an excellent framework to reach the goal of an optional federal charter for the insurance marketplace. It will provide real choices for all participants – insurance companies and insurance agents and brokers and, most importantly, insurance consumers. Zurich and the entire AIA membership support the legislation and look forward to working with the Committee as it moves 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 approximately 6,500 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 addressing the cost of insurance to cover such multi-jurisdictional risks, the state regulatory system does just the opposite. By artificially making each state an isolated individual marketplace with its own rules and standards, the state-based system constrains the ability of carriers to innovate and has a negative effect on the availability and cost of coverage.

To their credit, the state insurance regulators, individually and through the NAIC, have attempted to institute regulatory reforms that focus on uniformity and consistency, and they have made some strides in recent years toward simplifying and streamlining regulatory requirements. We appreciate that effort, 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. Efficiency in the insurance marketplace lags behind other financial services sectors due in large part to the regulatory structure's shortcomings and inconsistencies, issues 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 regional, 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 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 and fosters greater transparency, better consumer protection, heightened efficiency both for the companies and the regulators, more product availability, and increasingly 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 by obtaining a 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 last several years as an insurance regulator 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 the 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 the degree of agreement 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.

Likewise, the introduction of risk-based insurer solvency requirements across the European Union, through an initiative that is known as "Solvency II," will pose enormous challenges to state-regulated insurers. The new solvency requirements are intended to be more risk-sensitive and more sophisticated than in the past, thus enabling better tracking of the real risks run by any particular insurer, while at the same time encouraging competition and innovation. As a result, trade experts believe that Solvency II will enhance the international competitiveness of EU insurers to the detriment of their U.S. peers. U.S. insurers cannot be easily integrated into Solvency II because the U.S. does not provide supervision equivalent to that of the EU. Because it is merely a committee of well-intentioned, individual state supervisors and not a national regulatory body that can guarantee uniformity and consistency, the NAIC cannot adequately address this situation. As noted in a recent analysis of Solvency II by Standard and Poors, "in the absence of supervisory equivalence, non-EU insurers may find themselves operating at a competitive disadvantage in Europe." U.S. insurers are also concerned that the growing

cohesiveness of the EU under Solvency II will yield cost and efficiency benefits for EU insurers that cannot be realized under the highly fragmented state system in the U.S.
A federal insurance regulator under OFC would change this dynamic. A 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. Even more immediately, an insurance office inside the Treasury Department could gather information, develop expertise, and assist USTR in international trade agreements affecting insurance. I have no doubt the states would remain involved internationally and encourage them to do so. Doing so alongside the federal government will bring a measure of practical importance to their activity that is absent in today's environment.

Strong Consumer Benefits

The current regulatory system assigns rhetorical importance to "consumer protection" but in fact focuses attention on regulatory functions that are not in the best interests of consumers, be they individuals, small businesses, or large corporations. Consumers across the spectrum will be better protected by a regulatory system that focuses on solvency and market conduct regulation, not on price and product approvals. Over the long-term, OFC will result in a stronger, more competitive, and modernized insurance industry that is better able to meet the needs of consumers and to empower those consumers in the marketplace, while reducing unnecessary costs—costs which have been estimated by the American Consumer Institute at more than $13 billion per year.

Additionally, consumers will benefit from access to new and improved consumer products, more companies competing for their business, and more streamlined ways of doing business, particularly for those who have homes in more than one state or move frequently. To further bolster consumer protection, S. 40 establishes consumer affairs and insurance fraud divisions to provide strong consumer service and protection.

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 33 member states, or 54 percent of the premium for covered products (life insurance, disability, long term care, and annuities), 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 two areas that would benefit from federal regulation: market deficiencies and speed to market.

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. A logical next step would be to create a single national insurance regulator with the ability to oversee the national market and interact with the legislative branch. From an implementation perspective, enforcement of federal insurance-related legislation typically has been left to the states, each of which understandably has its own concerns with its local markets. A federal regulator with responsibility for federally chartered insurers 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. In several states, commercial insurance products can be introduced immediately into the marketplace, but other states continue to maintain pre-approval requirements. For personal lines, most states play a major role in dictating the coverage insurers must offer and the premiums insurers are allowed to charge, even if that means providing coverage at a loss.

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 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 "potential problems" slowed the pace of product introduction to the policyholder 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. 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

Zurich and the AIA membership 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. Multi-region, 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 property and casualty and life insurance sectors; that option extends equally to insurance companies, reinsurers and insurance agents and brokers (producers); and the bill carefully addresses essential elements of insurance regulation including licensure, policy form oversight, 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, yet uniform regulatory structure for insurers and producers that operate on a national and international basis in this increasingly global industry.

- ***Creates an optional insurance regulatory system for all industry players.*** An OFC would provide insurance companies, reinsurers and producers a choice to operate under federal or state oversight. The Act preserves the ability of those industry participants to operate under State licenses, while giving both the option of doing business under a single federal license.

- ***Provides 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 whom 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.

- ***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 high level of 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 S. 40 are as strong as those in any state.*** The ultimate consumer protection is strong financial oversight of insurers. In this regard, 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 undergo a market conduct examination at least once every three years, creates a Division of Fraud and a Division of Consumer Affairs, leaves intact the state guarantee system to insure that policyholders are protected in case of insurer insolvency, makes the commission of a "fraudulent insurance act" a federal crime, and subjects National Insurers to federal antitrust laws in those areas such as insurance pricing where market competition replaces regulation.

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 such insurers serve – 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 AIA. We look forward to working with the Committee as you move forward with this important initiative.

ACLI
Financial Security. For Life.

STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

ON

STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

July 29, 2008

Statement Made by
John Pearson
Chairman, President & Chief Executive Officer
Baltimore Life Insurance Company

Mr. Chairman and members of the Committee, my name is John Pearson, and I am Chairman, President and Chief Executive Officer of Baltimore Life Insurance Company. I am appearing today on behalf of the American Council of Life Insurers, the principal trade association for U.S. life insurance companies. The ACLI's 353 member companies account for approximately 93% of the industry's total assets, 93% of the industry's domestic life insurance premiums and 94% of its domestic annuity considerations.

I appreciate the opportunity to appear before you today to discuss the critical need to comprehensively overhaul and modernize the insurance regulatory system in the United States. In the two years since this Committee last held a hearing on insurance regulation, the case for regulatory reform has become even stronger as domestic operational concerns have been joined by pressing international regulatory and competitive issues.

Mr. Chairman, in my testimony today I would like to cover four key points that I believe demonstrate the need for Congress to act quickly and comprehensively to reform the insurance regulatory framework by providing insurers with a federal charter option. The first is the vital role life insurers play in providing Americans with essential protection and retirement security products. The second is the enormous contribution life insurers make to the U.S. capital markets and to the overall U.S. economy. The third is the inability of state regulators and legislators to act collectively to transform a badly fragmented state regulatory system into a uniform, efficient national system that serves the needs of what is now a global industry. And forth is the growing prominence of international regulatory and competitive issues that fall largely outside the scope of states' authority.

The Importance of the Life Insurance Industry in Providing Protection and Retirement Security Products

The life insurance industry must be well regulated in order to operate efficiently and be in the best position to serve the protection and retirement security needs of baby boomers and others. One of the most significant benefits of insurance regulatory reform will be the elimination of substantial barriers to innovation – particularly as they relate to the ability of the life insurance industry to leverage its unique franchise to help address the looming retirement security crisis as some 77 million baby boomers near retirement.

Changing demographics and other related factors have given rise to a true retirement security crisis in this country. Medical advances continue to extend life expectancies and lengthen the time spent in retirement. Medical costs are increasing, particularly for retirees, while retiree health coverage continues to decline. Employers are discontinuing defined benefit pension plans, and employees covered by these plans are leaving earlier with lower benefits. Rising retirement age thresholds and lower rates of benefit increases mean Social Security will replace a significantly lower percentage of pre-retirement income for future retirees. Lower interest rates mean fixed income returns are lower. Taken together, these factors lead to the inescapable conclusion – borne out by numerous studies – that one of the biggest challenges people will face in retirement is outliving their assets.

Life insurers provide an array of products and services that benefit Americans in all stages of life, including life insurance, annuities and other retirement savings plans, disability income insurance and long term care insurance. Currently, there are over 375 million life insurance policies in force, providing Americans with

over $19 trillion in financial protection. In addition, Americans have saved $1.7 trillion towards their retirement by saving through our annuity products.
Life insurers are in a unique position to help America deal with the retirement security crisis. Significantly, life insurers – and only life insurers – can convert retirement savings into a guaranteed lifetime stream of income. That capability may well be the most potent tool that the private sector possesses to address the retirement savings challenges this nation faces.

The Importance of the Life Insurance Industry to the Capital Markets

The need for comprehensive regulatory reform should also be considered from an economic standpoint, since the life insurance industry plays a key role in capital formation and is a significant component of the overall U.S. economy.

The long-term commitments and investments of the life insurance industry make it one of the largest investors in the U.S. economy assisting in economic growth. In managing these obligations, the life insurance industry has invested $4.8 trillion in the financial markets, representing 9% of the capital supplied to the U.S. economy by the financial services industry, or 4% of the total capital in the entire U.S. economy. Life insurers are one of the largest holders of long-term, fixed rate commercial mortgages in the U.S. These long-term financial commitments are generally ten years and longer in maturity, much longer than commitments made by other financial intermediaries. In addition, our most recent figures indicate that life insurers invested $225 billion in new net funds in the nation's economy, an amount equal to about 30% of the net new funds saved by persons in the U.S. Fifty-seven percent of the industry's assets, or $2.7 trillion, are held in long-term bonds, mortgages, real estate, and other long-term investments. This includes: $523 billion invested in federal, state and local government bonds, helping to fund urban revitalization, public housing, hospitals, schools, airports, roads and bridges;

$314 billion invested in mortgage loans on real estate; $1.8 trillion invested in long-term U.S. corporate bonds; and $1.5 billion invested in corporate stocks. The importance of the continued growth and vitality of the life insurance industry to Americans cannot be overstated.

Patchwork Regulation for a National Business: Needless Inefficiency, Wasted Costs and the Frustration of Product Innovation

Despite the fact that the insurance industry has pressed state regulators and legislators for years to modernize the state regulatory system, the reality is that the state insurance regulatory system has failed to keep pace with marketplace developments. Life insurers today operate under a patchwork system of state laws and regulations that lack uniformity and are applied and interpreted differently from state to state. This Balkanized form of regulation makes no sense for the life insurance business, which is truly a national in nature with national rather than local issues and regulatory needs. Product standards, capital requirements, consumer protections – indeed every aspect of our business - need not and should not vary from one state to another. Yet we operate under a system in which companies must navigate a multiplicity of different regulatory gauntlets in parallel, each subject to its own timetable, in order to operate nationally, regionally or even in just a handful of jurisdictions.

Companies would be able to offer consumers more innovative products in a much more timely manner under an optional federal charter. Today, life insurers end up with multiple variations of any product they try to bring to a multi-state market due to differing state-mandated requirements. In contrast to the more centralized, uniform regulatory systems of the banking and securities businesses that allow them to get products to the national marketplace quickly – often within 30 to 90 days – it can take up to two years or more for life insurers to bring a product to market nationwide.

And the product approval process is not the only impediment to innovation. Virtually every aspect of our business is subject to disparate laws, disparate regulations and disparate interpretations of these laws and regulations that stifle innovation. Concerns in this regard include, among other things, the capital and reserving standards we must meet, the rules by which we must administer our products, our sales practices and the qualifications and licensing standards for the people who sell our products. The result fractionalizes what, for so many companies, is a national business – depriving insurers of the scale and speed to market necessary to sustain innovation.

Not surprisingly, the large number of product variations that result from the current regulatory system creates significant challenges for our operations and customer service areas that must manage and administer these multiple versions over the life of the contract – which in our business often means the lifetime of the customer. It also creates enormous inefficiencies for the individuals who we rely on to sell our products. That's one reason why so many life insurance producers have come out in favor of reforming insurance regulation. Thousands of them have joined a grassroots organization – Agents for Change – whose mission is to give voice to their frustrations with the current system. The National Association of Independent Life Brokerage Agencies has also endorsed the concept of an optional federal charter as has the Association of Advanced Life Underwriters. Among the most significant benefits that agents and brokers will realize in a federal regulatory system is the opportunity to get a single national license, with singular qualification, renewal and continuing education requirements.

While most aspects of insurance regulation are state specific, state boundaries do not constrain all aspects of state regulation. Paradoxically, in some cases, state regulation vests extraordinary extraterritorial reach in an insurer's home state regulator. For example, a home state regulator can determine capital requirements for business done nationwide. This, of course, creates the potential for radically disparate protections of consumers within the same state – and since capital is typically among an insurer's biggest costs, radically different costs of doing business for insurers depending on their state of domicile.

While working with Congress toward the implementation of an optional federal insurance charter, the ACLI and its member companies remain committed to the parallel track of working with the states to make state insurance regulation more modern and efficient. Without question there are many life insurers that would wish to remain state regulated even if a federal charter were available. Incremental progress is being made in improving state regulation, particularly with respect to the interstate compact some states have embraced that would provide a centralized, uniform mechanism for life insurance product filing and approval. However, until all states, including in particular large insurance states, enact the compact legislation, its full value and utility will not be realized.

Some progress is also being made in efforts to make state regulation of the life insurance business more uniform in all jurisdictions, but overall positive change has been frustratingly slow to materialize. The National Conference of Insurance Legislators (NCOIL) and the National Association of Insurance Commissioners (NAIC) are reasonably effective in adopting model laws and regulations intended to promote a uniform and more national approach to insurance regulation. These organizations are trade associations, not regulatory bodies, so to benefit consumers these models must be enacted in each individual state. Unfortunately, many of these model laws and regulations never get adopted by the individual states or, if the states act, the measures get modified to such an extent that the benefits of uniformity are lost.

The General Accountability Office last week noted this problem in the context of long-term care insurance.[1] In its report the GAO cited variations in state laws as the reason some consumers enjoy greater policy protections than other consumers when it comes to long-term care insurance.

Another telling example of the inability of the state regulatory system to implement important consumer protections on a national basis involves annuity disclosure. In 1998, the NAIC adopted the Annuity Disclosure Model Regulation to address important consumer protection issues. To date it has been adopted in only 16 states, notwithstanding the fact that annuity disclosure has repeatedly been the subject of highly critical articles in the financial press. State insurance regulators unquestionably have consumer interests at heart, but the fragmented state regulatory system all too often produces results like this.

International Considerations Argue for Federal Regulation

The absence of a federal insurance regulator leaves the U.S. insurance industry at a distinct disadvantage in a variety of ways. For example, foreign markets offer additional growth opportunities. Life insurance premiums in the U.S. grew by only about 4% in 2006. In contrast, premium growth in India was 60% in 2006; in Africa, 22%; in Central and Eastern Europe, 19%; in Latin America, 14%; and in China life insurance premiums grew over 9% in 2006. Yet, when U.S. life insurers try to expand into these and other growing markets they are often rebuffed. The reason is that, from the European Union to China, other countries

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[1] http://www.gao.gov/new.items/d07202.pdf

perceive that our current insurance regulatory structure discriminates against foreign companies and is so complex, inefficient, and costly as to be a de facto trade barrier.

There may be merit to these concerns. For example, 27 states will not license insurance companies owned, even partially, by foreign governments. Moreover, states have widely varying requirements about who can serve on a life insurer's board of directors, based on the nominee's residency, citizenship and other attributes – all of which can pose particular problems for foreign based companies. Indeed the very terms the states use to describe a company based overseas, 'alien' (i.e., subsidiaries or branches of non-U.S. insurers) versus 'foreign' (i.e., subsidiaries or branches of a U.S. insurer domiciled in another state) are viewed as politically charged and discriminatory. And recently, the European Commission has expressed frustration that may force it "to explore other routes to ensure that EU reinsurers receive a fair treatment" in connection with states' requirements that even highly rated European insurers deposit liquid assets in the U.S. in an amount equal to their gross U.S. liabilities as a precondition to insuring U.S. life insurers on a cross border basis.

In addition, the absence of a federal insurance supervisory authority operationally impedes the ability of U.S. life insurers to compete overseas. For example, neither U.S. state governments nor the NAIC have the constitutional authority to enter international agreements of mutual recognition or joint supervision on behalf of the U.S. Similarly, the U.S. has no national insurance supervisor with the legal mandate to represent the government or the interests of U.S. consumers or industry in responding to crisis or maintaining stability.

The *Blueprint for a Modernized Financial Regulatory Structure* prepared by the Treasury Department and released last April recognizes the difficulty of addressing insurance issues on the global stage through a state-based regulatory system. While calling for a federal insurance charter option in the longer term, the Treasury blueprint suggests the creation in the near term of an Office of Insurance Oversight within the Treasury Department to deal with, among other things, international insurance matters. Legislation has been introduced in the House by Chairman Paul Kanjorski consistent with this concept (H.R. 5840, creating an Office of Insurance Information). We see substantial merit in the creation of such an office as a means of gathering industry-wide information on insurance, providing Congress and the Administration with advice on critical insurance issues, and enabling the U.S. to deal more effectively with other countries and regulatory authorities on international insurance matters. We encourage this Committee to consider moving a similar measure in the Senate. While this would in no way be a substitute for an optional federal charter, it would in our view be a very worthwhile step toward where insurance regulation in the 21st Century needs to be.

Misperceptions Regarding an Optional Federal Charter

Consumer Protection – Critics of the optional federal charter have asserted that consumer protections would be diminished relative to what they are under the current state-based system. We strongly disagree. It is unrealistic to think that Congress would ever enact federal charter legislation without mandating consumer protections that are at least as strong as – if not stronger than – those that are now in place. Moreover, the ACLI has made it clear from the outset of the debate over the optional federal charter that it is not seeking deregulation of the life insurance business and in fact advocates rigorous financial oversight and strong consumer protections as part of the federal charter framework.

In a number of respects, consumers would likely fare better under a federal charter than they would under the current state system. For example, we are an increasingly mobile society, and people are more likely than ever to purchase an insurance product in one state and then move to another state. If the issuing insurer is not licensed to do business in the state to which the individual moved, then the insurance regulators in that state will not have the authority to address problems or questions regarding the product. Similarly, if a consumer has a long-term relationship with a trusted insurance agent but moves to a state where that agent is not licensed, the consumer will be forced to find a new financial advisor. "Gaps" of this nature would not exist for those companies operating under a federal charter.

Similarly, under an optional federal charter, market conduct as well as financial examinations would occur more regularly (at least once every three years) and would be conducted pursuant to uniform standards. The national regulator would also have a Division of Consumer Affairs as well as a Division of Insurance Fraud. And the regulation of companies and producers in all respects would be uniform from state to state. Finally, regulation in a particular state would not be dependant on the relative expertise of the insurance department staff or on the relative level of financial resources available to that department.

Contrary to assertions from opponents of the optional federal charter, consumer complaints would not be handled exclusively from Washington, DC. The legislation pending in both the Senate and House, S. 40 and H.R. 3200, provides that the federal insurance regulator must have at least six regional offices. The legislation also expressly authorizes the regulator to delegate certain functions to one or more self-regulatory organizations. A useful parallel to consider is the way in which the SEC and FINRA address the training, testing, licensing and market conduct aspects of registered securities representatives and broker/dealers.

Regulatory Arbitrage - Some have suggested that the implementation of a federal charter option would lead to regulatory arbitrage as companies seek increasingly lax regulation and regulators rush to accommodate. However, we are highly confident that Congress would be careful to assure that any federal regulatory option was at least on a par with the strongest state systems. Indeed, the industry is seeking uniform regulation, not weak regulation. Moreover, the potential for regulatory arbitrage already exists in the current state-based system. Today, insurers have the right in virtually all jurisdictions to change their state of domicile – that is, to move to a different state that would have primary responsibility for the company's financial oversight. We fail to see how adding the option of a strong federal regulator would increase the potential that exists today. Finally, we submit that these dire predictions find no support in the experience of the dual charter bank regulatory system.

Smaller Companies – We have heard it suggested that a federal charter option would be of benefit only to large insurers. While it may be true in the commercial banking world that only the larger banks gravitate toward a federal charter, that would not be the case with respect to life insurers. Many mid-sized and smaller insurers do business nationally or on a regional basis. As a consequence, they must clear all the same hurdles state-by-state as their larger counterparts in terms of getting licensed to do business, getting products approved, getting producers licensed and so on. However, smaller companies do not typically have the same in-house resources (e.g., legal and compliance personnel) as the larger companies to deal with these matters. Additionally, their projected level of sales would be such that it would take them longer to recoup capital expenditures associated with the product approvals and licensure processes. When viewed in this light, it is clear that the optional federal charter is every bit as significant to smaller companies doing business in multiple jurisdictions as it is to larger companies.

State Premium Tax Revenue - Opponents of an optional federal charter have suggested that if such an option were to become a reality, national insurers would, over time, somehow escape the payment of state premium taxes, which constitute a significant source of revenue for all states. This concern is unfounded. As this committee knows better than most, with the exception of Government Sponsored Enterprises, all for-profit federally chartered financial institutions such as commercial banks, savings banks and thrifts pay state income taxes. Insurers' state tax obligations predominantly take the form of a state premium tax. There is no precedent for, nor is there any expectation of, exclusion from this state tax obligation. Indeed, all versions of the optional federal charter legislation introduced to date expressly provide for the continuation of the states' authority to tax national insurers.

Cost – Skeptics of the optional federal charter have asserted that this initiative will result in some huge bureaucracy that will cost taxpayers untold millions. However, the life insurance industry has made clear from the outset that it is asking for a new federal regulator that would be funded exclusively through filing and user fees. Moreover, the industry has recommended that the initial costs of the regulator be covered through a loan that the industry would pay back over time. Those concepts are reflected in the optional federal charter legislation pending in both the Senate and House.

In the same vein, two recent studies indicate that there would be significant cost savings to both companies and agents under an optional federal charter. The first study, conducted by Steven W. Pottier of the University of Georgia, focuses on potential cost savings to life insurers. It finds that life insurance costs could be reduced by an estimated $5.7 billion annually if insurance companies functioned under a single regulator system as opposed to the current system of multiple

regulators. The full text of this study can be accessed here:
http://www.acli.com/NR/rdonlyres/3A7453E3-FDF9-44DC-9A5B-66A41C949F97/9195/PottierPackage3.pdf

The second study, by Dr. Laureen Regan of Temple University, focuses on the cost savings that could be realized by insurance agents under a federal charter option. The study estimates that the savings in producer licensing associated with moving to an optional federal charter from the current system of exclusive state regulation could range from $268 million to $377 million annually. In addition, an optional federal charter would benefit producers by creating uniform requirements for pre-licensing and continuing education. The full text of this study can be accessed here: http://www.acli.com/NR/rdonlyres/EF95BEF6-506D-4D2B-B867-EADC09B42565/10737/OFC_ReganStudyFinal090409.pdf

As Congress has given more serious consideration to the reality of a federal charter option, questions have arisen regarding what a federal insurance regulator would actually look like in terms of budget, staffing and function. In order to provide some helpful perspective on these questions, the ACLI along with the American Insurance Association and the Financial Services Roundtable commissioned a study to analyze what a new Office of National Insurance would look like based on the provisions of S. 40, the National Insurance Act of 2007 introduced in this Congress by Senators Sununu and Johnson. We will share the results of that study with the Committee once it is completed.

Solutions

The ACLI carefully considered various ways to address the issue of regulatory reform, and focused in particular on four possibilities: improving the state-based system; regulating by the state of domicile; establishing federal (national) standards that would be administered by the states; and the creation of a federal charter option. Ultimately, the industry settled on a dual-track approach to regulatory reform under which we continue to work with the states to make a state-based regulatory system operate more efficiently and at the same time push for an optional federal charter. We believe the dual banking system provides an excellent template for a regulatory system that ensures company solvency and consumer protection, promotes efficiency and accommodates the operational needs of a diverse industry. The availability of a federal option would encourage state regulators to be more responsive and would establish a federal insurance regulator as a peer to other financial regulators in the critical Washington arena. For insurance companies doing business on a national basis, the ability to interact with one regulator rather than 56 would dramatically reduce what has increasingly become a logistical and administrative nightmare. In addition, the states' acknowledged lack of authority to address increasingly important international issues, including reinsurance regulation, mutual recognition and convergence with initiatives such as Solvency II point to the wisdom of a federal insurance regulator.

For these reasons, we strongly encourage Congress to move forward with an optional federal insurance charter. We also support the creation of an office of insurance information within the Treasury Department as a means of providing Congress, the Administration and other federal financial regulators with critical information on the insurance industry.

Mr. Chairman, for the benefit of our country, our customers and our industry we urge you to work with us on an expedited basis to put in place an appropriate federal regulatory option.

CFA

Consumer Federation of America

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

TESTIMONY OF

TRAVIS B. PLUNKETT,
LEGISLATIVE DIRECTOR,
CONSUMER FEDERATION OF AMERICA

BEFORE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

REGARDING

THE STATE OF THE INSURANCE INDUSTRY:
EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

JULY 29, 2008

Good morning Chairman Dodd, Ranking Member Shelby and members of the Committee. My name is Travis Plunkett and I am the Legislative Director of the Consumer Federation of America (CFA). Thank you for inviting me here today to discuss the state of the 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. As both an insurance regulator and a consumer advocate, our Director of Insurance, J. Robert Hunter, has been at the forefront of efforts to improve the quality of insurance regulation for Americans for over 40 years.[1]

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 Committee 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 fact, most the regulatory proposals that have been introduced in both houses of Congress to date have been driven by the insurance industry, rather the kind of thorough, balanced review of the successes and failures of the current regulatory scheme that this Committee is conducting.

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

[1] Hunter is a former Federal Insurance Administrator under Presidents Ford and Carter. He also served as Texas Insurance Commissioner. He is also an actuary, a Fellow of the Casualty Actuarial Society, and a member of the American Academy of Actuaries.

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 a system that guts consumer protections in the states and establishes one uniform but weak set of national standards. Next I will identify the most pressing problems that insurance consumers are presently facing that require a regulatory response, including claims practices, overpriced policies and availability concerns.

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 effective regulatory oversight of policy forms -- the type of coverage that is offered, and risk classifications -- how consumers are grouped together for the purpose of charging premiums. I will also address 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.[2] In April, CFA released an exhaustive study of automobile insurance regulation over the last two decades that concluded that insurance rates have risen more slowly in the fifteen states that require insurers to receive advance approval of rate increase from the state. States with "prior approval" regulation also performed well in spurring competition and generating significant profits for insurers.[3]

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.[4]

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

[2] "Why Not the Best? The Most Effective Auto Insurance Regulation in the Nation," Consumer Federation of America, June 6, 2000.
[3] "State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System," April 2008, http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.
[4] 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.

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 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.[5] 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 website of the Editor of *The National Underwriter*:

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 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

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

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' Website 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[6]

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).[7] 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."[8] 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.[9] Other lawsuits have been filed against most of America's leading insurers for the use of these computerized claims settlement products.[10]

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.

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[6] "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.

[7] 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.

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

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

[10] Ibid.

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.[11] "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]."[12]

When McKinsey introduced Allstate to Colossus, "McKinsey already knew how Colossus worked having proved it in the field at USAA."[13] 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."[14]

Our insurance director, J. Robert Hunter, has been a witness in some of the cases against insurers using the Colossus product and is limited in discussing this topic to what is in the public domain. However, 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 shown in the below graph, the trend in payouts is sharply down

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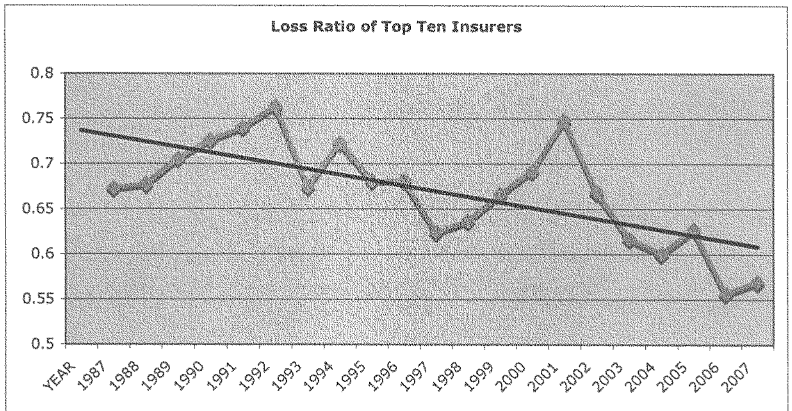
[11] "...Mc Kinsey & Co. has taught Allstate and other insurance companies how to deliver less and less." Berardinelli, Freeman and DeShaw, page 17.
[12] Ibid. Page 57.
[13] Ibid. Page 132.
[14] Ibid.

over the last twenty years, a period during which most state insurance regulators have allowed consumer protections to erode significantly.[15]



It is truly inappropriate for property/casualty insurers to be delivering only about half of their premium back to policyholders as benefits.[16]

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,

[15] CFA tested this drop in benefits related to premiums to see if it could be attributed to a drop in investment income. Within 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, investment income explains only about one-tenth of the drop in benefit payouts to consumers per dollar expended in insurance premiums.

[16] Insurers contend that the loss adjustment expense is a benefit to consumers. Obviously, this is a "benefit" that does not go to the consumer to pay for car repairs and doctor bills, etc. But even the loss and LAE ratio itself is at a record low for many decades, at under 70 percent, as shown in the chart in Addendum A.

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.[17] Regulation exists to limit destructive selection competition that harms consumers and society.

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 have surfaced in recent years 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."

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

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.[18] 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.

<u>Reverse Competition:</u> In certain lines of insurance,[19] 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 -- 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

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

lowering rates. Title insurance is vastly overpriced due to rampant reverse competition in that line of insurance.[20]

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.

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

[20] Testimony of J. Robert Hunter, Director of Insurance, Consumer Federation of America, U.S. House Committee on Financial Services, April 26, 2006, http://www.consumerfed.org/pdfs/Title_Insurance_Testimony042606.pdf.

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.

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.[21]

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.

CFA's insurance director, J. Robert Hunter, is one of the very few people who have served as both a state and federal insurance regulator.[22] His experience demonstrates that either a federal or state system can succeed or fail 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:

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[21] See the discussion of the anti-concurrent causation clause below.

[22] Hunter, was Texas Insurance Commissioner and Federal Insurance Administrator when the Federal Insurance Administration (FIA) was part of HUD and had responsibility for the co-regulation of homeowners insurance in the 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.

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 data 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.

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.[23] 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

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

through the flood insurance program,[24] 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.[25] 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 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.

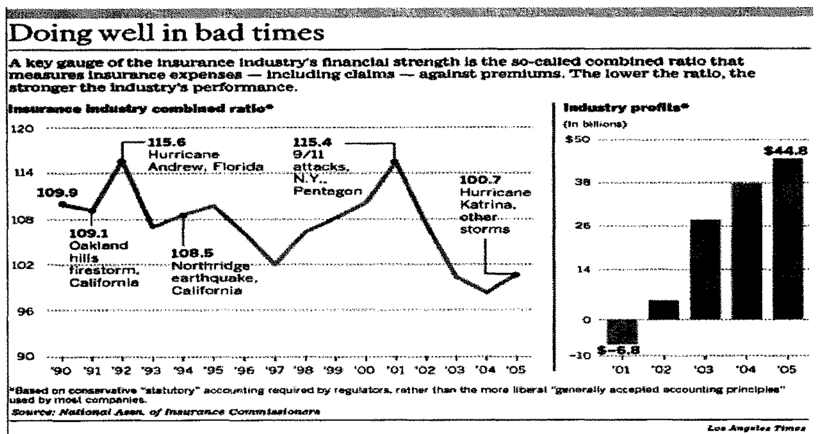
Where Have All the Risk Takers Gone? Unaffordable Home Insurance Covers Less and Less Risk

In 2004, four major hurricanes hit Florida, but the property/casualty insurance industry enjoyed record profits of $40.5 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 $48.8 billion. Below is a chart from a *Los Angeles Times* article on the subject:[26]

[24] 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.

[25] CFA has estimated post-tax profits for the last four years to be an unprecedented $253.1 billion, with insurers earning $40.5 billion in 2004, $48.8 billion in 2005, $67.6 billion in 2006 and $65 billion in 2007. "Property/ Casualty Insurance in 2008: Overpriced Insurance and Underpaid Claims Result in Unjustified Profits, Padded Reserves and Excessive Capitalization," Americans for Insurance Reform, Center for Economic Justice, Center for Insurance Research, Center for Justice and Democracy, Consumer Federation of America, Consumers Union, Empire Justice, Florida Consumer Action Network, Foundation for Taxpayer and Consumer Rights, Neighborhood Economic Development Advocacy Project, New Jersey Citizen Action, Texas Watch, United Policyholders, January 10, 2008, www.consumerfed.org/pdfs/2008Insurance_White_Paper.pdf.

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



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 and near-record profits in 2007, as cited above.

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, 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 Value Line statistics, which assess the riskiness of particular stocks. One key measure is the stock's Beta, which is the sensitivity of a stock's returns to the returns of a particular market index, such as the Standard and Poor's 500 (S&P 500). A Beta between 0 and 1 represents a low-volatility investment, such as most utility stocks. A Beta equal to 1 matches the index, such as the returns yielded by an S&P index fund. A Beta greater than 1 is anything more volatile than average, such as most "small cap" funds.

Another measure of a shareholder's risk is the Financial Safety Index, with a range of 1 to 5, 1 being safest and 5 being least safe; 3 is an average risk.

A third measure is the Stock Price Stability assessment, reported in five percentile intervals with 5 signifying the lowest stability and 100 the highest stability; 50 is average stability.

Value Line posts results for 27 property/casualty insurers.[27] The simple averages for these carriers are: Beta = 0.95, Financial Safety = 2.4, and Stock Price Stability = 83.

By all three measures, property/casualty insurance stocks represent below-average risk, safer than buying an S&P 500 stock index fund. Therefore, long-term below-average returns for insurers should be expected given the low-risk nature of this investment. The fact that, calculated properly, returns for stock insurers are above that of the Fortune 500 is disturbing and is yet another example of excessive insurer profitability. As stated above, these profits have been extraordinary in recent years.

Evidence that investment in insurance companies represents a below-average risk is also found in the market action of the property/casualty insurers stocks. Since June 17, 2002, the date S&P started to track insurance stocks, S&P 500 stocks increased by 60 percent through year-end 2006, while the S&P Insurance Index,[28] weighed down with life insurance stocks, increased only 45 percent. The simple average increase of the property/casualty insurance company stocks in the S&P Insurance Index was 48.0 percent over that period, lower than the S&P 500 mostly because of the impact of AIG, which declined sharply when it was punished for bid rigging and other illegal activities. However, if AIG is removed from the calculation, the rest of the

[27] Value Line, March 23, 2007. The stocks are ACE Ltd., Alleghany Corp., Allstate Corp., American Financial Group, W.R. Berkley Corp., Berkshire Hathaway, Inc., CNA Financial, Chubb Corp., Cincinnati Financial, Erie, 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., RLI Corp., Safeco Corp., St. Paul/Travelers Group, Selective Insurance, Transatlantic Holdings, 21st Century Insurance Group and XL Group, Ltd.

[28] The index is made up of AFLAC, Allstate, AIG, Chubb, Cincinnati, Conseco, Hartford, Jefferson Pilot, Lincoln National, Lowes, MBIA, MetaLife, MGIC Investment Corp, Progressive, Safeco, St. Paul/Travelers, Torchmark and UNUM.

insurance stocks increased by 56.8 percent in value, roughly the same as that the overall S&P 500. This demonstrates that the property/casualty insurance industry overall has done just fine with overall returns on equity that are less than that of the S&P 500. Individual insurers do much better than the S&P averages.[29]

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.

[29] In its "2007 Notice of Annual Meeting/Proxy Statement/2006 Annual Report," Allstate states that Allstate's stock value rose by 115.66 percent through 2006, whereas the stock value of all property/casualty insurers rose by 60.58 percent (indexed to early 2002). During the same period, the Standard & Poor's 500 index increased by 35.43 percent. Further, A. M. Best reports, in its 2007 statistical study, that the total P/C industry had an ROE of 18.9 percent. Consider the top five writers, State Farm 16.4%, AIG 24.5%, Allstate 30.3%, Berkshire Hathaway 24.3% and Travelers 27.1%.

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.[30] 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 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

[30] 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."

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."[31]

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.' "[32]

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,[33] 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,

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

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."

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 homeowner's 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.[34] 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, <u>all</u> 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

[34] 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.

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.[35]

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.

[35] McQuaid, John; Schleifstein, Mark, "Washing Away," *New Orleans Times Picayune.* June 23-27, 2002.

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.

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,[36] 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.[37] And recently, GEICO's use of data about occupation and educational status has garnered the attention of New Jersey legislators.[38] But

[36] 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.

[37] "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.

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

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.[39]

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 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

[39] Testimony of J. Robert Hunter, Director of Insurance, Consumer Federation of America, Subcommittee on Oversight and Investigations of the U.S. House Committee on Financial Services, May 21, 2008.

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.[40] 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

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

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.

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[41] 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.

[41] 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).

- 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 has been reviewing this antitrust exemption. The Chairman and bipartisan members of the Committee have introduced S.618, which would 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.[42]

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

[42] Testimony of J. Robert Hunter, Director of Insurance, Consumer Federation of America, U.S. Senate Judiciary Committee, March 7, 2007, http://judiciary.senate.gov/pdf/03-07-07McCarran-FergusonHearing-HunterTestimony.pdf.

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.[43] 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."[44]

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

[43] Reviews of calls to the Americans for Insurance Reform hotline are available at www.insurance-reform.org.
[44] "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.

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.[45] 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 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

[45] 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.

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.[46] They have been assisted in this effort by a series

[46] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville, which was witnessed by CFA director of Insurance J. Robert Hunter. 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 people refocused." No commissioner challenged Mattera and many commissioners seemed to beg industry representatives 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 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.

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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)."

NAIC Failures to Act

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.

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.[47]

[47] Florida has held hearings on the practice.

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, 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 York, New Jersey, Texas, Louisiana, and New Hampshire have done so in the last few 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.[48] 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

[48] 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 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.

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 was permitted but rate collusion by rating bureaus was allowed, while consumers received 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.

In April, CFA released a detailed, national study of automobile insurance regulation over the last two decades that found that rates have risen more slowly in the fifteen states that require insurers to receive advance approval of rate increases from the state. States with "prior approval" regulation also performed well in spurring competition and generating significant profits for insurers. The top-performing state in keeping rates down and providing comprehensive consumer protections was California. Among the worst-performing states were those with weak or no regulation of rates at all. These states had the steepest rate increases, less competitive markets and among the highest profits for insurers.

The study assessed automobile insurance regulation in all 50 states and the District of Columbia. It examined a number of factors that are important to consumers and insurers, including rate increases from 1989 through 2005, insurer profits from 1997 through 2005, as measured by return on net worth, and the current level of competition.

The chart below shows the results for each of these factors for the six different systems that states use to oversee insurance rates. With the exception of the one state that mandates the rates insurers can charge, the fifteen states that require insurers to receive approval for rate changes before they go into effect had the smallest increase in rates (54 percent) from 1989 through 2005. In fact, column 3 shows that the weaker the regulatory system, the greater the price increase consumers have faced. States with a prior approval regime also had a similar level of competition and slightly lower insurer profits compared to states with different forms of regulation. According to the widely used Herfindahl-Hirshman Index (HHI), states with prior approval rules have insurance markets that are on the border between competitive and moderately concentrated. The states that provided the lowest level of consumer protection used the regulatory system known as "Competition," in which the state has no authority to control rates. These states had sharper rate increases, higher profits and greater market concentration than all other regulatory systems other than the one state that sets prices for insurers.

PRIVATE PASSENGER AUTO INSURANCE

Regulatory System	Number of States Using the System	1989/2005 Change in Expenditure	1997/2005 Return on Net Worth	HHI Index
State Set	1	52.8%	6.4%	1371
Prior Approval	15	54.0%	8.6%	984
File & Use	23	68.1%	9.0%	1016
Use & File	8	70.0%	9.7%	935
Flexible	2	70.8%	7.0%	1292
Competition	2	73.9%	9.6%	1111

<u>State Set</u>: state establishes rates insurers can charge.
<u>Prior Approval</u>: insurers cannot put rate changes into effect without state approval.
<u>File and Use</u>: rate changes can take effect without state approval, but must be filed with the state before use and can be later disapproved.
<u>Use and File</u>: rate changes can go into effect without state approval but must be filed after use and can be later disapproved.
<u>Flexible</u>: rate changes can be filed and used without approval unless they change by more than a particular amount, when filing and approval are required.
<u>Competition</u>: state has no authority to control rates.

California's regulatory system, which was adopted by state residents when they voted for Proposition 103 in 1988, performed well in virtually every category examined by the report, including all of the factors cited above. Two exceptions were insurer profit levels over the longer term (1989 through 2006), which were somewhat high, and a large population of uninsured motorists. The California system's positive results for consumers include the following:

- Generated estimated savings of $61.8 billion for consumers over the sixteen years that Proposition 103 has been in effect;
- First among all states in holding down rate increases (to 12.9 percent);
- Fourth in market competitiveness as measured by the HHI (716);
- The only state to totally repeal its antitrust exemption for automobile insurers;
- The only state to put reasonable limits on expenses passed through to consumers, such as fines and excessive executive salaries;
- Has a very low number of residents participating in higher cost "assigned risk" insurance plans;
- Among the eleven states with the highest ranking from the Insurance Institute for Highway Safety for strong seat belt laws;
- One of only four states that guarantees that good drivers can receive a policy that can be renewed from an insurer of their choosing;
- The only state to require that a person's driving record is the most important factor in determining insurance rates, followed by the number of miles driven and years of driving experience. All other factors used by insurers must have less impact on rates than these criteria;
- One of only three states to ban the use of credit scoring for setting rates or granting coverage;
- The only state to require that insurers offer consumers the lowest price available from all of the companies in the insurer group;
- The only state that funds consumer participation in the ratemaking process if a substantial contribution is made. [49]

[49] "State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System," April 2008, http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

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,*[50] 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:

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[50] See Attachment 1.

- 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.
- 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 in recent years – 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."

Optional Federal Insurance Charter

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.

State Modernization and Regulatory Transformation (SMART) Act

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 have overridden important state consumer protection laws, sanctioned 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.

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.

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. The legislation (H.R. 1065) passed the House of Representatives in 2007 and has been introduced 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. 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 who buy non-admitted insurance.

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 Approach to National Insurance Regulation: The Insurance Consumer Protection Act of 2003

The drafters of this legislation--introduced by Senator Hollings before he retired, considered the consumer perspective in its design. S. 1373 of 2003 would have adopted 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.

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.

The Insurance Information Act of 2008

CFA supports the goals of this legislation, which has been introduced in the House by Representatives Kanjorski and Pryce as H.R. 5840. At a time when losses due to natural catastrophes are increasing, international terrorism is an ever-present threat, and consumers are coping with a diverse array of insurance problems, it is essential that the federal government has an office with insurance expertise to advise the Administration and Congress on pressing domestic and international insurance matters. In fact, from the early 1970s to the early 1980s, the Federal Insurance Administration had a similar mandate.

H.R. 5840 establishes an Office of Insurance Information (OII) within the Department of Treasury that, among other responsibilities, is required to collect and distribute insurance information to the President and Congress, coordinate and establish federal policy on international insurance matters and determine whether state insurance regulation conflicts with federal international insurance policy as expressed in international agreements. Significantly, H.R. 5840 takes steps to ensure that the OII focuses on insurance matters that are important to consumers. For example, the legislation requires that the OII advise the Secretary of the Treasury on insurance issues that affect consumers, as well as insurers. The bill also creates an advisory committee to the Secretary that includes the Federal Trade Commission (FTC). FTC participation on the advisory committee is essential because of the agency's expertise regarding unfair and deceptive acts and practices, and antitrust activities—two problems that have frequently harmed insurance consumers. Many of the problems cited in this testimony would also be worthy of investigation by the OII.

CFA supports the creation of the OII because there is a strong need for a federal office to investigate and advise on insurance matters that adversely affect consumers, as well as issues that would have a serious effect on the economy. Fortunately, there is not a single provision in the bill that would allow the OII to be used for the establishment of an Optional Federal Charter system of insurance regulation.

CFA has two very important recommendations to improve this legislation. First, the provision of information by insurers to the OII should not be strictly voluntary, as it is currently. The OII simply will not be able to function effectively in advising the President and Congress unless it is able to, when necessary, compel insurers to provide information needed to examine crucial national insurance developments. Secondly, the bill should be clear that the OII will not move to preempt state insurance laws unless they directly conflict with international treaties to which the United States has agreed. We are concerned that the bill as drafted could be used to undermine strong state consumer protection laws and rules under the pretense that they undermine international "agreements." As currently written, the bill might allow the OII to attempt to preempt state law merely on the basis of the office's interpretation of low-level agreement on international matters. We strongly recommend that the bill be clarified on this matter.

Expansion of the Liability Risk Retention Act

Legislation to expand the federal Liability Risk Retention Act to include property coverage has been introduced in House by Representatives Moore and Pryce as H.R. 5792. This legislation should help increase access to property coverage and moderate price increases for commercial property insurance, especially in areas of the country where coverage options are limited and during "hard" insurance markets when capacity dries up.

The Product Liability Risk Retention Act of 1981 was developed by Congress as a direct result of the product liability insurance hard market of the mid-1970s. The current version of the Act, the Liability Risk Retention Act (LRRA) of 1986,[51] was passed to expand the Act to all commercial liability coverages as a direct response to the hard market of the mid-1980s. It allowed businesses to join together to form purchasing groups to buy liability insurance as a unit or to form self-insurance combinations by getting approved in only one state.

The expansion of the LRRA helped overcome the problems of the three previous hard markets. Not only would further expansion of the Act to include property coverage enable

[51] 15 USC §3901 et sec.

businesses to get together to cover additional risks, but this option puts pressure on the insurance industry to avoid price gouging or risk losing market share.

Expansion of the RRA to cover property damage could also help companies, especially small and mid-sized firms, to insure against future terrorism losses. Even firms, office buildings and public facilities with high exposure to terrorism risk could benefit. Expansion of the RRA to cover property would offer airlines, for example, the opportunity to spread risk and cover potential terrorism losses from property (e.g., the airplane hull) as well as liability.

H.R. 5792 wisely increases corporate governance requirements for risk retention groups to address abuses documented by the Governmental Accountability Office (GAO), among others. CFA recommends two improvements to these standards to ensure that "independent" group directors truly make independent decisions. First, the bill should significantly reduce the amount of income such a director can receive from a risk retention group.[52] Secondly, H.R. 5792 should increase the "cooling off" period for independent directors who have previously had a material relationship with a group from one to two years.

CFA looks forward to working with this Committee to strengthen consumer protections for insurance, Mr. Chairman. I will be happy to respond to questions at the appropriate time.

[52] H.R. 5792 currently allows an independent director to receive compensation from a risk retention group of up to five percent of the group's gross written premium or two percent of surplus during a one year period.

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 COUNCIL
of INSURANCE
AGENTS & BROKERS

Statement of
George A. Steadman,
President and Chief Operating Officer, Rutherfoord Inc.

On
State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure

Before the
U.S. Senate Committee on Banking, Housing and Urban Affairs

July 29, 2008
Washington, D.C.

Good morning, Chairman Dodd, Ranking Member Shelby and members of the Committee. My name is Shad Steadman. I am the President and Chief Operating Officer of Rutherfoord, Inc., a regional insurance brokerage based in Roanoke, Virginia. Rutherfoord has eight offices stretching from Philadelphia to Atlanta. We employ more than 300 insurance professionals and are the 38th largest U.S. broker as reported this month in Business Insurance magazine. We provide insurance placements and are licensed in all 50 states as well as more than 60 other countries. Thank you for the opportunity to testify before you today on behalf of The Council of Insurance Agents & Brokers (The Council), an organization I currently chair, regarding the current insurance regulatory structure and the need for reform.

The Council represents the nation's leading insurance agencies and brokerage firms, including Rutherfoord. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place more than 80 percent – well over $200 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked to secure innovative solutions and create new market opportunities for its members at home and abroad.

Executive Summary

Insurance regulatory reform, which is critical for the long-term health of our industry, is long overdue. Modernization of the insurance regulatory structure is an important element in maintaining a strong, vibrant insurance sector and is essential to allow the marketplace to evolve in order to address the needs of insurance policyholders in the 21st century. Unfortunately, the current regulatory structure for insurance is simply not equipped to handle an insurance marketplace that today is not just national but international in scope and also is both increasingly complex and sophisticated. My firm serves clients in 50 states and multiple countries – not unlike most of the other member firms of The Council, yet strikingly different from the local mode of operation that existed for many of us 20 – or even 10 – years ago. Like the marketplace, our clients have risks and exposures that transcend state boundaries and are both national and international in scope. The current state regulatory patchwork quilt of regulation not only has not kept up but cannot keep up due to the globalization of the business, and the current regulatory failures have had a very real and detrimental impact on the availability and affordability of coverage for commercial insurance consumers.

The Council is not opposed to regulation. Our members support prudent regulation that benefits consumers, but the current state structure does not get us that. This is why we are a strong supporter of insurance regulatory reform and are working so hard for change.

The Council is very grateful for the work of Senators Johnson and Sununu in drafting The National Insurance Act of 2007, S. 40. We believe the proposal is an excellent framework on which to build a dialogue around the issues of insurance regulatory modernization. We endorse the legislation for many reasons, not the least of which is its purely voluntary nature – voluntary for companies and agents/brokers, as well as consumers. The bill provides real choice for all participants in the insurance marketplace.

The Council has been a strong advocate for optional federal charter legislation for a number of years. We realize, however, that this is a difficult set of issues and debate will take a considerable amount of time. It is a major undertaking with a great number of issues to be resolved. Political reality dictates that it will not be an easy process, nor will it be quick. Meanwhile, however, insurance regulation is in desperate need of reform. In order to better serve our policyholders and clients, we need practical solutions to real marketplace problems. To achieve these goals, we hope the members of this committee will consider proposals in the near term that address fundamental flaws in the state-based system of insurance regulation itself and for which solutions are readily at hand.

Regulation of surplus lines insurance provides a perfect example. More than 25 percent of commercial insurance in the U.S. is placed through the "non-admitted" or "surplus lines" marketplace. Although the purchase of surplus lines insurance is generally considered to be less regulated than the "admitted" marketplace, in reality the regulatory structure governing such coverage is quite burdensome and restrains the availability of coverage. When surplus lines activity is limited to a single state, regulatory compliance issues are minimal because there is a single set of rules that govern the transaction. When activity encompasses multiple states, however, which is the norm in the surplus lines market, full regulatory compliance is difficult, if not impossible because the laws of every state in which an exposure being insured is located may technically apply to the transaction. Thus, the difficulty of complying with the inconsistent and sometimes conflicting requirements of multiple state laws is a real problem. Simply keeping track of all the requirements can be a Herculean task.

Legislation that would clean up this regulatory morass has been approved by the House of Representatives and introduced in this chamber by Sens. Mel Martinez and Bill Nelson of Florida. The Nonadmitted and Reinsurance Reform Act, S. 929 would streamline the regulation of the surplus lines insurance marketplace, primarily dictating that the rules and regulations only of the insured's home state would apply to any multi-state surplus lines transaction. The NRRA is a critical piece of insurance regulatory reform legislation, the adoption of which will have an immediate positive impact on consumers and the insurance marketplace and, equally important, will complement the adoption of the broad-based regulatory reform envisioned by pending OFC legislation. Similar legislation has been adopted twice on the House floor without any opposition.

Importantly, the legislation would not deregulate the non-admitted insurance marketplace or reduce consumer protections. I should note here that all of the major stakeholders are supportive of this legislation – large and small insurers and reinsurers, large and small intermediary firms, and the only organization whose explicit purpose is to represent commercial insurance consumers – the Risk Insurance Management Society. I should also note here that despite our disagreements on broader federal reforms, the National Association of Insurance Commissioners has taken a progressive stance on the surplus lines title of this legislation, and we believe that their suggestions for modest adjustments in the legislative language have merit. On that front, we are grateful for the leadership of NAIC Chairwoman Sandy Praeger of Kansas, Commissioner Jim Donelan of Lousiana (chairman of the NAIC's Surplus Lines Task Force), and Illinois Insurance Director Mike McRaith.

I should also note that there is one necessary technical change to the legislative language of S. 929, one which adjusts the definition of a "sophisticated insurance purchaser" consistent with the language adopted by the House of Representatives in 2007. The authors of the Senate bill, for whom we are greatly indebted, introduced S. 929 as it was House-approved in 2006, before the evolution of this technical but important provision.

Surplus lines regulatory reform will not detract at all from the debate over the OFC, nor is it a substitute for that legislation. But in the meantime, it is an achievable reform of the state-based regulatory system; it is a somewhat uncontroversial reform that even the state insurance regulators support; and its resolution will save millions of dollars for brokers and consumers and, we believe, ultimately increase compliance with state premium tax requirements by resolving the conflicts that make compliance difficult, if not impossible, today. Some of the member firms of The Council have attempted to quantify the costs of regulatory compliance for multi-state surplus lines placements, and the unnecessary bureaucratic burdens add up to the millions – for individual firms. I can assure you that in my regional firm alone, countless hours are spent in the treadmill of trying to reconcile state surplus lines requirements that are unnecessary and even conflicting. Even the state regulators acknowledge this, and also acknowledge that their decades of efforts for reform (specifically, to achieve an interstate compact to govern such multi-state transactions) will not be fulfilled unless this legislation is enacted. We believe this bill offers the committee a political and substantive trifecta – lowering costs to insurance consumers, providing greater access to affordable products, and doing so with little to none of the political controversy that surrounds other federally preemptive insurance legislation. We hope that you will seize this opportunity this year.

In the balance of my testimony, I will first discuss the background of the state insurance regulatory framework that exists today. I will then focus on a broader discussion of several specific problems embedded in that current framework that together undermine competition and efficiency in the U.S. insurance marketplace while at the same time detracting from rather than enhancing consumer protection. I will then close with an overview of four reform measures we champion: surplus lines regulatory reform; "NARAB II" which would establish a national agent/broker licensure regime; the Office of Insurance Information; expansion of the Liability Risk Retention Act, and, finally (and most importantly), the National Insurance Act which would create an option federal insurance chartering regime.

The State of Insurance Regulation

Background

The insurance marketplace has changed and evolved in the millennia since ancient traders devised systems for sharing losses and in the centuries since the Great Fire of London led to the creation of the first fire insurance company. Indeed, insurance has become increasingly sophisticated and complex in the last 60 years, since enactment of the McCarran-Ferguson Act, which preserved a state role in the regulation of insurance.

In the United States, insurance has historically been governed principally at the state, rather than the national, level. This historic approach, codified by McCarran-Ferguson in 1945, made sense when risks and the impact of losses due to those risks was concentrated in relatively small geographic areas and the insurance markets were similarly small. Initially, risks were generally local and losses were most likely to be felt by the local community. Fire, for example, was a major threat not only to individual property-owners, but to entire communities because of the widespread devastation fire can cause. As populations and economies grew, so did the risks, and the impact of losses became more widespread. The pooling of risks has grown ever wider, and more sophisticated as well.

Initially, state regulation of insurance addressed those needs. The primary objective of insurance regulation has always been to monitor and regulate insurer solvency because the most essential consumer protection is ensuring that claims are paid to policyholders. State regulation initially advanced that goal by giving consumers with no direct knowledge of carriers based in other communities comfort that they would be able to – and would – pay claims when they came due. This, in turn, led to increased availability and affordability of coverage because carriers were able to expand their reach, making the insurance marketplace more competitive.

But things have changed. While some risks – and insurance markets – remain local or state-based, in general, insurance has become a national and international marketplace in which risks are widely spread and losses widely felt. The terrorist attack on the World Trade Center and the devastation caused by Hurricane Katrina are, perhaps, two of the most recent notable examples, but many policyholders, particularly in the commercial sector, have risks spread across the country and the globe. 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 compete and thereby reduces availability and affordability.

Continuing Problems under the Current Regulatory System

Although the state insurance regulators, through the NAIC, have attempted to institute regulatory reforms without federal involvement, the reality is that today's marketplace demands far more dramatic action than the states alone are able to provide. The pace of financial services convergence and globalization are far outstripping the pace of reform efforts by state regulators and legislatures. Competition and efficiency in the insurance industry lags behind other financial services sectors due to the regulatory inefficiencies and inconsistencies in the state insurance regulatory system, inefficiencies and inconsistencies that must be addressed if the insurance sector is going to be able to keep up with the pace of change in the rapidly-evolving global marketplace and thereby expand the insurance marketplace for the benefit of insurers, producers and consumers.

The states have made some strides in recent years in 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. Nonetheless, the inconsistent, duplicative and often-times conflicting nature of state-by-state regulation plagues our membership. I would like to focus this portion of my testimony on a couple of specific areas that illustrate some of the failings of the current regulatory system: surplus lines regulatory compliance; agent/broker licensure and regulation; speed-to-market issues; and the Liability Risk Retention Act.

Surplus Lines Regulation: A Hopeless Morass

Surplus lines insurance provides coverage for unique, unusual or very large risks for which insurance is unavailable in the admitted market. A surplus lines product is an insurance product sold by an insurance company that is not admitted to do business in the state in which the risk insured under the policy is located. In essence, the insured goes to wherever the insurance company is located to purchase the coverage. The insurer may be in another state, or it may be in Great Britain, Bermuda or elsewhere. Potential insureds can procure this insurance directly, but they generally do so through their insurance brokers. In short, "surplus lines" are: (1) insurance products sold by insurance carriers that are not admitted (or licensed) to do business in a state, (2) to sophisticated commercial policyholders located in that state, (3) for insurance coverages that are not available from insurers admitted (or licensed) to do business in that state. Surplus lines products tend to be more efficient and a better fit for commercial coverages because they can be tailored to the specific risk profiles of insured with specialized needs.

Surplus lines insurance is universally recognized as an important component of the commercial property and casualty insurance marketplace in all states, and commercial property and casualty business is done increasingly through the surplus lines marketplace.

Although the purchase of surplus lines insurance is legal in all states, the regulatory structure governing such coverage on a multi-state basis is a morass. For example: Maryland and the District of Columbia require a monthly "declaration" of surplus lines business placed, but only require payment of premium taxes on a semi-annual basis; Virginia, in contrast, requires that a declaration be filed and taxes be paid quarterly; New Jersey has 36 pages of instructions for surplus lines filings, including a page discussing how to number the filings and a warning not to file a page out of sequence because that would cause a rejection of the filing and could result in a late filing.

As a general matter, state surplus lines regulation falls into five categories: (i) taxation; (ii) declinations; (iii) insurer eligibility; (iv) regulatory filings; and (v) producer licensing and related issues.

Taxes: States have inconsistent and sometimes conflicting approaches regarding the allocation of premium taxes, which can lead to double taxation and confusion when a surplus lines policy involves multi-state risks.

- Single situs approach – 100 percent of the premium tax is paid to the insured's state of domicile or headquarter state. This approach is imposed by some states regardless of what percentage of the premium is associated with risks insured in the state. Virginia, for example, utilizes this rule.

- Multi-state approach – Premium tax is paid to multiple states utilizing some method of allocation and apportionment based upon the location of the risk(s). Because there is no coordination among the states on allocation and apportionment, determination of the amount of tax owed to each state is left to brokers and insureds. If a policy covers property insured in a single situs state and in an apportionment state, double taxation also is unavoidable. A majority of the states utilize this basic rule but the manner in which it is implemented (including the allocation formula) can vary wildly.

- No clear requirement – More than a dozen states that impose surplus lines premium taxes do not have statutory or regulatory provisions indicating the state's tax allocation method, leaving it up to the insured and the insured's broker to determine how to comply with the state law. In such states, determination as to whether any tax should be paid and whether the allocation of any such tax is permissible and appropriate is often based on informal guidance from state insurance department staff.

In addition to the near-impossibility of determining the correct allocation for surplus lines premium tax in a way that does not risk paying too much or too little tax, the differences among the states with respect to tax rates, tax exemptions, taxing authorities, and the timing of tax payments impose huge burdens on surplus lines brokers (who are responsible for paying the taxes if they are involved in the placement) and on commercial consumers, who must navigate these requirements on their own for placements that do not involve a broker and who ultimately bear the costs of not only the tax but the administrative costs of compliance in any event.

For example, state surplus lines premium tax rates range from about 1 percent to 6 percent. In one state, surplus lines taxes are levied not at the state level but at the municipality level. A member of The Council reports that in order to properly rate taxes in that jurisdiction, it must use electronic maps to determine the city and county in which a risk is located. There are hundreds of cities and counties in the state. Some counties charge a tax in lieu of the city tax, some charge it in addition to the city tax, some charge the difference between the city and county taxes, and some do not charge a city or county tax at all.

The due dates for premium taxes vary even more widely across the states. Surplus lines premium taxes are due:

- annually on a date certain in some states; the dates vary but include: January 1, January 31, February 15, March 1, March 15, April 1 and April 16;
- semi-annually in some states. Again, the dates vary but include: February 1 and August 1, February 15 and August 15, and March 1 and September 1;
- quarterly in some states (generally coinciding with the standard fiscal quarters);
- monthly in some states; and
- 60 days after the transaction in some states.

The states also differ with respect to what is subject to the tax, what is exempt from the tax, whether governmental entities are taxed, and whether brokers' fees are taxed as part of or separately from the premium tax (if they are taxed at all). As you can see, determining the proper surplus lines tax payment for the placement of a multi-state policy is a daunting task.

Declinations: Most states require that an attempt be made to place coverage with an admitted insurer before turning to the surplus lines market. Some states specifically require that one or more licensed insurers decline coverage of a risk before the risk can be placed in the surplus lines market. If it is determined that a portion of the risk is available in the admitted market, many states require that the admitted market be used for that portion of the risk.

State declination requirements are inconsistent and conflicting, and the methods of proving declinations vary tremendously, from specific requirements of signed affidavits to vague demonstrations of "diligent efforts." For example, Ohio requires five declinations, but does not require the filing of proof of the declinations. New Mexico requires four declinations and submission to the insurance department of a signed, sworn affidavit. Hawaii does not require declinations but prohibits placement of coverage in the surplus lines market if coverage is available in the admitted market. Further, Hawaii does not require filing of diligent search results but requires brokers to make such information available to inspection without notice by the state insurance regulator. In California, prima facie evidence of a diligent search is established if an affidavit says that three admitted insurers that write the particular line of insurance declined the risk. In Alabama, the requirement is much more vague. The broker is required only to demonstrate "a diligent effort" but no guidance is provided suggesting what constitutes such an effort. In Connecticut, the broker must prove that only the excess over the amount procurable from authorized insurers was placed in the surplus lines market.

Insurer Eligibility: Most states require that a surplus lines insurer be deemed "eligible" by meeting certain financial criteria or having been designated as "eligible" on a state-maintained list. Although a majority of the states maintain eligibility lists (also called "white lists"), in many of the remaining states the surplus lines broker is held responsible for determining if the non-admitted insurer meets the state's eligibility criteria. In addition, although the NAIC maintains a list of eligible alien (non-U.S.) surplus lines insurers that is used by four states, this does not seem to have any bearing on the uniformity of the eligible lists in the remaining states. As one would expect, as a result of differing eligibility criteria from state to state – and changes in individual states from year to year – the insurers eligible to provide surplus lines coverage vary from state to state. This can make it exceedingly difficult to locate a surplus lines insurer that is "eligible" in all states where a multi-state policy is sought.

The flip side of insurer eligibility is also an issue: that is, when multi-state surplus lines coverage is placed with an insurer that is an admitted insurer (not surplus lines) licensed in one of the states in which part of the risk is located. This is problematic because surplus lines insurance cannot be placed with a licensed insurer. In these situations, more than one policy will have to be used, or the insured will have to use a different surplus lines carrier – one that is not admitted, but "eligible" in all states in which the covered risks are located.

Filings: Most states require one or more filings to be made with the state insurance department in connection with surplus lines placements. These may include filings of surplus lines insurer annual statements, filings regarding diligent searches/declinations, filings detailing surplus lines transactions, and filings of actual policies and other informational materials. Some states that do not require the filing of supporting documentation require brokers to maintain such information and make it available for inspection by the regulator.

Like other surplus lines requirements, state filing rules vary widely. Some states require signed, sworn affidavits detailing diligent search compliance; some require such affidavits to be on legal sized paper, others do not; some states require electronic filings, others require paper; some states have specific forms that must be used, others do not; some states require the filing of supporting documentation, some do not – although some of those states place the burden on the broker, who is required to store the information in case regulatory inspection is required.

Depending on the state in question, filings can be required annually, quarterly, monthly or a combination thereof. For example, several states require the filing of surplus lines information in the month following the transaction in question: Colorado requires such filings by the 15th of the month; and the District of Columbia by the 10th. Other states peg the filing date to the date of the transaction or the effective date of the policy: Florida requires filing within 21 days of a transaction; Idaho within 30 days; Kansas within 120 days; Missouri requires filing within 30 days from the policy effective date and New York 15 days from the effective date; Illinois and Michigan require semi-annual filings of surplus lines transactions. Although Illinois does not require filing of affidavits, carriers must maintain records of at least three declinations from admitted companies for each risk placed in the surplus lines market. Some states have different deadlines for different filings. Louisiana, for example, requires quarterly filings of reports of all surplus lines business transacted, and "diligent search" affidavits within 30 days of policy placement. North Dakota, in contrast, requires a single annual filing of all surplus lines transactions, and allows 60 days for the filing of "diligent search" affidavits.

In addition, some states treat "incidental exposures" – generally relatively small surplus lines coverages – differently from more substantial coverages with respect to filing requirements. States have differing definitions of what constitutes incidental exposures and who has to make required filings for such an exposure: some states require the broker to make the filings; others the insured; and some require no filings at all for incidental exposures.

Producer Licensing and Related Issues: In addition to the substantial issues outlined above, there are other vexing regulatory issues facing the surplus lines marketplace:

- Producer Licensing: All states require resident and non-resident surplus lines producers to be licensed, and all states have reciprocal processes in place for non-resident licensure. Nevertheless, there remain significant differences among some states with respect to producer licensing that can delay the licensure process, particularly for non-residents. For example, most states require that an individual applying for a surplus lines broker license be a licensed property and casualty producer. The states vary, however, as to how long the applicant must have held the underlying producer license. In addition, some, but not all, states exempt from licensure producers placing multi-state coverage where part of the risk is located in the insured's home state. In states without such an exemption, the laws require a producer to be licensed even for such incidental risks.

- Sophisticated Commercial Policyholders: Some states exempt "industrial insureds" from the diligent search, disclosure, and/or filing requirements. The definition varies among the states, but generally industrial insureds are analogous to the concept of sophisticated commercial insureds. They are required to have a full time risk manager, minimum premium requirements for selected lines of coverage, and a minimum number of employees. If an insured meets a state's criteria, the insured's surplus lines transaction is exempt from the surplus lines requirements, as provided for by the state.

- Automatic Export: A number of states allow certain risks to be placed directly in the surplus lines market. This is called "automatic export" because no diligent search is required before the risk is exported from the admitted market to the surplus lines market. As with every other surplus lines requirement, however, the states are not uniform in their designation of the risks eligible for automatic export.

- Courtesy Filings: A courtesy filing is the payment of surplus lines tax in a state by a surplus lines broker who was not involved in the original procurement of the policy. Courtesy filings are helpful when a broker places a multistate filing that covers an incidental risk in a state in which the broker is not licensed. The problem is that most states either prohibit courtesy filings or are silent as to whether they will be accepted. This uncertainty essentially requires surplus lines producers to be licensed even in states where they would otherwise be exempt.

Producer Licensure: Welcome Improvements, but Incomplete Reform

The concrete progress that the states have been able to make in their regulatory reform efforts has primarily been in the producer licensing area – thanks to the enactment of the NARAB provisions included in the Gramm-Leach-Bliley Act (GLBA). NARAB-compliance notwithstanding, there remain several problem areas in the interstate licensing process that impose unnecessary costs on our members in terms of both time and money. Our trade association formed its first task force to work on non-resident agent/broker licensing reforms more than 70 years ago. We believe that these problems will be resolved under the provisions of the proposed National Insurance Act legislation, which would give producers a choice as to whether to stay state-based or secure a federal license to sell insurance products. Consistent with our unrelenting support for necessary reform, we likewise are supportive of the incremental reform bill (recently approved by the House Financial Services Committee's Capital Markets and Insurance Subcommittee) commonly called "NARAB II," which would create an interstate producer licensing clearinghouse.

The NARAB provisions included in GLBA required that at least 29 states enact either uniform agent and broker licensure laws or reciprocal laws permitting an agent or broker licensed in one state to be licensed in all other reciprocal states simply by demonstrating proof of licensure and submitting the requisite licensing fee.

After enactment of GLBA, the NAIC pledged not only to reach reciprocity, but ultimately to establish uniformity in producer licensing. The regulators amended the NAIC Producer Licensing Model Act (PLMA) to meet the NARAB reciprocity provisions, and their goal is to get the PLMA enacted in all licensing jurisdictions. As of today, nearly all the states have enacted some sort of licensing reform, and the NAIC has officially certified that a majority of states have met the NARAB reciprocity requirements, thereby averting creation of NARAB. This is a good effort, but problems remain; there is still much work to be done to reach true reciprocity and uniformity in all licensing jurisdictions.

Most states retain a variety of individual requirements for licensing, and they all differ with respect to fees, fingerprinting and certifications, among other requirements. Although most of the states have enacted the entire PLMA, a number of states have enacted only the reciprocity portions of the model. Of the states that have enacted the entire PLMA, several have deviated significantly from the model's original language. One state has enacted licensing reform that in no way resembles the PLMA. And two of the largest states in terms of insurance premiums written, Florida and California, have not enacted legislation designed to meet the NARAB reciprocity threshold at all.

The inefficiencies and inconsistencies that remain in producer licensing affect every insurer, every producer and every insurance consumer. Many Council member firms continue to hold hundreds of resident and non-resident licenses across the country. One of the larger members of The Council holds almost 50,000 resident and non-resident licenses for 5,400 individual producers, and approximately 3,400 resident and non-resident entity licenses for itself and its subsidiaries/affiliates. My firm and our individual producers hold a total of thousands of licenses and I hold several hundred, and we employ staff members whose jobs are dedicated to licensing compliance that has little to nothing to do with standards of professionalism. This is not a "once and done" deal – state licenses, by and large, must be renewed annually throughout the year, based upon the individual requirements in each state, and there are continuing regulatory requirements and post-licensure oversight that must be attended to, as well. As you can imagine, this requires significant monetary and human resources from each and every producer. This is especially frustrating because, let's face it, the incremental consumer protection value of the tenth or hundredth or thousandth or 50,000th license is questionable, at best.

In addition to the lack of full reciprocity in licensing procedures for non-residents, the standards by which the states measure compliance with licensing requirements differ from state to state, as well. These include substantive requirements – pre-licensing education, continuing education and criminal background checks, for example – as well as administrative procedures such as agent appointment procedures and license tenure and renewal dates.

It also applies to interpretation and application of statutory language. For example, as I have mentioned, most of the states have enacted new producer licensing laws based in whole or part on the NAIC's Producer License Model Act, which was adopted by that organization in 2000. Yet eight years later, the regulators still cannot agree on the meaning of basic – yet critical – terms that are present in every state law, such as what it means to "sell," "solicit" and "negotiate" insurance. Nor can they agree on the meaning of other critical provisions of the law – even when the language in their individual state provisions are identical – word for word. While these may seem like small issues – and individually they may be – taken as a whole, they are significant. It is a bit like Senator Dirksen's take on congressional about spending, but instead of "a billion here and a billion there," we are talking about a regulation here and a rule there.

In addition to the day-to-day difficulties the current regulatory regime imposes, this inconsistent application of law among the states inhibits efforts to reach full reciprocity in producer licensing. As I have mentioned, several states have failed to adopt GLBA-compliant reciprocal licensing regimes, including California and Florida. These states, in large part, are disinclined to license as a non-resident a producer whose home state (they believe) has "inferior" licensing standards to their own, even a state with similar or identical statutory language. Thus, they are not reciprocal because they do not trust their fellow states to sufficiently regulate producers. This strikes us as indefensible – regulators defending the system of state regulation of insurance while essentially admitting that consumers in some states benefit from stronger oversight than others.

A third major area in need of streamlining is the processing of license applications. Although a uniform electronic producer licensing application is now available for use in many states – arguably, the biggest improvement in years – several states, including Florida, do not use the common form, and even in states that use the form, there is no common response mechanism. Each state follows up on an application individually, which can be cumbersome and confusing.

More problematic is the fact that every state requires the filing of "additional information" if an applicant responds affirmatively to certain background or other questions on an application. Council members have no objection to the regulators looking into the background of a producer applicant and asking for explanatory information if, for example, a producer has had regulatory or legal issues in the past. We hold ourselves to the highest standards and think the regulators should, as well. Our objection is with the repetitiveness and burdensome nature of the process. The additional information that must be submitted with an application generally must be submitted in paper form (or fax) – it cannot be submitted electronically. Thus, the technological benefit of the uniform electronic application is nullified.

Undeniably, progress in streamlining the producer licensing process has been made since GLBA's NARAB provisions were enacted in 1999, and the National Insurance Producer Registry (NIPR) is working diligently to overcome the burdens of the various state "business rules" and additional filing requirements. It is clear, however, that despite the revolutionary NARAB achievements, comprehensive reciprocity and uniformity in producer licensing laws remains elusive, and it does not appear the NAIC and the states are capable of fully satisfying those goals.

As we learned with GLBA and other federal legislation, when Congress acts, the NAIC and states listen. So movement on legislation in Washington will put pressure on the states to step up their own regulatory reform activity in an effort to stave off federal intervention. We are already seeing evidence of this at the NAIC, where, in the last year, regulators have jump-started producer licensing reform efforts, and even constructively engaged with members of the House Financial Services Committee on proposed NARAB II legislation. We fully support their efforts and are working with the regulators to achieve results at both the state and federal levels.

Another important producer issue today is transparency in compensation. In today's marketplace, it is imperative that insurance intermediaries be transparent in their business dealings with their clients, and we believe there should be uniform disclosure rules and regulations. The problem is that it is virtually impossible to satisfy the differing requirements of the states with a uniform compliance approach. Some states, for example, fully allow the simultaneous receipt of both fees and commissions with disclosure. Other states allow the simultaneous receipt of a commission and a fee for non-placement related services provided that the client is made aware of this and affirmatively agrees to it. Still other states, however, impose a variety of differing limitations, some prohibiting the collection of fees altogether – even in lieu of commissions – on the theory that this may jeopardize their premium tax revenue base.

For clients with exposures across the nation and their brokers who are endeavoring to serve them efficiently and economically, the differing and conflicting rules and requirements and the inflexibility of their application in some states serves no apparent consumer protection purpose. Moreover, it is at odds with the scope of the activities of the consumers these states are attempting to protect.

Speed-to-Market Remains a Critical Problem

The state-by-state system of insurance regulation also gives rise to problems for the carriers that directly impacts the availability of coverage for our clients. Although these problems appear to affect insurance companies more than insurance producers, the unnecessary restraints imposed by the state-by-state regulatory system on insurers ultimately inure to the detriment of our clients and thus harm producers as much as companies because they negatively affect the availability and affordability of insurance, and, thus, our ability to place coverage for our clients.

Most Council members sell and service primarily commercial property/casualty insurance. While current market conditions are soft, there have been many challenges in recent years, ranging from losses as a result of the September 11 terrorist attacks; increased liability expenses for asbestos, toxic mold, D&O liability and medical malpractice; and years of poor investment returns and negative underwriting results. When product availability is challenged, the current state-by-state system of insurance regulation exacerbates the problems.

The current U.S. system of regulation can be characterized as a prescriptive system that generally imposes a comprehensive set of prior constraints and conditions on all aspects of the business operations of regulated entities. Examples of these requirements include prior approval or filing of rates and policy forms. Although the prescriptive approach is designed 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. This approach also encourages more regulation than may be necessary in some areas, while diverting precious resources from other areas that may need more regulatory attention.

It is also important to note that insurers wishing to do business on a national basis must deal with 55 sets of these prescriptive requirements. This tends to lead to duplicative requirements among the jurisdictions, and excessive and inefficient regulation in these areas. Perhaps the best (or worst, depending upon your perspective) example of this are the policy form and rate pre-approval requirements still in use in many states. Over a dozen states have completely deregulated the commercial insurance marketplace for rates and forms, meaning that there are no substantive regulatory approval requirements in these areas at all. Other states, however, continue to maintain pre-approval requirements, significantly impeding the ability of insurers to get products to market. Indeed, some studies have shown that it can take as much as two years for a new product to be approved for sale on a nationwide basis. Banking and securities firms, in contrast, can get a new product into the national marketplace in 30 days or less. The lag time for the introduction of new insurance products is unacceptable. It is increasingly putting the insurance industry at a competitive disadvantage as well as undermining the ability of insurance consumers to access products that they want and need.

Let me give you an example that Council members are familiar with: a few years ago, PAR, an errors and omissions captive insurer sponsored by The Council, sought to revise its coverage form. In most states, PAR was broadening coverage, although in a few cases, more limited coverage was sought. PAR had to re-file the coverage form in 35 States where PAR wrote coverage for 65 insureds. After two years and $175,000, all 35 states approved the filing. Two years and $5,000 per filing for a straightforward form revision for 65 sophisticated policyholders is unacceptable and is symptomatic of the problems caused by outdated rate and form controls.

We support deregulation of rates and forms for commercial lines of insurance. There is simply no need for such government paternalism. Commercial insureds are capable of watching out for their own interests, and a robust free market has proved to be the best price control available. The proposed National Insurance Act contemplates this approach by restricting the federal regulator's authority to dictate rates or the determination of rates.

Despite recent improvements, the states clearly cannot solve the problems with insurance regulation on their own, so congressional action is necessary if insurance regulatory reform is to become a reality.

Although the state insurance regulators, through the NAIC, have attempted to institute regulatory reforms without federal involvement, the reality is that today's marketplace demands 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. It is a national and international marketplace, the development of which is far outstripping the pace of reform efforts by state regulators and legislatures. The state regulatory system is simply not equipped to handle this increasingly complex and sophisticated marketplace and state boundaries no longer match our clients' national and international business models. Competition and efficiency in the insurance industry lag behind other financial services sectors due to the regulatory inefficiencies and inconsistencies in the state insurance regulatory system. These inefficiencies and inconsistencies must be addressed if the insurance sector is going to be able to keep up with the pace of change in the rapidly evolving global marketplace and thereby provide adequate and affordable coverage to insurance consumers.

In an effort to get better leverage on the reform options, the Council wanted to see a full, economic analysis of the alternatives for reform. To that end, The Council's Foundation for Agency Management Excellence (FAME) commissioned an independent study of the economic costs and benefits of the various proposals. Our study, entitled "Costs and Benefits of Future Regulatory Options for the U.S. Insurance Industry," provides an in-depth examination of the pros and cons of the regulatory options available for oversight of the business of insurance. A copy of the study is attached to my testimony. I hope it will serve as a useful tool as you consider insurance regulatory reforms.

The FAME study reinforced The Council's long-standing belief that it is critical to the long-term viability of the U.S. insurance industry that regulatory relief is needed, and it is needed now. Broad reforms to the insurance regulatory system are necessary to allow the industry to operate more efficiently, to enable the insurance industry to compete in the larger financial services industry and internationally, and to provide consumers with a strong, competitive insurance market that brings them the best product at the lowest cost.

What we are advocating is fixing the current regulatory system to allow insurance companies and producers to have a choice between state and federal oversight. Many insurers and producers will likely choose to remain within the state system because it works best based on the size of their business and their customer base. For the same reasons, others will choose the federal option. For this latter group, jettisoning the current multi-state system for a single federal regulator makes eminent good sense, allowing them to avoid the overlapping, burdensome dictates of 55 jurisdictions for a single regulator and thereby easing regulatory burdens – and doing so without sacrificing consumer protections. We believe the long-term effects of such reform on the marketplace will ultimately benefit the consumer by increasing capacity and improving availability of coverage.

Studies have shown that the regulatory modernization efforts attempted by the NAIC in the past several years have been the direct result of major external threats – either the threat of federal intervention, or the wholesale dislocation of regulated markets. It follows that there is no guarantee the state-based system will adopt further meaningful reforms without continued external threats to the states' jurisdiction. Too much protectionism and parochialism interferes with the marketplace, and the incentive for reform in individual states simply does not exist without a federal threat. Thus, congressional involvement in insurance regulatory reform is entirely in order and, in fact, overdue. Broad reforms to the insurance regulatory system are necessary to allow the industry to operate more efficiently, to enable the insurance industry to compete in the larger financial services industry and internationally, and to provide consumers with a strong, competitive insurance market that brings them the best product at the lowest cost.

Surplus Lines Regulatory Reform: The Nonadmitted and Reinsurance Reform Act, S. 929.

Sens. Mel Martinez and Bill Nelson of Florida have introduced a bill that would reform the regulation of the surplus lines market place primarily by dictating that the regulatory requirements only of the policyholder's home state would apply to any surplus lines placement. Although there are a few other bells and whistles included in the legislation, the fundamental reform would dictate that only a single set of state regulatory requirements would apply to any single surplus lines transaction. This simple reform would transform the marketplace, and is supported by all stakeholders – including the state insurance regulators themselves who believe that this type of reform is long overdue and that it can come only through Congressional intervention.

NARAB II – Fixing Agent/Broker Licensure

Legislation has been introduced in the House that would take the NARAB structure outlined in GLBA and make it into a national clearinghouse for agents and brokers that would like to use the mechanism to obtain non-resident licenses in other states. The legislation would establish a regime under which an agent/broker licensed in his, her or its home state could – upon satisfaction of the NARAB eligibility requirements which would be required to be based on the highest licensure requirements applicable in the states and which would be required to include a criminal background check – become a NARAB member and then be automatically licensed in any non-resident state upon the payment of the appropriate licensure fee. NARAB would only have a role in licensure; a state's post licensure market-conduct (include consumer unfair trade practices) requirements and prohibitions and a state's post-licensure administrative enforcement policies and procedures would continue to apply in full to NARAB members.

The Council believes that NARAB II type reforms of the state system make sense for all stakeholders and will better allow agents/brokers to better focus their attention where it should be focused – on serving their clients' needs.

An Office of Insurance Information -- Step in Right Direction

Earlier this year, the Treasury Department recommended a three-tiered, long-term approach toward radically reforming the way that insurance is regulated: first, establishment of an office within Treasury that would be a credible source of information and expertise on insurance matters, with U.S. policy on international insurance matters guided by that expertise; second, the enactment of an Optional Federal Charter; and third, movement toward an "activities-based functional system" regulating the activities of financial services firms as opposed to individual industry segments.

With respect to the first goal, legislation has been initiated in the House of Representatives that would create an Office of Insurance Information. The Office would collect data on insurance, analyze the data, and issue reports to Congress. It also would establish federal policy on international insurance matters and ensure that state insurance laws are consistent with agreements between the U.S. and a foreign jurisdiction. The Treasury Department would have a limited ability to preempt a state insurance measure that is inconsistent with an agreement regarding such policies.

The Council supports such legislation and believes that in an increasingly global world, it is essential to have a single office housed in the federal government that is capable of articulating a global policy on matters of insurance.

Changes to the Liability Risk Retention Act

During periods of hard commercial markets, insureds – particularly sophisticated commercial clients – are increasingly drawn to the appeal of alternatives to the traditional, regulated marketplace to expand their coverage options and hold down costs. Aside from surplus lines, there is an excellent mechanism that offers such an alternative: risk retention groups, created under provisions of the federal Liability Risk Retention Act. Although insurance purchased through risk retention groups technically is less regulated than insurance in the admitted market, the law currently prevents this marketplace from fully realizing its potential. Specifically, we would urge the committee to consider approving legislation that would enhance corporate governance standards for risk retention groups (as suggested by the Government Accountability Office), in addition to allowing such groups to underwrite property coverage. The House Capital Markets and Insurance Subcommittee recently approved a bipartisan bill to achieve these changes, with support from a diverse collection of organizations, including consumer groups, housing authorities, policyholders and insurance companies.

The Optional Federal Charter

The Council believes the ultimate, long-term insurance regulatory solution is enactment of legislation creating an optional federal insurance charter as contemplated in the National Insurance Act. An OFC regime would enhance the surplus lines reforms and support their further extension through the commercial marketplace. An optional federal charter also would give insurers and producers the choice between a single federal regulator and multiple state regulators. It would not dismantle the state system, rather it would 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 very likely opt for a federal charter, thereby relieving themselves of the burden of compliance with 55 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:

- ***The National Insurance Act creates a truly optional insurance regulatory system for all industry players.*** The structure it creates gives insurance companies and producers a real choice as to whether they want 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.

- ***The Act 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 producers that choose a national license is that they would be subject to a 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 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.

- ***Consumers' product choices will expand.*** A single federal regulator for national insurers will give insurance consumers expanded product choices. By offering an alternative to the multiple state regulatory that insurers must now jump through, the federal charter will enable insurers to get products to market in a more streamlined fashion. This will enable them to address consumers' needs more quickly and more specifically with products tailored to consumer needs.

- ***The Act bolsters rather than diminishes current protections for insurance consumers.*** At present, insurance consumer protections are uneven from state to state. Some states have a robust system of consumer protection, while others devote fewer resources to it. Under the Act, consumers purchasing products from national insurers would have the same protections and rights whether they live in Los Angeles, Topeka or Providence. Importantly, their rights under a policy would not change simply because they move across the Potomac from Washington to Alexandria.

- ***The consumer protections in the Act are stronger than those in many states and provide protections that are simply unavailable in many states.*** For example, the Act requires every insurer to undergo both a financial and a market conduct examination at least once every three years. In addition, the Act provides for the creation of a Division of Fraud, Division of Consumer Affairs, and an Office of the Ombudsman to protect consumers. The Act makes the commission of a "fraudulent insurance act" a federal crime and subjects National Insurers to federal antitrust laws.

- ***The Act provides for comprehensive, rigorous oversight of insurers and insurance producers that protects producers in case of insolvency and is comparable to the best practices currently in place in the states.*** In addition to traditional consumer protections, the Act protects insurance consumers in another essential way: federally-chartered insurers will be subject to the financial solvency oversight of a federal regulator with the resources and staff to adequately supervise large corporations that may be beyond the capability of the states. The Act provides for financial and market conduct examinations every three years, allows for self-regulatory organizations to be created to police the industry, ensures that sufficient resources and federal attention will be devoted to insurance oversight, and does not eliminate or reduce in any way the ability or effectiveness of state insurance regulation. In addition, the Act leaves the state guaranty system intact to ensure policyholders are protected in case of insurer insolvency. The Act sets stringent standards that state funds must meet in order to secure national insurer participation. A national guaranty fund is established to protect policyholders in states where the guaranty fund falls short of the national standards.

Conclusion

Again, The Council greatly appreciates this opportunity to participate in this debate. We know that you, Chairman Dodd, and Senator Shelby, have been enormously effective in working together to produce good insurance legislation, such as your Federal Flood Insurance reauthorization legislation, as well as the extraordinary enactment (and revisions) of the Terrorism Risk Insurance Act. The Council has strongly supported an Optional Federal Charter, such as the one envisioned by the National Insurance Act, for decades. We look forward to being a constructive voice in this debate.

Despite its ambitious reform agenda, the NAIC is not in a position to force dissenting states to adhere to any standards it sets. Moreover, in many ways the business of insurance – and the consumers that business needs to serve – have moved beyond artificial state boundaries and it is long past time that the regulation of that business move beyond those artificial boundaries as well.

Obviously, we implore the Committee to seize the opportunity to enact the Nonadmitted and Reinsurance Reform Act this year, due to the extraordinary consensus that has emerged around its basic tenants. And looking toward next year, we believe that the Optional Federal Charter is the ultimate solution to the many competitiveness issues that impact our industry. We look forward to these critical debates. Again, thank you.

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Costs & Benefits of Future Regulatory Options for the U.S. Insurance Industry

An Analytical Framework

Prepared for the Foundation for Agency Management Excellence by
Georgetown Economic Services, LLC and Adam K. Lee (Independent Consultant)

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PROMOTING LEADERSHIP AND EXCELLENCE THROUGH MANAGEMENT EDUCATION, RESEARCH AND TRAINING.

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Established in 1993, FAME was created to achieve the following goals:

- To encourage high standards of excellence and leadership;
- To prepare young managers to meet the leadership challenges of the future; and
- To study management issues and develop a body of research, ensuring that agents and brokers stay on the cutting edge of technology and productivity issues throughout the industry.

FAME is administered by The Council of Insurance Agents + Brokers, located in Washington, DC, USA. FAME is guided by a volunteer board of directors and is a 501(c)(3) charitable and educational organization.

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Published by THE COUNCIL of Insurance Agents + Brokers

FOREWORD

We would like to express our appreciation to the Foundation for Agency Management Excellence for their patience in providing us with 12 months to complete this study. The time frame allowed us to review thousands of pages of material from dozens of different sources in preparation of this report.

In undertaking this study, we expressly avoided any attempt to find a particular position along the continuum of different ideas and approaches that have been put proposed to date. Instead, we adopted the role of impartial examiner. While we reached certain preliminary and generalized conclusions, we have stopped short of recommending an idealized regulatory structure. Instead, the study is intended to help frame or focus the debate, rather than settle it.

The landscape was considerably different just one year ago when we began the study. There was a talk of an extended hard market in property-casualty lines and uncertainty whether a sufficient number of states would adopt NARAB reciprocity requirements. There was less pressure on state budgets, and hopes that the Gramm-Leach-Bliley Act might better clarify regulatory jurisdictions between federal bank and state insurance regulators. Enron Corporation's market value was nearly $50 billion.

And, most significantly of course, terrorist attacks were not a primary concern. In that connection, we extend our deep condolences to all of those in the industry who were impacted so directly by this tragedy. Even as the industry was coping with its own disproportionate toll, it provided an invaluable stabilizing influence that helped restore confidence that such challenges could be overcome. This is a worthy achievement for which the industry should be given tremendous credit.

We resisted the temptation to continue reshaping our analysis to reflect the latest shift, seismic or otherwise, in the landscape. We recognized that as far and as fast as conditions had changed in just one year, they easily could do so again. Consequently, we thought it more appropriate to maintain our initial stance and focus. While we have incorporated and referred to these major developments as we felt they were pertinent, we have not focused directly on them.

We do feel, however, that one point bears mentioning in this regard. At the outset, we emphasized that, unlike in many past episodes, the current impetus for regulatory change is not being driven by a crisis, but rather by the accelerated evolution of the insurance and entire financial services industry. Consequently, we posit that the current environment may be uniquely conducive to the achievement of regulatory changes long-sought by the industry. While we maintain that premise today, we believe the environment has been transformed significantly by these interim developments, which may have ramifications on the potential for achieving dramatic changes in the near-term.

Ideally, this study will be received as an objective overview of the environment based on sound but not arcane economic principles, as opposed to more partisan, presumptive or theoretical approaches. We hope that it is useful in helping to trigger new ideas, as well as order priorities and set future strategies.

Adam K. Lee

On behalf of
Georgetown Economic Services, LLC

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Executive Summary

The Council is pleased to present an introductory economic study of the regulatory options for oversight of the business of insurance. This study, a project of the Foundation for Agency Management Excellence ("FAME"), was prepared to educate Council members on this important topic. FAME retained Georgetown Economic Services, an independent economics consultant, to provide the analysis. Its publication at this moment could not be more timely as policy makers in Washington are initiating their own investigation into these important questions. The House of Representative's Financial Services Committee will, for example, begin a series of preliminary hearings in June that are designed to bring these issues to the fore.

That the current state-based system of insurance regulation needs repair is beyond question. Duplicative and sometimes conflicting regulatory requirements from state to state often-times make compliance by both insurers and agents and brokers difficult if not impossible, and can lead to confusion and frustration among consumers. Indeed, state regulators themselves have recognized the need for modernization —

"The Commissioners [of Insurance] are now fully prepared to go before their various legislative committees with recommendations for a system of insurance law which shall be the same in all States — not reciprocal, but identical; not retaliatory, but uniform."

This statement was made by George W. Miller, the New York Insurance Commissioner, in 1871 at the close of the inaugural meeting of the National Association of Insurance Commissioners which he chaired. Unfortunately, as we sit here today — over 130 years later — the full promise of that good intent still has not been realized.

The questions we now face both as an industry and as a country are how best to resolve these problems and how to regulate the business of insurance as we enter the 21st century. This project was not designed to answer that question directly but to develop an objective framework in order to evaluate and compare the various regulatory structure options that are available to ensure a quality regulatory environment going forward. The next step in the process is to analyze the regulatory options available through this framework and apply the lessons learned during the initial phase of the study. We believe, however, that the framework itself and the findings and conclusions on which it is based help to shed light both on the extent of the regulatory problems that currently exist and on the costs and benefits of the potential structural reforms that have been identified to date.

OVERVIEW

The purpose of this study is to develop an objective framework in order to evaluate and compare the costs and benefits of various regulatory structure options available to the industry. The differentiation between the scope of regulation (what is regulated) and the structure of regulation (how/by whom it is regulated) is crucial to this framework.

In the context of this study, the interaction between scope and structure is a critical dynamic and might be seen as a strong rationale for structural change as an impetus toward achieving improvements in the scope of regulation. The existing structure's inherent tendency toward non-uniformity, redundancy and distortions (via externalities) often produces inefficient regulations, whether with respect to developments in emerging areas or reforms in existing areas of oversight.[1] Once implemented, non-uniform regulations tend to perpetuate the scheme that created them — i.e., once state-by-state requirements are adopted, state-by-state monitoring and enforcement usually follows. Consequently, structure becomes a critical influence on those regulations under conditions of change and reform.

The structure of the state regulatory system in an increasingly interstate or even international market makes it prone toward generating externalities.[2] While state-by-state variations in regulatory requirements (i.e., *scope*) are a product of the system's structural weaknesses, they also exacerbate the state system's inherent tendency toward non-uniformity, redundancy, and generating unintended consequences. The generation of negative externalities — when other states accrue a cost without a corresponding benefit as a result of the regulatory actions of another state — is key in this context. While variations in the scope and conduct of regulation often appear to be the root cause of many externalities, in most cases, they are facilitated by the structural limitations of the regulatory scheme.

Certainly, there are compelling and legitimate reasons for maintaining functional and/or geographical elements in the structure of regulation. For example, historical expertise and the endorsement by GLBA are prime reasons for maintaining functional boundaries, while local market familiarity, legal standards, and sunk "investment" costs are prime reasons for maintaining state oversight. Nevertheless, as the insurance industry becomes less functionally distinct and more international in breadth, interim and incremental improvements along traditional functional and geographic lines may prove to be only a temporary panacea.

The perspective from which regulators approach their oversight responsibilities can have an important bearing on the relative efficiency and effectiveness of any given combination of alternatives and options. The two basic variations in regulatory perspective are ***prescriptive approaches*** and ***prudential approaches***. The prescriptive approach characterizes the current U.S. system of regulation and utilizes a detailed set of generally *ex-ante* restrictions or requirements on regulated entities with regard to each aspect of their operations. The prudential approach, more evident in European regulation, provides greater overall flexibility and fewer specific restrictions, but relies on greater *ex-post* emphasis in oversight, such as more intensive regulatory monitoring and greater discretion for intervention by regulatory authorities.

GENERAL CONSIDERATIONS

- One of the primary contributors to the inefficiency of regulation, whether in terms of its excessive

1 At the same time, these characteristics of the state-based structure provide certain advantages. Non-uniformity is not a fault by itself if it is founded on legitimate economic or other (localized) considerations. Moreover, while redundancy rarely constitutes the most *efficient* approach, it can lead to more *effective* regulation since the collective activities of multiple regulators have the potential to produce broader and better-rounded solutions. The key point is whether these advantages represent a reasonable and necessary trade-off for the cost of the inefficiencies and distortions that tend to be characteristic of this structure.

2 Externalities are costs or benefits that arise from an economic transaction which are borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality. See Spulber (1989) at 46. Externalities involve the unfair or inadvertent shifting of costs and benefits such that a single event gives rise to both positive externalities (to the recipient of the benefit) and negative externalities (to the bearer of the cost). The immediate discussion is focused on negative externalities and omits consideration of the corresponding positive externalities that also are generated.

costs or capacity to introduce distortions into the market, is its tendency to be oriented toward outcomes in the short-run, rather than processes in the long-run. This is understandable since outcomes are more tangible and obvious than processes, and ultimately, regulators are more directly responsible for the outcomes, rather than the method or efficiency with which those outcomes are achieved.

- Indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of the regulatory goals. By extension, efforts to reform and modernize regulation will likely alter the incidence (impact) of those costs and benefits, as well as generate their own indirect and unintended effects.

- Regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate, if not promote, market failures, and increase the overall cost of risk to the overall economy.

- The optimal regulatory structure must meaningfully address the costs and distortions to the market directly related to regulation.

- At the very minimum, alternative regulatory structures must demonstrate adequate performance on the core regulatory objectives of solvency and consumer protection. However, most of the potential efficiency gains will come from improved performance in the secondary or peripheral areas of regulation (e.g., licensing and rate and form approval) ideally by reducing the scope of regulation (deregulation) rather than by reengineering existing processes.

- While agents and brokers may be affected uniquely or discretely by regulation vis-à-vis other segments of the industry, the regulatory structure that best serves the industry as a whole likely will prove optimal for agents and brokers as well. While agents and brokers play a key role in the market by helping to mediate and minimize conflicts between insurers and consumers, as well as reduce information constraints on both sides of insurance transactions, they are neither designed nor equipped to undertake direct regulatory responsibilities for either insurers or consumers. Transferring such responsibilities to agents and brokers will decrease the effectiveness and the efficiency of regulation.

- The market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

- Deregulation often is preferable to lesser reforms, even though the later may constitute a necessary interim step

POLICY CONSIDERATIONS

- Both regulators and politicians have demonstrated increased awareness that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. These factors have been transformed from costs and inconveniences to potential competitive disadvantages that threaten the long-term health and performance of the industry.

- An increasing proportion of insurance transactions is migrating beyond the reach and direct control of state regulators to alternative markets and other non-traditional risk-financing mechanisms, with little evidence of adverse ramifications. This shift has important implications regarding the cost/benefit profile of regulation, whether information constraints still constitute a legitimate market failure, whether such constraints can be overcome by the industry and consumers, and whether the overall system faces greater or lesser risk as a result of this migration.

- The business environment is being transformed by financial services convergence and modernization, e-commerce and globalization, all of which have accelerated and sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints. While this applies to the costs of even minimally necessary regulation, it is most relevant when regulatory constraints begin to impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales.

- The tendency of insurance regulations to produce distortions and other unintended effects, regardless of the structure in which they are administered, can generally be attributed to two fundamental causes — the undermining of competitive market forces that generate incentives for loss control and the interference with the normal relationship between premium levels and expected loss costs.

- Efficiency concerns are critically important to the industry, since they affect its direct compliance costs. Under such circumstances, the efficient conduct of unnecessary or excessive regulation becomes the next best alternative to more effective regulation generally, in order to minimize both its direct and indirect costs. The critical point is that the focus on achieving the next best alternative — making unnecessary regulation less costly and more efficient — may come at the expense of the best alternative — eliminating such regulation altogether. To a certain extent, efforts focused on improving the conduct of, or otherwise curbing, ineffective and unnecessary regulation, while perhaps more achievable than seeking its complete elimination, inadvertently tend to validate the necessity of such regulation in the first place. Nevertheless, this focus is understandable given how firmly entrenched and resistant to change many of these regulatory processes have become.

STRUCTURAL CONSIDERATIONS

- The limitations of traditional regulatory structures under current competitive conditions have tended to increase jurisdictional and functional disputes among the regulating agencies and other authorities as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. In addition, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. Regardless, the continuing trend toward convergence in financial services has shifted the burden of adjustment to the regulators.

- As the insurance industry becomes less functionally distinct and more national and international in breadth, interim and incremental improvements in regulation along traditional functional and geographic lines may prove to be only temporarily palliative. Even worse, limited reforms may tend to further entrench structures and practices that may not be suitable or optimal for the industry in its new competitive environment.

- Two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies. These advantages are offset by inefficiencies related to redundancies and diseconomies of scale that are characteristic of decentralized authority.

- The state-based structure's primary weakness may be its susceptibility toward generating negative externalities. Consequently, assessments of alternative structures must address this issue and the extent to which this particular susceptibility can be reduced or minimized. A related problem concerns geographical limitations within the state structure, which often require that regulatory determinations be made on a state-by-state basis. The fundamental question is whether such state-specific analyses are meaningful in an increasingly national and international market.

- Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. Corollary issues include concerns regarding the regulatory reach and expertise of regulators with respect to foreign markets and insurers, nontraditional markets and products and reinsurers (who play a relatively low profile but key role in market functioning).

- All of the major reforms accomplished under the existing state structure have occurred only in response to major external threats of federal intervention or wholesale dislocations in the regulated markets. Based on these precedents, there is no assurance that the state-based system will enact meaningful further reforms absent a significant level of continuing threat and pressure. The experience with NARAB and producer licensing to date supports this conclusion.

- The imposition of minimum standards within the existing state system could potentially improve uniformity. There is considerable evidence, however, that when these standards are set relatively low or when they continue to permit significant state discretion and variation, much of the potential benefits are undermined. There also is increasing evidence that the lack of uniformity among the states acts as a shaky foundation for improvements in reciprocity.

- Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation. Nonetheless, the state structure will remain under pressure whether the states move ahead or obfuscate.

ALTERNATIVE/FUTURE STRUCTURAL CONSIDERATIONS

- The optimal regulatory structure must meaningfully address the most problematic regulatory areas identified — primarily company and producer licensing as well as rate, risk classification and form regulation — even though these are less critical areas than solvency and consumer protection. Regulatory conduct in these areas is generally excessive, inefficient and often ineffective, if not harmful, to market functioning. In this context, deregulation likely is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

- Convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure may lack the capacity to manage its functions adequately, particularly under adverse business conditions.

- In evaluating alternative regulatory structures, the industry is advised to give greater weight to alternatives that facilitate deregulation rather than those that facilitate specific changes in existing regulations. While the state structure has shown it can achieve deregulation, it tends to occur on a non-uniform and piecemeal basis. Moreover, such efforts have been most successful under the threat of federal intervention.

- Universal options and regulatory perspectives — the net benefits of each of the regulatory alternatives (including maintaining the existing system) would tend to be maximized if the alternative incorporated certain universal options or approaches that are not specific to each structure. These include broader versus narrower application of changes and participation by regulating entities, the degree of self-certification or self-regulation allowed, the reorganization of regulation along distinct product or consumer segments and the adoption of a prescriptive versus prudential approaches to regulation more generally.

- Any alternative that reduces the number of potential jurisdictions (e.g., interstate compact, mandatory or optional federal regulation in any form, or financial services super-regulator) has the potential to achieve rapid or wholesale deregulation, as well as improvements in uniformity (or even make uniformity cease to be an issue).

- The Gramm-Leach-Bliley Act, while offering significant near-term regulatory improvements, also has set the industry upon a potentially conflicting course in the longer-term. While the Act simply synthesizes and embodies a number of forces already at work, it likely will trigger further changes in the financial services industry as a whole that will continue to strain the regulatory structure. The Act encourages less functional differentiation within the industry while maintaining functionally distinct oversight. Without further changes, maintaining functional regulation as the industry continues to converge, integrate and globalize will produce many of the same problems as maintaining state regulation in an increasingly interstate and even international market.

Introduction

The purpose of this study is to develop an objective framework in order to evaluate and compare the various regulatory structure options available to the industry. Critical to this framework is differentiating between the *scope* of regulation (what is regulated) and the *structure* of regulation (how/by whom it is regulated). While the framework seeks to rely on empirical information on the explicit costs and benefits of each alternative to the extent possible, it recognizes the severe limitations in the availability of such information.

Nevertheless, the framework suggests that evaluations of alternative regulatory structures require a holistic approach that begins with the fundamental premise that regulation imposes costs upon the market that should be justified by its benefits. This approach forces consideration away from outcomes (e.g., solvency and consumer protection) and toward overall market efficiency and functioning (i.e., the overall cost of risk).[3]

The framework also suggests that the indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of stated regulatory goals. By extension, efforts to reform and modernize regulation will likely alter the *incidence* of those costs and benefits, as well as generate their own indirect and unintended effects.

Importantly, the study does not focus on the regulations themselves or how they might be improved, except to test them generally against typical economic rationales for regulation and assess their effects on overall market efficiency. In accordance with these tests, however, the study identifies several regulatory *areas* that lack adequate justification from the standpoint that they are economically unnecessary, impose excessive costs, and/or introduce other distortions into the market.[4] One of the study's key conclusions is that the optimal regulatory structure must meaningfully address these problematic regulatory areas, and that deregulation often is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

There is little debate that the rules and regulations must be modernized, streamlined and made more flexible, as industry dynamics and market growth continue to strain, as well as be constrained by, the limiting tendencies of the existing, primarily state-based structure. This study takes a more generic viewpoint in its focus on regulatory efficiency and accountability, as well as business facilitation and competition issues. Thus, the study consciously avoids consideration of political realities and the views of interest groups, or debates regarding the efficiency of one type of regulation over another within a given regulatory area.

The main points of emphasis and unique considerations of the study are summarized as follows:

- Rather than rationalizing a particular regulatory solution, the study analyzes where inefficiencies and distortions are evident under the current structure, and how regulatory structure (as opposed

3 One of the primary contributors to the inefficiency of regulation, whether in terms of its excessive costs or capacity to introduce distortions into the market, is its tendency to be oriented toward *outcomes* in the short-run, rather than processes in the long-run. This is understandable since outcomes are more tangible and obvious than *processes*, and, ultimately, regulators are more directly responsible for the outcomes, rather than the method or efficiency with which those outcomes are achieved.

4 Regulatory *areas* and specific types of regulations are distinct. For example, price or rate regulation constitutes a regulatory area, whereas competitive rating or prior approval laws constitute specific regulations within that area. Similarly, entry qualifications and barriers constitute a regulatory area, whereas bond requirements and countersignature laws constitute specific regulations within that area.

to regulatory scope or conduct) may either contribute to, or potentially resolve, these inefficiencies and distortions.

- Since the study focuses on regulatory structure, it takes as a given that the specific rules and regulations could be improved and instead seeks to provide a starting point for determining how structure may impact the achievement of desirable changes (including deregulation) in the rules and regulations.

- By avoiding conclusions regarding a particular solution, the study circumvents many of the complicating factors inherent in the proposals offered and discussed to date by other interested parties. These factors involve complex political and legal considerations, state tax revenues, regulatory bureaucracy, and funding issues that tend to obscure the purely economic foundations or merit of such proposals. Thus, rather than evaluate possible structures subject to comparatively indeterminate political and legal considerations, this phase of the study attempts to outline a more efficient *manner* of regulation based on typical economic rationales.

- While this study was prepared on behalf of the Foundation for Agency Management Excellence ("FAME"), its completion and conclusions were developed independently and with no guidance from any interest group. Consequently, the views expressed in this report are those of the authors and do not necessarily reflect the views of FAME.

II Regulatory Scope Versus Structure

A. Underlying Market Dynamics

The possible regulatory alternatives to the existing, primarily state-based structure are numerous and differ greatly. Moreover, each alternative has a number of variations that complicates their evaluation and comparison. While all of the alternatives and options share the same fundamental goals, the sheer number of interrelationships and competing interests among the market participants, as well as among the regulations themselves, make clear that these basic goals can be produced in a multitude of ways and with widely varying degrees of success. How that success is judged is dependent not only on one's perspective, but also on how reform changes the overall costs and benefits of regulation, as well as the incidence of those costs and benefits.

While reform is expected to yield improvements for the market overall, the effects on the various segments and components of the market likely will be disparate, creating opportunities for some and handicaps for others. In addition, the *unintended and indirect* effects of reform and modernization have the potential to undermine or even overwhelm the *intended and direct* effects, such that achieving limited improvements in one area could cause more significant problems in other areas.

It is important to recognize, therefore, that while some alternatives and options likely will be more effective than others, pinpointing the optimal or ideal solution, or even combination of solutions, is considerably more difficult. As has been recognized, it is perhaps more important at this juncture to systematically assess the alternatives as the industry engages in the evolutionary process of modernizing its regulatory scheme.

Before turning to the specific regulatory alternatives, it is important to recognize two fundamental points. First, the insurance market is competitively structured and serving the basic needs of its participants, and regulation has contributed in part to this performance. While market functioning certainly can be improved, there is no immediate crisis driving the impetus for change as there has been in the past, although that possibility suddenly looms large following the industry's unprecedented experience in 2001. Crisis or not, it is clear that certain aspects of regulation have interfered with and distorted the market and has undermined its ability to carry out its core functions. The salient point is that the market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

Second, the regulation of the insurance market is not accurately characterized as a monolith of state oversight and control. While state regulation forms the backbone, there are many other aspects incorporating federal regulation, interstate compacts, international, national and voluntary standards, self-regulation, alternative markets and last, but certainly not least, the natural forces of competition. In short, the industry and its regulation are constantly interacting and evolving, with each playing a direct role in influencing and shaping the other. Indeed, the accelerated modernization effort now underway is a direct product of the industry's own development and evolution, which is believed by many to have outpaced the ability of the existing regulatory structure to keep pace.

Evaluations of alternative regulatory options encompass both scope/conduct and structure. *Scope/conduct* refers to the activities subject to regulation and how regulatory requirements are governed by the relevant authorities. *Structure* refers to who regulates the activities and establishes the basis for jurisdiction and enforcement. In order to make fair comparisons, the scope/conduct of regulation must be assumed the same for each alternative under evaluation. By starting with this assumption, the contribution that each alternative structure may provide can be assessed more discretely.

B. THE SCOPE/CONDUCT OF REGULATION

Under the current regulatory scheme, the scope of regulation can be organized into several broad categories, as follows:

Corporate structure and authority to conduct business — includes company and agent/broker licensing, agent appointments, continuing education requirements, change of control, affiliations and related party transactions, and company structure (especially demutualization and establishment of financial services holding companies under the Gramm-Leach-Bliley Act ("GLBA")).

Market conduct and operational trade practices — encompasses all points of interaction between underwriters/agents and brokers and their customers, including market conduct examinations to assess compliance with regulations and guidelines on advertising and other marketing activities, sales activities, complaint handling, underwriting and claims handling, and privacy protections.

Product approval, pricing and risk classification — includes review of policy or contract forms and pricing, minimum disclosures, plan structure and administration, and underwriting standards.

Financial regulation, taxation, and solvency monitoring — includes minimum capital and reserving requirements, guaranty fund assessments, rehabilitation and receivership, portfolio restrictions and valuation, accounting standards, disclosure and reporting, and state and federal taxation.

The scope/conduct of regulation continues to undergo significant changes, especially agent and broker licensing, rate and form filings/approvals, and the more general deregulation of commercial lines. Changes in the underlying regulatory structure will likely broaden and accelerate changes in the scope of regulation, though it is not clear exactly how that might happen or who might benefit or suffer. Many proposals for change presume that the desired changes in the regulatory structure will produce the desired changes in the regulatory scope, primarily by altering or even eliminating regulations deemed to be unnecessary or ineffective. This study, however, limits its focus to the extent to which changes in the regulatory structure might lead to improvements in the *administration* of the existing scope of regulations, as well as fostering an *environment* more conducive to achieving future changes in scope that are more in accordance with standard economic rationales.

C. THE STRUCTURE OF REGULATION

1. BACKGROUND

In the debate over the industry's regulation, numerous problems with the existing, primarily state-based system have been identified. Most of these problems center on the *efficiency* as opposed to the *effectiveness* of the state-based structure, although concerns regarding the latter have dominated at times. In this context, *efficiency* refers to the presence or absence of regulatory frictions, the primary of which are compliance costs and the speed of regulatory responses, as well as market distortions. *Effectiveness* refers to the achievement of regulatory goals, the primary of which are industry solvency and consumer protection.

Over the last ten years, the property/casualty industry has endured a relatively tumultuous operating environment, posting both record profits and record losses within that time frame, although it has so far avoided the market problems that arose in the late 1980s and early 1990s. The resulting Congressional attention and significant reform efforts at that time helped improve the *effectiveness* of regulation. While there have been occasional major insolvencies, fraud and other market problems in the interim, the industry avoided the systemic crises that plagued the other financial services sectors during this period.[5]

As a result, the balance of regulatory concern has tilted more in favor of overall market functioning and the industry's ability to respond to new competitive challenges. Both regulators and politicians have demonstrated increased awareness of the fact that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. Indeed, the Gramm-Leach-Bliley Act, along with the series of important shifts in financial services regulation that preceded it, is a product of that awareness. While the Act reflects a culmination of change in one sense, it will spur further changes in shaping all segments of the financial services industry in an increasingly interrelated manner in the future.

The market conditions under which state regulatory reforms and financial services modernization were inaugurated, however, have deteriorated dramatically in recent years. As detailed further in Section V, the property/casualty segment of the industry has endured a sharply fluctuating operating environment over the last decade, punctuated by recurring setbacks. On top of extended soft market conditions, the segment has suffered persistent underwriting losses in every year of the last decade, while repeatedly sustaining unprecedented catastrophe losses. These developments have put tremendous pressure on the financial condition of insurers and reinsurers in this segment.

These unsustainable trends deteriorated even further in 2001 following the disastrous losses due to the terrorist attacks, the failure of Enron Corporation and a surge in toxic mold claims, culminating in the segment's *first-ever annual net loss.* While the industry has weathered these difficulties to date, their full impact has yet to be felt.[6] The industry remains vulnerable to further loss shocks, particularly as reinsurance capacity has been withdrawn, leaving both insurers and consumers to bear potentially hazardous risks they would normally cede.[7] The industry has responded by accelerating rate increases and tightening underwriting standards, but it still faces substantial operating risk from continuing underwriting and market share losses, an absence of capital gains, and a reduction in investment income.

There is evidence that regulatory constraints are partly to blame for the segment's financial woes. Not coincidentally, the segment's worst performing lines — personal and commercial auto liability, medial malpractice and workers' compensation — are the most heavily regulated. Moreover, the segment's overall poor performance reflects a sharp increase in competition, particularly from new entrants and offshore capacity that incumbent insurers are struggling to counter within the bounds of traditional regulated products and markets. Finally, as noted above, the most serious operating risks faced by insurers in the near-term may be regulatory constraints on their ability to exclude or limit terrorism risks in the absence of reinsurance capacity.[8]

The emergence of incalculable new risks within an already difficult operating environment does not portend well for the industry.[9] Current operating conditions are beginning to draw comparisons to the

5 In particular, the banking sector's savings and loan crisis and the Federal Reserve-engineered bailout of Long Term Capital Management within the securities sector are prominent examples in this regard. More recently, the securities sector has drawn increased scrutiny and criticism following the bankruptcy of Enron Corporation, the largest corporate failure in United States history, and the contributing role that accounting firms and securities analysts may have played. The insurance industry's relative performance in a period of often skyrocketing cost inflation (especially for medical costs) and unforeseen claims frequency and severity (asbestos, mold, terrorism and D&O cover) stand in contrast.

6 See ISO (2002). ISO estimates that less than half of the segment's total net underwriting loss due to the terrorist attacks was recognized in 2001. Thus, results in 2002 and beyond will continue to be depressed by the recognition of the balance of these claims as they are administered, in addition to new losses that may be experienced.

7 See GAO (2002) at 5-7, 16-17.

8 IBID.

9 Examples of the numerous prevailing loss risks besides terrorist attacks currently faced by property/casualty insurers include environmental liabilities (asbestos and toxic mold), natural and industrial catastrophes (hurricanes, storms and accidents), computers and business interruption (viruses), employee benefits (new mandatory coverages), corporate governance (bankruptcy, fraud, and D&O liabilities), and political risks (Argentina, Venezuela and the Middle East).

market crisis of the mid-1980s due to the combined forces of capital and capacity depletion, along with potential claims several orders of magnitude greater than resulted from Hurricane Andrew in 1992.[10] Just as that catastrophe caused a sharp spike in insolvencies and guaranty fund assessments, the industry once again may be headed toward a similar experience.[11] Thus, while the reform and modernization effort began under relatively stable market conditions with an eye toward incrementally improving efficiency and industry performance, now the effort has taken on a much more vital role in protecting market confidence and stability, as well as insurer survival.

Against this backdrop, convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure simply may not be able to manage its functions adequately under adverse business conditions. Despite these pressures and complexities, however, many proposals advocating fundamental structural changes are premised on a relatively seamless and incremental evolution from the existing structure wherein the effectiveness of regulation is never threatened, but emerges stronger and more flexible from the outset. While this outcome is ideal, such broad and fundamental changes in structure have the potential to introduce strains, dislocations and many unintended consequences that could offset the imputed benefits of such changes. These risks must be weighed against the potential continuing problems and limitations that maintenance of the existing state structure likely will produce, as evident in the industry's current operating and financial performance.

2. BASIS FOR STRUCTURE

Regulatory structure is dictated by the basis of compliance and enforcement activities. There are generally three types pertinent to financial services firms:

By entity or charter — "what they are" — the nominal classification of the company determines by whom it is regulated. Companies chartered as insurance companies are regulated by insurance regulators (potentially including their non-insurance activities). Companies classified differently are regulated separately.

By function — "what they do" — the specific and/or primary activities in which a company is engaged determines by whom it is regulated, regardless of its type and/or location. All companies selling insurance products are regulated by insurance regulators, at least in connection with their insurance activities.

By territory/geography — "where they are" — the location of the company, usually in conjunction with its entity/charter and/or function, determines by whom it is regulated, particularly in terms of legal jurisdiction. Companies located or operating in a given locale are regulated by the regulators of that corresponding locale, whether or not further differentiated by charter or function.

These three bases are deceptively simple, as is evident when they are applied to financial services firms that are increasingly doing more than one thing in more than one place, often with similar products that make clear distinctions difficult to find. Innovations, both product and technological, as well as intensifying competition are leading to a convergence in the financial services industry and acceleration in its evolution that are straining traditional regulatory structures. Pertinent examples include the emergence of the internet as an automated and adjunct market to traditional direct contact markets, customer service

10 See Pilla (2002).

11 Again, the full impact of the terrorist attacks and related losses on market solvency has yet to be felt. Even before the terrorist attacks, however, the number of property/casualty insurer insolvencies increased from 7 in 1999 to 31 in 2000. In 2001, a number of large multi-state insolvencies occurred (Credit General, HIH America, United Capital, Superior National, Frontier Pacific and Reliance), of which Reliance is expected to be the costliest insurance insolvency in history. At the same time, more than 20 companies were downgraded by Standard & Poor's and more than 30 placed on "credit watch" with negative implications in 2001. See KPMG (2002); National Council of Insurance Guaranty Funds (NCIGF).

functions that may be encroaching upon advisement and selling functions, and the growing irrelevance of traditional product definitions distinguishing financial products and services that have increasingly become interchangeable with each other.

There have been two primary consequences of the limitations of traditional regulatory structures under current competitive conditions. On the negative side, jurisdictional and functional disputes among the regulating agencies and other authorities have increased as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. These disputes tend to increase regulatory frictions without benefiting either the industry or consumers and are contrary to market dynamics.[12] On the positive side, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. While these developments are only beginning to be achieved and will encounter setbacks, they are important because they implicitly acknowledge the imprudence of championing one sector of the industry over another as counter to the interests of the industry as a whole. Despite long-standing attempts by regulatory bodies to maintain traditional distinctions in the financial services industry, momentum is clearly now on the side of convergence and that has placed the burden of adjustment on the regulators.

These developments are driving the calls for fundamental changes in the regulation of the insurance industry. Its primarily state-based structure stands in contrast to the banking and securities segments of the financial services industry, whose regulation is much more federally-based. Consequently, some interest groups support a transition toward greater federal involvement led by proposals for optional federal chartering patterned after bank regulation.[13]

If state regulation as currently configured is deemed incapable of efficiently and effectively operating within the industry's new competitive environment, the pertinent issue is not whether a given alternative structure may be more adept at doing so.[14] The proper focus identifies the alternative that most fully resolves the market failures and regulatory frictions that the industry faces given its environment and own evolution, while minimizing the potential indirect and unintended effects that may result from adopting this structure. Moreover, the achievement of improvements under an alternative structure should be accorded comparable weight with the avoidance of indirect and unintended effects, which have significant potential to be even greater in magnitude.

Despite the obvious importance of regulatory structure, structure by itself can only make a secondary contribution to the efficiency and effectiveness of regulation. The rules and regulations themselves generally have greater implications to the industry than the structure under which they are specified, interpreted and enforced. Under any regulatory structure, good rules and regulations — those that are specified clearly, are well understood and which limit arbitrary discretion of regulators — tend to trump poor rules and regulations under the optimal regulatory structure. Nevertheless, under conditions of

12 Jurisdictional turf battles represent a hidden and particularly invidious regulatory cost to the extent that they siphon limited resources away from actual oversight and/or compliance activities. A recent example is the dispute between the Office of the Comptroller of the Currency and West Virginia regarding the preemption under GLBA of certain consumer protections in the State's law governing the solicitation and sale of insurance products. Such disputes are particularly relevant to proposals for alternative regulatory structures that seek either to complement or partially replace the existing primarily state-based structure, since the likelihood of jurisdictional disputes increases as the number of distinct regulating entities grows. Nevertheless, many of these proposals tend to focus on the benefits of competition between regulators without corresponding emphasis on its potential costs.

13 Two pieces of legislation along these lines already have been introduced. The National Insurance Chartering and Supervision Act was introduced by Senator Charles Schumer in December 2001, while the Insurance Industry Modernization and Consumer Protection Act (H.R. 3766) was introduced by Representative John LaFalce in February 2002. Both measures would create a national insurance regulator within the Department of Treasury.

14 To a significant extent, such evaluations are prone to bias against the standing structure, since it is the only one that can be evaluated concretely based on actual historical experience. Consequently, all of the perceived faults of the standing system are easily highlighted and demonstrable. In contrast, proposed alternatives tend to be outlined in more idealized form, often with their speculative benefits highlighted, while their speculative costs and distortions (including transitional costs and unforeseen ramifications) discounted or even omitted. Nevertheless, since the benefits and costs of proposed alternatives can neither be confirmed nor denied concretely, their comparatively subjective/positive assessments usually are accorded similar weight to the more objective/negative assessments of the standing structure. This understandable tendency promotes conclusions or perspectives that any alternative marks an improvement over the existing structure.

change and reform, structure becomes more critical since it can be a key determinant of how rules and regulations are changed going forward.[15]

In the context of this study, therefore, the interaction between scope and structure is a critical dynamic and might be seen as a strong rationale for structural change as an impetus toward achieving improvements in the scope of regulation. The existing structure's inherent tendency toward non-uniformity, redundancy and distortions (via externalities) often produces inefficient regulations, whether with respect to developments in emerging areas or reforms in existing areas of oversight.[16] Once implemented, non-uniform regulations tend to perpetuate the scheme that created them — i.e., once state-by-state requirements are adopted, state-by-state monitoring and enforcement usually follows. Consequently, structure becomes a critical influence on those regulations under conditions of change and reform.

Certainly, there are compelling and legitimate reasons for maintaining functional and/or geographical elements in the structure of regulation. For example, historical expertise and the endorsement by GLBA are prime reasons for maintaining functional boundaries, while local market familiarity, legal standards, and sunk "investment" costs are prime reasons for maintaining state oversight. Nevertheless, as the insurance industry becomes less functionally distinct and more international in breadth, interim and incremental improvements along traditional functional and geographic lines may prove to be only temporarily palliative.

The list of potential regulatory solutions provided in the next section includes several ideas that have not received as much attention, and, for that reason alone (as opposed to any core unsuitability), are unlikely to be supported. These ideas include increasing domiciliary-based regulation with automatic reciprocity, the use of interstate compacts, the establishment of a single-body financial services super-regulator, greater employment of self-regulation, and the reorganization of existing regulators according to regulatory goals as opposed to regulatory functions.

15 See Grace and Klein (1999) at 42-43.

16 At the same time, these characteristics of the state-based structure provide certain advantages. Non-uniformity is not a fault by itself if it is founded on legitimate economic or other (localized) considerations. Moreover, while redundancy rarely constitutes the most *efficient* approach, it can lead to more *effective* regulation since the collective activities of multiple regulators have the potential to produce broader and better-rounded solutions. The key point is whether these advantages represent a reasonable and necessary trade-off for the cost of the inefficiencies and distortions that tend to be characteristic of this structure.

III Alternative Regulatory Structures/ Conduct Options

While the regulatory alternatives under consideration differ widely, they all tend to share a number of common goals, as follows:

- Increasing efficiency through uniformity and reduced redundancy;
- Restoring a more free-functioning market (i.e., greater competitive market regulation);
- Increasing transparency and feedback regarding enforcement and compliance;
- Increasing regulatory accountability and flexibility (i.e., reducing arbitrary discretion);
- Improving regulatory expertise;
- Reducing jurisdictional gaps and conflicts;
- Adapting to the convergence of financial services segments;
- Facilitating globalization of insurance markets; and,
- Retaining performance on oversight of solvency and consumer protections.

A. STATE STRUCTURES

1. *No change* to existing system;
2. Improvements to existing system without federal involvement:
   a. *empowerment of the National Association of Insurance Commissioners ("NAIC")* to mandate certain measures designed to achieve a minimum level of uniformity related to both compliance and enforcement and move away from voluntary participation and adoption by the states (e.g., broadening of *accreditation* beyond solvency oversight);
   b. reduce redundancy through measures focused on centering regulation in a company's *domiciliary state* and providing for *automatic reciprocity* (similar to the European Union structure);[17]
   c. establishment of minimum or explicit *national standards* (e.g., by NAIC, with or without industry and consumer involvement), leaving enforcement responsibility to the states; and,
   d. use of *interstate compacts* to regionalize and reduce the number of regulatory jurisdictions while maintaining some degree of individual state discretion and local control.

B. COMBINED STATE/FEDERAL STRUCTURES

1. *Optional federal charter* — creates new federal regulator that would coexist with existing state regulators but have preemptive powers in specified areas of overlap or conflict; federal chartering left to the discretion of regulated companies; specific lines and activities subject to the charter may vary;

17 See Skipper, Jr. and Klein (1999) at 19-20.

2. *Shared state/federal model* — regulatory responsibilities divided among state and federal authorities (similar to the Canadian structure);[18]
3. Establishment of *limited national standards* (e.g., authority to do business) by a federal regulator, which retains implementation/enforcement responsibility *with respect to those standards only*; and,
4. Establishment of *broad national standards* by federal regulator with implementation/enforcement responsibility left to the individual states. A variation upon this approach could involve the *limited preemption of state laws* to address specific market problems. A good example is the Products Liability Risk Retention Act of 1981, later revised and expanded to cover all casualty risks (except workers' compensation) in the Liability Risk Retention Act of 1986 ("LRRA").[19]

C. FEDERAL STRUCTURES

1. *Direct federal regulation* (i.e., mandatory federal charter) — new federal regulator replaces state regulation in its entirety without discretion of regulated companies;
2. *Financial services super-regulator* — creates umbrella agency as new federal regulator for all financial services industries (similar to models in the United Kingdom and Australia, as well as Denmark, Japan, Korea, Norway, Singapore and Sweden);[20] and,
3. *Goal-oriented* restructuring of financial services regulation with reallocation and reassignment of responsibilities across existing agencies and authorities.[21]

D. UNIVERSAL OPTIONS

There are numerous variations in the manner in which these alternative structures could be implemented vis-à-vis the existing state-based structure. Changes could range from being very broad (e.g., direct federal regulation of all insurance activities) to very narrow (e.g., pertaining only to licensing or market conduct, or only to certain lines and/or consumers). Moreover, the changes can be developed with the involvement of any of the following entities: new federal insurance regulator/agency, federal bank and securities regulators, state insurance regulators and legislators, industry participants (underwriters, agents and brokers or other service providers) and consumers. Similarly, implementation and enforcement of changed standards could be left to the existing state authorities, transferred in whole or in part to either federal authorities (whether existing or newly-created) or to self-regulatory organizations.

Similarly, there are a number of complementary modulations regarding the extent to which regulations involve prior review and approval by authorities versus enabling conditional permission of self-certification

18 As federal regulatory involvement continues to increase in discrete areas, the U.S. system is moving away from a strictly state-based structure to a more combined state/federal structure as envisioned in this alternative. In the case of Canada, the role of provincial governments is quickly decreasing, leading to a more integrated federal-based structure for all financial services via its Office of the Superintendent of Financial Institutions. See Gibbons and Webb (2000) at 60-64.

19 Due to continuing problems in the availability and cost of liability coverage in the early 1980s, Congress passed these laws to increase consumer coverage options and facilitate group insurance programs through risk retention groups (RRGs) and purchasing groups (PGs). A key feature of these laws was the limited preemption of certain state laws and regulations that would otherwise hinder the formation and operation of such groups. This mechanism or structure is seen as a possible solution to the availability and cost problems that have arisen in the property market following the terrorist attacks, since similar issues in the liability market spurred the passage of these Acts.

20 See Gibbons and Webb (2000) at 60-64.

21 For example, one agency/authority would be responsible for each of the primary goals of financial regulation — protecting investors and consumers (e.g., Securities and Exchange Commission or Federal Trade Commission), controlling systemic risk (e.g. Federal Reserve), insolvency and guaranty funds (e.g. Federal Deposit Insurance Corporation or Office of the Comptroller of the Currency), and ensuring market functioning and competitiveness (e.g., Securities and Exchange Commission or Federal Trade Commission). As noted previously, however, such a structure runs a significant risk of creating jurisdictional disputes if specific responsibilities among these authorities are not clearly delineated. Proponents of this alternative generally find no continuing function for state insurance regulators within this system. See, for example, Wallman (1998) at 26-29.

or self-regulation by the industry and/or waivers by consumers. Such freedoms could improve regulatory efficiency significantly, by permitting the industry and consumers to assume more responsibility for compliance when reasonable and desired, yet maintaining regulators' fundamental oversight and intervention authority.

Indeed, these freedoms were a driving force behind the Federal Liability Risk Retention Act of 1986 ("LRRA"), as noted above, which sought to give insurance buyers greater control of their liability insurance programs in the midst of a market crisis which rendered coverage either prohibitively costly or altogether unavailable.[22] LRRA primarily sought to improve the market performance in liability lines by providing alternative coverage mechanisms (RRGs and PGs), and increasing competition among insurers, thereby reducing costs to consumers.[23] While these goals would be expected to consistent with those of state regulators, Congress recognized the potential for discrimination by the states against such alternative coverage mechanisms and enacted specific protections that exempted them from certain state laws that restricted group purchases (including the terms, rates and conditions of coverage) or were otherwise discriminatory.[24] Nevertheless, RRGs and other captives have continued to encounter regulatory frictions with state regulators concerning their authority to do business and the applicability of state assessments.[25] Absent further preemptions or clarifications by Congress, these frictions would be expected to increase if the Act were expanded to other lines such as property coverage.

A final variation involves reorganizing regulation around the type of insurance product and/or consumer. The insurance market as a whole is fairly well divided into discrete segments — life/health and property/casualty *lines*, personal/individual and business *consumers*, etc. Since the primary goal of regulation is to protect the consumer both in terms of market practices and solvency, it is worthwhile to consider a structure that is organized accordingly, since it might better reflect the underlying differences in each market's needs and dynamics, from which the potential benefits of regulation arise in the first place.[26]

These alternatives and variations reflect a multi-dimensional continuum, with areas of considerable overlap, as well as distinct and unique features. The discrete combinations of structures and options are limitless and, consequently, amorphous and difficult to analyze systematically. Nevertheless, it is important to recognize that each nominal alternative can be expected to perform quite differently depending on these variations that may be adopted alongside.

E. REGULATORY PERSPECTIVES

In addition to the structural options note above, the perspective from which regulators approach their oversight responsibilities can have an important bearing on the relative efficiency and effectiveness of any given combination of alternatives and options. The two basic variations in regulatory perspective are ***prescriptive approaches*** and ***prudential approaches.*** The prescriptive approach characterizes the current

22 See Risk Retention Reporter, *Guide to the 1986 Risk Retention Act.*

23 See National Risk Retention Association, *Frequently Asked Questions*, downloaded at http://www.nrra-usa.org/about_faq.html.

24 A key feature of the Act concerns regulatory responsibilities. Although LRRA is a federal law, it still relies on state regulators for enforcement at the same time it constrains those enforcement powers (via preemption), which underpins the continuing regulatory conflict between state insurance agencies and RRGs/PGs. LRRA enables RRGs to be chartered in and regulated by their state of domicile, but largely exempts them from redundant oversight (including licensing, rate and form approval) in non-chartering states. Moreover, LRRA eliminates onerous residency and countersignature requirements of state laws on agents and brokers acting on behalf of these entities. IBID.

25 See Pilla, David. "Risk-Retention Groups Lobby Congress for Expanded Role." *BestWire Services*, April 4, 2002.

26 Such an organization, while theoretical and perhaps difficult to implement in practice, would better confine the direct and indirect costs of regulation to those accruing the corresponding benefits. By doing so, the inefficiencies and distortions caused by typical problems encountered such as cross-subsidization and negative externalities would be reduced.

U.S. system of regulation and utilizes a detailed set of generally *ex-ante* restrictions or requirements on regulated entities with regard to each aspect of their operations. The prudential approach, more evident in European regulation, provides greater overall flexibility and fewer specific restrictions, but relies on greater *ex-post* emphasis in oversight, such as more intensive regulatory monitoring and greater discretion for intervention by regulatory authorities.[27]

The crux of the differences in these approaches lies in the trade-off between more proactive and restrictive regulation that is designed to forestall problems (prescriptive approach) and more reactive and flexible regulation that is designed to quickly address emerging problems (prudential approach). Regulatory perspective has interesting implications in terms of shifting responsibilities away from regulators and providing greater discretion and freedom to regulated entities, particularly in the context of deregulation or self-regulation. In exchange for less regulation or greater self-regulation, the industry might face stricter enforcement and penalties for violations. By way of specific example, if the industry were permitted to self-regulate the licensing function, it might then be subject to more rigorous market conduct examinations and more severe enforcement penalties for violations.[28]

It also is essential to understand some of the fundamental predispositions of regulation regardless of the particular approach, as listed below.[29]

- Regulation naturally tends toward constraints and limits. This is often due to public and political perceptions that focus more on regulatory failures than successes.

- Regulators favor straightforward, objective and easily observable standards. The desire to maintain simplicity and treat regulated entities equally promotes rigidity in the face of unique or unusual circumstances.

- Regulators' evaluations are often geared toward clear cut, black and white assessments — regulated entities are either in compliance or out of compliance.

- Regulators' desire to maintain full authority and discretion undermines the goal of regulated entities for clarity on permitted and non-permitted activities and transparency in the regulatory process.

- Regulators often perceive that their task of ensuring compliance puts them in an adverse position with the entities they regulate (and vice-versa). Providing assistance and feedback to the industry to facilitate and strengthen compliance is sometimes seen as inconsistent with their enforcement role.

- There are few, if any, incentives for regulators to tend toward permissiveness or risk-taking when it comes to specifying, interpreting and enforcing rules and regulations.

27 See Grace and Klein (1999) at 10-11.

28 It is interesting to consider the effect of regulatory perspectives when juxtaposed with the tendency of regulators, noted previously, to be more concerned with regulatory *outcomes* than regulatory *processes*. In general, prescriptive approaches have strong preferences toward certainties in the outcomes (i.e., solvency and consumer protection), with less regard to the relatively high direct costs, rigidity and indirect or unintended effects of this approach. In contrast, prudential approaches are more cognizant of the adverse and inefficient effects of regulation and are willing to tolerate less certainty in the outcomes. The potential gains, however, can be significantly vitiated by the greater latitude and enforcement power often conferred upon regulators under prudential approaches. Thus, under the prudential approach, the industry potentially faces greater enforcement risk in exchange for greater operating freedom and flexibility (or less operating risk). This is due to the fact that the industry might carry out a given activity for some time before it comes under scrutiny by regulators. If regulators then have the authority to conduct enforcement retroactively, the resulting compliance costs could be substantial. Under the prescriptive approach, industry activities generally are constrained so that enforcement risk is lessened, but at the expense of increased operating risk (i.e., less operating flexibility).

29 See Wallman (1998).

- Failures often are easier to attribute to market malfunctions or violations and indiscretions by regulated entities, rather than to rigid, outmoded or even inappropriate regulatory standards or approaches that may, in fact, be the root cause of non-compliance and market malfunctioning.

These predispositions generally run counter to flexibility and innovation, even as those characteristics become more and more critical to the financial services industry in the current environment. They also are more "human" in nature than a product of regulatory structure, but nevertheless can be equally important determinants of regulatory efficiency and effectiveness. Furthermore, these tendencies underscore the very critical distinction between nominal rules and regulations as they exist on paper (i.e., scope), and their application in practice (i.e., conduct), which often is influenced strongly by individual interpretation. Consequently, in assessments of alternative structures, it is important not to overlook these tendencies even if they cannot be rectified or minimized by the regulatory structure per se.

IV VIEWPOINTS FOR THE STUDY

As noted above, the primary goal of this study is to develop a systematic and objective framework with which different regulatory alternatives/options can be assessed. Several viewpoints comprise the backbone of this framework, as outlined below. These viewpoints are intended to provide a balanced perspective on regulatory structure.

Empirical focus — many evaluations of alternative structures rely minimally on actual cost/benefit comparisons of the existing system versus the proposed alternatives. To a certain extent, this may be due to the lack of meaningful data on the relevant costs and benefits. For the proposed alternatives, such data are speculative at this juncture. Nevertheless, a more empirical focus will tend to produce less biased and more technically accurate results. Moreover, such assessments are not only more reliable, but also more defensible in the context of lobbying efforts, whether within the industry or with regulators and legislators.[30]

Regulate market failures — when the economic rationales for regulation become obscured by the goals of regulation, perverse results are likely to occur. Given the focus on outcomes by regulators and the difficulty that consumers have discerning the costs of regulation (which primarily they bear), there is a tendency for the process and costs of regulation to receive inadequate attention. Regulation serves the market best when it is focused on mitigating and correcting legitimate market failures, rather than replacing market mechanisms or achieving regulatory goals without regard to the means by which they are achieved.

The impact of regulation — beyond particular regulatory goals and outcomes, regulation often produces many indirect impacts by interfering with normal market forces. These indirect impacts are insidious because they are difficult to isolate and easy to attribute elsewhere. Nevertheless, these impacts can be substantial and often lead to even more regulatory intervention seeking to correct these distortions.

The costs of change — before the potential benefits of any alternative are realized, there will be a period of development and disruption that should be recognized in comprehensive and accurate assessments of relative costs and benefits.[31] The more extensive the change involved in a given alternative, the greater the costs of change likely will be, thus offsetting some of the potential benefits. Moreover, even relatively minor changes can produce indirect and unintended consequences that undermine the beneficial aspects of the changes (usually by causing new problems to emerge). While such consequences typically are not known in advance and are always difficult to quantify, history has shown that their prospect is real and, therefore must be considered in any proposal for change.

The industry is not monolithic — the industry, its markets and its customers comprise numerous interrelated yet typically distinct segments, as follows:

30 The existing state structure provides the only concrete basis for empirical assessments based on actual historical experience. Nevertheless, the lack of accurate and reliable data on the costs and benefits of regulation proved to be a significant limitation in this study, even for the existing state structure. While useable information on the direct costs — actual state expenditures on regulation and estimates of industry compliance costs — were obtained and analyzed, indirect costs could only be described, but not typically quantified.

31 This recognition is important in the interest of objectivity since omitting or ignoring the costs of change denies the existing state structure one of its primary advantages — that it is already in place and familiar, and that its weaknesses and shortcomings are known with comparative certainty vis-à-vis other alternatives.

- *by function* — regulators, customers, underwriters, reinsurers, agents and brokers, rating companies and other service providers;
- *by type of insurance* — consumer/individual or business, voluntary or compulsory, standard or non-standard, etc.;
- *by line of insurance* — personal (auto, homeowners, life, health), property & casualty (general property and liability, workers' compensation, business interruption, employee practices liability, directors & officers), and employee benefits;
- *by size* — applicable to underwriters, agents/brokers and consumer segments;
- *by regulatory reach* — traditional regulated markets, excess and surplus markets, alternative markets and foreign markets;
- *by method of distribution* — direct, by captive agent, by independent agent, self-insurance and risk retention; and,
- *by geographical market or locus of regulation* — state, regional, national/federal and international.

These myriad differences and segments make it exceedingly difficult to describe, let alone regulate the industry in broad terms. Arguably, each segment faces unique dynamics that optimally deserve a tailored approach. On the other hand, such micro-level approaches tend to be susceptible to arbitrariness or unfairness in the overall market and can adversely impact other segments. As noted previously, any initiative that tailors regulation more closely to subsets of regulated entities and/or consumers will produce significant benefits to the entire market, but at the risk of increased jurisdictional disputes and less uniformity as the number of regulating entities likewise increases.

Divining the optimal single approach, therefore, amounts to a weighing exercise involving numerous trade-offs and resolving mutually exclusive options that seek to maximize the overall net benefits. At the same time, as regulatory scope and/or structure changes, it is important to consider the effects on the incidence of the corresponding costs and benefits of regulation. Overall improvement, while desirable, will not necessarily ensure that the gains and losses are apportioned equitably among the market's participants. Nevertheless, the extensive nature of state-by-state control of so many aspects of insurance operations ensures that there are numerous opportunities to achieve net improvements and benefits for the overall market without imposing undue costs or risks to any particular segment.

V. Historical Background

Historically, the regulation of the insurance industry has been marked by relatively brief episodes of rapid and dramatic change. These periods are well-known in the industry, but each has had very important implications on the evolving rationale for how the industry should be regulated and by whom.

A. 1860'S

- In 1863, the National Bank Act was passed permitting federal charters for banks. While the Act did not affect the insurance industry directly, it set the two industries on different regulatory courses.[32]

- In 1868, the differences between banking and insurance were further underscored in the seminal U.S. Supreme Court decision *(Paul v. Virginia)* that held that insurance was not commerce, thereby affirming the power of the states rather than the federal government to regulate the industry.[33]

Following this period, perceived market failures drove two important interim developments that led to the next period of significant change. An increasing number of insolvencies led to the development and use of rating bureaus, which sought to improve solvency by ensuring adequate rates. These bureaus, in turn, led to the acceptance and expansion of state management of insurance rates, either directly or indirectly, as an effective means of controlling excessive competition and maintaining market solvency.[34]

B. 1940-1950'S

- By the early 1940's, the regulatory management of the industry in the interest of market stability and industry solvency expanded well beyond simple rate setting to encompass areas of market conduct and the nature of competition itself. This trend culminated in the investigation and indictment of the South-Eastern Underwriters Association, a large rating bureau, for anticompetitive practices in violation of the Sherman Antitrust Act. In its defense, the rating bureau argued that since insurance was not commerce, the Sherman Act did not apply.[35]

- In 1944, in connection with the South-Eastern Underwriters Association case, the U.S. Supreme Court essentially reversed its prior decision of 1868, holding that insurance was, in fact, commerce.[36] The

32 See Harrington (2000-1) at 21; Sinder (2001) at 55.

33 See Harrington (2000-1) at 23; Grace and Phillips (1999) at 6; Sinder (2001) at 52-53.

34 See Harrington (2000-1) at 24-25; Grace and Phillips (1999) at 6-7.

35 See Harrington (2000-1) at 24-25; Grace and Phillips (1999) at 7-8.

36 See Harrington (2000-1) at 24-25; Grace and Phillips (1999) at 7-8; Sinder (2001) at 53-54.

decision threatened to unravel the preceding 75 years of state regulatory development and opened the door to greater federal regulation and oversight.

- The Court's reversal produced considerable confusion regarding not only established operating procedures within the industry, but also regulatory responsibilities and jurisdictions. Congress quickly clarified these issues by enacting the McCarran-Ferguson Act in 1945, which set forth its regulatory intentions. The Act once again affirmed the states as the primary regulating authorities of the insurance industry, but also set forth the conditions in which the federal government could preempt the states' authority.[37]

- In 1956 through the Bank Holding Company Act, Congress expanded the banking industry's limited insurance powers first granted forty years earlier by way of so-called "Section 92" of the Federal Reserve Act.[38] This expansion in bank insurance powers set the stage for regulatory conflict between the Office of the Comptroller of the Currency ("OCC") and state insurance regulators. The states responded by prohibiting bank insurance sales activities and refusing to permit the OCC to exercise its regulatory authority.[39] These measures went largely unchallenged and resulted in the states' maintaining their primary authority.

Over the next 40 years, the evolution of insurance regulation followed traditional lines, with court decisions, as well as periodic crises that were attributed to market failures, driving the major changes. Courts effectively narrowed the industry's antitrust exemption, while states grappled with a series of solvency and affordability crises that arose in each subsequent decade following passage of McCarran-Ferguson. Each crisis called into question the effectiveness of state regulation and spurred reconsideration of whether federal oversight was needed. Each time, however, the states responded by enacting reforms that ultimately forestalled direct federal intervention.

C. LATE 1990-2000'S

- The last two decades of the 20th century were marked by an acceleration in the evolution of the financial services industry in the United States. These developments involved both *expansion* — as each segment of the industry broadened its focus to national and international markets as well as new products and product markets — and *convergence* — as each segment's activities increasingly encroached upon the other segments through both product innovation and corporate consolidation across the segments. The dual-pronged nature of this evolution put tremendous pressure on the existing regulatory system. After nearly two decades of parallel debates and numerous failed initiatives, another landmark Supreme Court decision triggered further changes.

- The so-called "Barnett Bank" decision in 1996 effectively struck down the states' prohibition of bank insurance sales activities by underscoring the OCC's preemption rights over state laws restricting such activities. While the states retained their authority to regulate the insurance activities of banks, the exercise of that authority was subject to OCC preemption if it were deemed to "significantly interfere" with such activities.[40]

37 See Harrington (2000-1) at 25-26; Grace and Phillips (1999) at 8; Sinder (2001) at 54-55.

38 See Sinder (2001) at 56-57; Ketcham (1998).

39 IBID.

40 See Sinder (2001) at 57-58; Ketcham (1998).

- The Barnett decision led to the repeal of the offending prohibitions by the states. Meanwhile, the OCC quickly moved to expand the scope of bank insurance activities in a manner that threatened to usurp or render optional the states' regulatory control and give national banks a significant competitive advantage over the insurance industry.[41]

- The conflicting directions of the states' and OCC's regulatory actions highlighted both the gaps and overlaps in the existing regulatory structure for financial services, and demanded a solution to the increasing regulatory conflicts. Thus, unlike in previous episodes of dramatic change, Congress' consideration during this period was driven by the evolution of the industry rather than by any emergent crisis. The justification for maintaining functional separation among the different segments of the industry, as has been the regulatory tradition since the Glass-Steagall Act of 1933, was called into question, particularly as the pace and scope of these developments continued to increase. The industries found the regulatory structure increasingly constraining, while regulators increasingly grappled with jurisdictional gaps or overlaps and synergistic effects beyond their area of immediate expertise. Together, these limitations of the regulatory structure began to produce significant unwanted or undesirable distortions (especially competitiveness issues) that few could argue benefited consumers.

- After two years of Congressional debate and failed legislative initiatives, GLBA was enacted in 1999, primarily to facilitate the convergence of the financial services sectors via authorized affiliations and expansions in permitted activities.[42] A secondary, but equally important (and still to be realized) goal of the Act was to clarify regulatory responsibilities and minimize the competitive effects of differential regulatory oversight among the various sectors in the financial services industry.

- In less than two years since its passage, GLBA has triggered numerous changes in the financial services industry and its regulation. Already, the Act has demonstrated the potential to clarify or settle many of the conflicts and problems evident in the years immediately preceding its passage, while at the same time setting the stage for new conflicts and the revisiting of past conflicts (e.g., OCC preemption powers). Consequently, the near-term environment has the potential to be as significant a period of change as any that preceded it.

- The current context must also include the terrorist attacks of last fall (and their continuing threat), as well as the fraud-driven bankruptcy of Enron Corporation. These developments could spur even more extensive regulatory changes than might have been imagined following the passage of GLBA. It is still too early to discern exactly how these events will shape the evolution of the industry's regulation, but strong cases can be made for two radically different outcomes — that these developments could either derail the momentum for evolutionary and generally positive change spurred by GLBA, or help pave the way for more extensive and much faster change than otherwise would have occurred.

D. RECENT INDUSTRY PERFORMANCE[43]

As noted previously, the market conditions and financial performance of the industry that prevailed when state regulatory reforms and financial services modernization were inaugurated have changed dramatically for the worse. Coincidentally, this deterioration has accelerated since passage of GLBA in

41 See Sinder (2001) at 59-60.

42 IBID at 63.

43 Data from the Insurance Services Office, Inc. (ISO), *Insurer Financial Results*, unless otherwise noted.

1999 and is likely to have important ramifications on both the momentum and focus of reform efforts in the near future. Considerable attention has shifted from more general modernization efforts to addressing specific and more urgent problems in the market, encompassing supply and availability issues, as well as insurer solvency and financial health. Although ongoing reform efforts continue, the possibility exists that they will be overshadowed by more pressing initiatives, causing a loss of the momentum that has been generated to date. On the other hand, since many of the urgent issues revolve around the effectiveness of regulation, they also could spur more rapid and extensive changes to the regulatory structure. Given its importance to current considerations of the regulatory environment, a brief summary of the industry's performance over the last decade, and particularly in the last several years, is provided below.

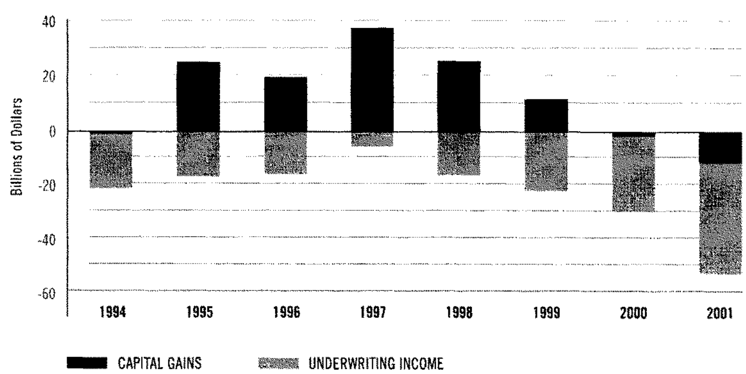
* * * * *

In the three years ending in 1997, the financial results of the property/casualty segment of the industry were buoyed by a continuing high level of investment returns and reductions in underwriting losses, which led to industry profits increasing to record levels in each successive year. Since 1997, however, the industry's performance has been steadily deteriorating, as investment returns have dwindled while underwriting performance has plunged again and remained dismal.

A closer look at this segment's performance over the 1991-2000 period reveals consistent underwriting losses averaging more than $20 billion per year in that decade.[44] Catastrophe losses contributed in large part to this performance, as six of the worst years for such losses all occurred in that decade alone — 1992, 1994-1996 and 1998-1999. Nevertheless, these historically high catastrophe losses simply magnified otherwise poor underwriting performance, as persistently sluggish premium growth and surging non-catastrophe losses helped produce underwriting losses in every year of the period.

Capital Gains Once Obscured Underwriting Losses in P/C Segement, But Now We Are Adding to Them

Annual 1994-2001



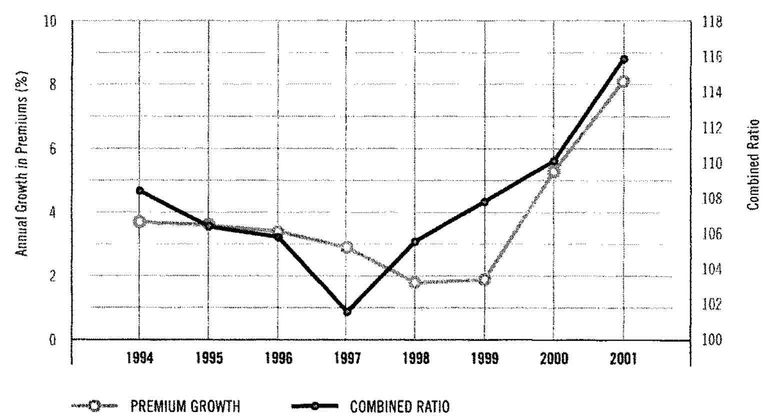
44 See Aon Risk Services of America at 8-9.

These losses would have caused much more significant problems among insurers but for high levels of investment returns that buttressed industry cash flow and profits. Capital gains surged dramatically through 1997, but fell sharply in 1998 and 1999. Meanwhile, underwriting performance marched downward in lock step as losses increased from less than $6 billion in 1997 to more than $23 billion in 1999. The segment's combined ratio reflected this deterioration, rising from 101.6 to 107.8 over the same period.

Soft market conditions finally bottomed following the worsening underwriting losses of 1998-1999,[45] although the increase in rates in 2000 failed to keep pace with the acceleration in underwriting losses that reached their worst levels since 1992, when the catastrophic losses of Hurricane Andrew were incurred.[46] Despite the absence of significant catastrophe losses in 2000, the segment's combined ratio deteriorated further to 110.1, while total capital gains declined for the third straight year and were negative for the first time since 1994.

Premium Growth Finally Rebounds, but the Combined Ratio Continues to Deteriorate

Annual 1994-2001



As 2001 began, the segment was hopeful that continuing rate hardening along with a return to more typical loss experience would finally lead to a much-needed turnaround in underwriting performance. Instead, the unprecedented cost and ramifications of the terrorist attacks, coupled with the failure of Enron and increased toxic mold claims, produced record losses, as the industry's combined ratio surged to 115.8,[47] its third worst level on record. Without capital gains to rely upon as before, the segment's financial condition came under increased pressure. Moreover, continuing losses from the terrorist attacks along with a surge in environmental liabilities (asbestos and toxic mold) are expected to continue to weigh on the segment in 2002 even as rates continue to harden. The drastic results posted by large reinsurers,

45 IBID at 12, 24-25.

46 IBID at 8-10.

47 See Greenwald (2002).

whose combined ratio surged from 108.4 in 2000 to an unsustainable 143.9 in 2001,[48] are also cause for concern for property/casualty insurers, since reinsurance capacity is being withdrawn in response.

While the industry has averted a crisis to date, the potential dangers are becoming more evident. Fortunately, additional terrorist attacks have not recurred in the interim, giving the industry several months to assess the damages and assimilate this new risk into the operating environment to some extent. Nevertheless, it is clear that the terrorist attacks have caused a market failure (manifest in inadequate supply) that the industry is unlikely to be able to resolve completely on its own. Against the backdrop of continuing poor financial performance, the emergence of this new market failure could easily trigger more significant difficulties for the industry, particularly should additional loss shocks occur in the near future.

E. IMPLICATIONS FOR THE FUTURE

This historical overview, while well-worn and simplified, is important in order to place the current environment in context, particularly given the recent further deterioration in operating conditions and their potential effect on reform efforts. As the various segments of the financial services industry weigh the possibilities and lobby for one form of change or another, more confusion than consensus has ensued. In many respects, the present is reminiscent of the period preceding passage of the McCarran-Ferguson Act in 1945 when the Supreme Court's reversal of *Paul v. Virginia* created considerable uncertainty in the industry. This time, GLBA has the potential to produce similar uncertainty by repealing Glass-Steagall and, while reaffirming McCarran-Ferguson, opening the door to federal regulation. While it remains to be seen how these tensions will be resolved, certainly the terrorist attacks, other loss shocks, and overall poor financial performance of the industry constitute new and potentially overwhelming factors that will assert themselves in the debate.

The industry and its regulators are considering numerous measures to address some of the most urgent problems, although their unprecedented nature has led to uncertainty regarding what measures are needed, what measures might be effective, and who should take primary responsibility for initiating and implementing them. Despite a steady accumulation of increasingly threatening evidence, the diffusion of the impact on the market may be contributing to some complacency among legislators, regulators and even the industry itself.

In addition, structural regulatory limitations are also contributing to the delay and difficulty in reaching a consensus. The existing state regulatory structure has demonstrated repeatedly that reaching a consensus and enacting reforms across 51 jurisdictions is not something that it can achieve quickly and effectively. As crises emerge, as in response to the terrorist attacks, the industry is forced to turn to the federal government seeking more rapid and effective responses. While Congress has been responsive to the industry's concerns, the absence of a continuing federal authority with the necessary capacity and expertise has proven to be a significant limitation in achieving needed changes. Together, these structural limitations have led to hesitation and delay that, while understandable, could prove to be quite costly should further developments occur in the meantime. In short, the industry and its regulators have managed to dodge a bullet so far, but numerous threats and risks remain that could quickly change the landscape and alter the reform and modernization efforts underway.

In summary, history underscores several important points that should be considered as the modernization effort and calls for structural reforms proceed:

Remember your roots. While few would disagree that the modernization effort is needed, Glass-Steagall and McCarran-Ferguson have been instrumental in defining the financial services industry. These laws have shaped the industry for more than 50 years and set the insurance and banking segments

48 "Attacks Make Reinsurer Results Even More Dismal." *Business Insurance*, April 8, 2002.

on different regulatory paths. Despite its repeal of Glass-Steagall, GLBA has, for the time being, helped to ensure that these regulatory paths largely remain distinct.

Regulation has limits and risks. While regulation can improve the workings of the industry, regulators have little control over many important factors — investment returns, the weather, the limits of science in discerning cause and effect or probability, and even human nature — that ultimately play a far greater role in the health of the industry. While regulation has succeeded in reducing overall market and systemic risk in some respects, in others it has contributed risk, which is contraindicated for an insurance industry that already operates in a constantly changing and uncertain environment.

There is no crisis (yet). GLBA focuses on the potential of the future rather than remedying an existing crisis. This is a critical difference. Moreover, the modernization effort is focused more on regulatory efficiency and should, therefore, be driven by objective assessments of relative costs and benefits, as opposed to more subjective or political concerns. As noted above, however, the industry has suffered a series of operating setbacks that have pushed it to the verge of crisis that, on one hand, may spur more rapid and extensive regulatory changes (as has occurred following past crises), or, on the other hand, may derail ongoing reform efforts by drawing attention to more urgent problems.

Do no harm. There is widespread agreement that regulation imposes costs on the industry and consumers that often exceed the corresponding benefits that might result. Some believe that regulation causes more problems than it resolves, and perhaps even creates or exacerbates market failures. While this study is not intended to settle that debate, it is reasonable to assert that regulation often has imposed additional costs and engendered risks to the industry and consumers through unintended consequences or miscalculation. Thus, regulatory reform presents a two-edged sword that, while promising potential benefits, raises the specter of harmful ramifications, even if unintended.

Carrots or sticks? History has evidenced an unmistakable pattern of regulatory crisis, followed by threat of federal intervention, and finally state reform that may ultimately have been more focused on the federal threat of preemption than on the underlying regulatory problem. Clearly, state-by-state reform has tended to occur more quickly and dramatically when this threat has been present. Three recent examples are instructive:

- The establishment of state guaranty associations in 1969-1970 in response to the threat of federal intervention to establish a federal guaranty association;
- NAIC's successful accreditation efforts and move toward risk-based capital standards largely were spurred by the threat of federal intervention following the spike in insolvencies in the late 1980's; and,
- The accelerated movement by the states to improve licensing uniformity over the last 2 _ years has been spurred by the threat of GLBA's NARAB provision.

To the extent that the industry seeks to achieve additional reforms within the state structure, these dynamics must be considered. At the very minimum, the states' ability to implement and achieve effective licensing reforms (in contrast to merely forestalling the creation of NARAB) provide a timely test regarding the inherent ability of state regulation to evolve at a satisfactory pace and manner. See Section VIII.

The devil you know. Some have interpreted or argued that GLBA establishes two critical points: 1) it reaffirms the authority of the states as the primary regulators of the insurance industry; and, 2) maintains the organization of financial services regulation along functional lines. While these are certainly prominent considerations in the debate over regulatory structure, perhaps more important and less disputable is the fact that GLBA has put the regulatory scheme in play, and could prompt another period of significant change. As was the case with the prior periods of change, there is considerable potential for improvement, as well as deterioration, particularly with respect to regulatory confusion and uncertainty.

High stakes require consensus. The number and varying nature of the positions and proposals being offered by each segment of the financial services industry, including its respective regulators, underscore the importance of the task at hand. As the debate continues and lines are drawn, achieving a consensus in the insurance industry (let alone the financial services industry as a whole) seems increasingly remote. Unless galvanized by crisis, it is reasonable to expect that the greater the differentiation in regulatory goals and preferences across the industry, the less likely that Congress and the states will be willing to contemplate dramatic changes in structure.

VI. Fundamental Evaluative Criteria for Regulation

In this section, the evaluative criteria for assessing alternative regulatory structures are outlined. These elements are universal and each should be fully considered when comparing alternative structures in a general rather than an applied sense. By relying first on these elements, the theoretical soundness of each structure can be tested before delving into more specific evaluations.

These fundamental concepts are often overlooked due to a more limited focus on specific problems in support of one alternative or another. While such approaches may appear more practical or applied, they run the risk of merely tweaking fundamentally inefficient or distorting regulations, and, therefore, ensuring their continuation and potential to cause future problems, albeit, perhaps, in an incrementally improved fashion. The approach of this study is broader given its goal of establishing a systematic framework for evaluating alternative regulatory structures generally (rather than supporting a particular proposal), as well as providing sound, economic reasoning to support such evaluations as empirically as possible.

These analytical elements force consideration of whether regulation is tied directly to resolving a fundamental market *failure* as a threshold matter, rather than a market problem or other perceived need for regulation in the market. Next, the analytical framework is applied to the primary areas of insurance regulation — solvency and financial risk, consumer protections and market conduct, and pricing — to determine where and how regulation can be most efficient, while retaining its effectiveness. Once the proper focus of effective and efficient regulation is established, a more applied review of the various direct and indirect costs of regulation follows.

A. TYPES OF MARKET FAILURES

The primary rationale for regulation is to address market failures, which encompass several discrete but related categories in the context of the insurance industry. As a starting point, it is important to distinguish between market *failures* and market *problems.* All markets experience problems, which stem most basically from the opposing goals of and conflicts among market participants. This is precisely the role that markets are intended to mediate by resolving differing preferences (not only between buyers and sellers, but among competing buyers and among competing sellers). In contrast, market *failures* represent structural flaws that cannot be overcome or corrected by competition, or that preclude viable competition in the first place. The primary market failures for which regulation usually is prescribed and accepted are discussed below.

1. BARRIERS TO ENTRY OR EXIT

Absent the effects of regulations themselves, there is no evidence of significant entry or exit barriers to the market among any of the different segments in the industry. To the contrary, there is considerable evidence that the insurance market, particularly the commercial lines, is structurally competitive, as concluded in numerous studies over an extended period of time.[49] None of the typical market-related

49 See, e.g., Joskow (1973) at 375, 391; Cummins and Weiss (1991) at 117-154; Feldhaus and Klein (1998) at 35-36, 38; Harrington (2000-2) at 15-24; Skinner and Klein (1999) at 14. See also, more generally, Cummins and Weiss (1992); Klein (1995); Grace and Barth (1993). Typical criteria used to assess the structural competitiveness of markets include the number of sellers and buyers, the range of consumer options, differentiation in pricing, firm market concentration, and the existence of excessive prices or profits.

barriers are present in the insurance industry and it is generally believed that inherent entry barriers are low.[50] The primary exit barriers are economic or practical in that exit decisions typically cannot be implemented quickly, often involve the forfeiture of significant investments in the given market (and loss of a national presence), and subject the exiting company to significant incremental costs.

The most significant entry and exit barriers to the market are those imposed by its regulation. Imposed entry barriers include company and agent licensing, agent appointments, countersignature requirements and minimum financial requirements.[51] Such entry barriers are intended to protect consumers, but in many respects can be harmful to consumers. The direct costs of compliance are inevitably passed on to consumers. More significantly, however, entry barriers tend to reduce competition among service providers and increase prices to consumers.[52]

The primary exit barriers imposed are "lock-in" rules, which are even more constricting when coupled, as is usually the case, with restrictive rate and/or form regulation. Once again, such exit barriers are intended to protect consumers, but do so at the cost of reduced insurer profits, which ultimately undermine solvency and tend to reduce the availability and quality of insurance products to consumers.[53]

2. MARKET CONCENTRATION AND FIRM MARKET POWER

Market concentration is an important element in the context of several unique and interrelated features of the insurance industry, as follows:

- The industry's limited exemption from federal antitrust laws (i.e., the Sherman Act, the Clayton Act and the Federal Trade Commission Act) conditioned upon affirmative antitrust regulation by the states;

- The permission of cooperative activities among competitors that are typically prohibited, ranging from the sharing of information on historical and prospective loss costs to explicit rate-setting in the interest of promoting the efficient development of accurate pricing information and risk evaluation, as well as preventing excessive competition that might unduly pressure insurer solvency; and,

- The use of form regulation as a means to ensure minimum levels of coverage and promote standardization. Standardization benefits both consumers (by facilitating price comparisons) as well as underwriters (by generating comparable loss experience data that can be pooled accurately). Form regulation, however, distorts the market by reducing the degree of product differentiation that would otherwise exist. If suppliers are not permitted to differentiate their products in terms of their coverage and other features, then they are forced to compete in other areas (e.g., price and level or quality of service).[54] Thus, form regulation is not necessarily advantageous or disadvantageous to consumers — it *can* promote greater competition (by facilitating price comparisons), but it does so at the cost of potentially distorting the market or, worse, merely providing the appearance of greater competition.

50 See Macey and Miller (1993) at 38; Feldhaus and Klein (1998) at 36; Harrington (2000-2) at 18; Skinner and Klein (1999) at 14. In this context, entry includes both new service providers as well as the expansion of existing service providers into a new market.

51 For companies and agents/brokers operating in multiple states or nationally and/or across multiple lines, state-by-state licensing requirements constitute a particularly significant entry barrier with a corresponding adverse limitation on overall competition.

52 See Feldhaus and Klein (1998) at 55-57.

53 See Harrington (2000-2) at 34-37; Macey and Miller (1993) at 110.

54 Moreover, a distinction must be made between the nominal standardization of forms and the corresponding standardization of actual loss coverage, since forms by themselves do not necessarily reflect insurer claims-paying ability or willingness under the range of particular circumstances giving rise to claims. These factors, along with other quality of service variations, run counter to the benefits of standardization for consumers.

Each of these features should tend to reduce competition and facilitate coordinated action by firms, typically leading to higher industry concentration and individual firm market power. There is little evidence, however, to support such a characterization of the insurance market, as noted previously. In short, the relatively low levels of industry concentration coupled with the relative ease of entry are not conducive to anticompetitive behavior.

Firm size and industry concentration must be evaluated on many different levels, with respect to the market's different service providers (i.e., reinsurers, insurers, and agents/brokers), the relevant market (i.e., local, state, regional, national, continental or international), and the type of insurance, which is beyond the scope of this study. It is important to note, however, that firm size and industry concentration are driven by many legitimate factors that need not be subject to regulatory scrutiny as a general matter. Given the degree of consolidation that has been occurring in recent years across all segments of the industry, firm size and industry concentration have increased significantly. Many academic studies have addressed the question of whether increasing concentration reflects less competition (negative) or the increasing dominance of more efficient firms at the expense of less efficient firms (positive). With respect to insurance specifically, a few studies have found a relationship between industry concentration and profitability.[55] It is not clear, however, whether such increased profitability stems from market power or simply better performance due to efficiency.[56] In the case of the latter, regulatory efforts to reduce market concentration effectively rewards less efficient firms at the expense of more efficient firms, which clearly is not a beneficial outcome.[57]

3. EXTERNALITIES

Externalities refer to a cost or benefit that arises from an economic transaction which is borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality.[58] This economic principle is especially critical in evaluating alternative regulatory structures, given the generalized tendency of decentralized, state-based regulatory structures to create externalities, particularly as regulated markets expand beyond state borders (as is the case for insurance).

Externalities can be either positive — when a party accrues a benefit without a corresponding cost (frequently referred to as a *free-rider* effect) — or negative — when a party accrues a cost without a corresponding benefit (*spill-over* effect).[59] Generally, externalities are not "either-or" propositions. One party's positive externality is another party's negative externality, such that, from an economic perspective, all externalities are undesirable since they involve a distortion in relative costs and benefits. These concepts are best illustrated by way of examples:

- uninsured or underinsured parties are prone to losses that cannot be claimed and, therefore, may be

55 See, e.g., Harrington (2000-2) at 48.

56 Assessments of relative profitability should account for differences in risk. A 1995 study by ISO based on industry performance in the 1979-1993 timeframe concluded that larger insurers were more profitable and less risky than smaller insurers, while commercial-lines insurers were more profitable and more risky than personal-lines insurers. See ISO, *Risks and Returns: Property/Casualty Insurance Compared to Other Industries*, December 1995. Notwithstanding these findings, the aggregate combined ratio for the largest property/casualty insurers was significantly worse than average in 2001 (118.2 versus 115.8 — see Greenwald (2002)), which may indicate that larger insurers may face higher than average risks in catastrophic losses and/or in underwriting the risks of large commercial insureds that have the potential to generate unusually large losses.

57 Industry concentration among agents and brokers is significantly higher than for insurers, but still not high enough to prevent continuing mergers and acquisitions by the leading firms. The wide range and increasing sophistication of risk management and ancillary services demanded by commercial insureds on a global basis has provided much of the impetus behind the consolidation among agents and brokers, as they seek to expand and round out capabilities to serve such clients. Consolidation among insurers also has been a factor since volume requirements for agents and brokers tend to increase along with insurer size. See "CNA Chairman Looks at the Future of the Agency System." *The Rough Notes Magazine*, January 1999; Schiff, Samuel. "Agency System Lives but Continued Agency Survival Will Require Adapting to Changes." *The Rough Notes Magazine*, February 1999; Boone, Elizabeth. "Trends for the New Millennium." *The Rough Notes Magazine*, January 1999.

58 See Spulber (1989) at 46.

59 IBID.

borne instead by other parties, whether or not they are involved directly in the loss occurrence or insurance transaction;

- restrictive risk classification regulations tend to force lower-risk insureds to "subsidize" higher-risk insureds by interfering with the natural relationship between risk and premium levels; and,

- states that fail to regulate adequately or efficiently either impose costs and risks upon other states, or benefit unfairly from the more rigorous and efficient regulation by other states.

The last example demonstrates why externalities are key in evaluating alternative regulatory structures. Theoretically, regulation is considered a "public good," which refers to goods or services that can be consumed simultaneously by everyone, even if they do not purchase or pay for it directly.[60] A secondary economic principle that governs the supply of public goods is the *Pareto optimal provision*. When applied to regulation, this principle holds that regulation should be "produced" at the most *decentralized* layer of government capable of internalizing all the economic costs and benefits associated with regulation.[61] Thus, this principle is at the core of the debate regarding the proper jurisdictional size, as well the locus and structure of regulation.

The principle, on its face, is deceptively simple and appears to favor smaller regulatory jurisdictions. The principle's apparent bias toward decentralization is premised on the ability of smaller jurisdictions to be more responsive to particular preferences in those jurisdictions. As jurisdictions become larger, it becomes more difficult to address particular preferences, which can impact the ability of regulation to achieve its stated goals. Logically, two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies (discussed below).[62]

The primary offset to the benefits of decentralization is its tendency to generate negative externalities upon other jurisdictions. A common example is when a given jurisdiction (often smaller) fails to conduct sufficient oversight and either relies on other jurisdictions to do so ("free-rider" effect) or causes market problems (e.g., fraud or insolvency) whose impact is not confined to that jurisdiction ("spill-over" effect). Inefficiencies related to redundancies and diseconomies of scale or scope in regulation are also key disadvantages of decentralized authority. These shortcomings are the chief source of complaints and criticisms regarding state regulation.

In practice, therefore, it is difficult to evaluate this ostensibly simple principle. As a starting point, merely *identifying* all of the costs and benefits associated with regulation is a complex matter. Accurately *measuring* those costs and benefits (including their incidence — i.e., by whom the costs are borne and by whom the benefits are accrued) is even more difficult. Nevertheless, given the state-based structure's susceptibility to generating negative externalities, assessments of alternative structures must address these complex but important considerations.

4. INFORMATION CONSTRAINTS

An unrestricted, cost-effective and balanced flow of accurate and timely information to market partici-

60 Common public goods besides regulations include naturally-occurring air and water, national defense, and public radio. The notion of direct payment is key in differentiating between public and private goods. Due to the lack of direct payment or readily apparent consequence, consumers of public goods tend to be insensitive to their ultimate cost.

61 See Grace and Phillips (1999); Inman and Rubinfeld (1997); Oates (1972).

62 As the market becomes broader, these rationales may begin to benefit consumers more than insurers. While insurers also benefit from the ability to tailor products to specific risks, the maintenance of many discrete jurisdictions runs contrary to the fundamental objectives of many insurers — gaining economies of scale through market penetration and pooling risks across larger populations. This divergence between consumer and insurer preferences is least evident in commercial lines, especially for larger consumers whose need to obtain coverage nationally or internationally tends to outweigh their need for tailored coverage and regulated protections.

pants is an essential precondition of market functioning irrespective of the particular market. The quality of information in the market is driven by three factors:

- **Disclosure:** developing and reporting a comprehensive set of information.
- **Access:** making the information available to those who need it.
- **Understanding:** making the information useful by ensuring its consistency and comparability, as well as its presentation in a readily understandable manner.

In addressing information constraints, a key consideration is which of the above factors should be subject to regulatory control. In insurance markets, the chief manifestation of information constraints is *asymmetry* or *asymmetric information*, which exists when one party to a transaction has relevant information that the other party lacks.[63] While asymmetry does not necessarily have to lead to problems, it certainly raises the potential for problems and provides one of the strongest justifications for regulating the insurance market.[64] As discussed further below, asymmetry also contributes to another insurance market failure — *principal-agent conflicts* — that arise when one party, due to a lack of information, is unaware of the actions of the other that might affect future performance on the insurance contract.

Throughout the financial services industry, the primary thrust behind regulating information constraints has been centered on ensuring adequate levels of disclosure.[65] While regulators also seek to ensure that the information, once disclosed, is obtainable and understandable by consumers, regulation cannot compel consumers to utilize such information, particularly if they perceive no hazard in their failure to do so. Consequently, regulation may undermine consumer willingness to obtain and analyze the relevant information (whether directly or through an intermediary), while promoting more exclusive reliance on regulation to do so on their behalf. This is particularly relevant in personal and health lines among individual consumers, but less so in commercial lines where consumers are more sophisticated and able to justify the costs of such evaluations.

When buyers and sellers lack adequate information, they are unable to express their preferences properly in terms of products, distribution methods, quantities and prices they are willing to demand and supply, respectively. While such constraints will not preclude the market from functioning, they will cause the market to function at suboptimal levels that fail to maximize overall welfare. By providing distorted signals to both buyers and sellers, the market will tend to experience sharp fluctuations in market-clearing behavior, characterized by alternating periods of shortages or excess supply and excessive or inadequate pricing,[66] as well as less suitable product features and a lack of innovation. In short, overall market efficiency deteriorates for all participants.

For insurers, information constraints or asymmetric information lead to *adverse selection* (inadvertent risk assumption) and *moral hazard* (imprudent risk assumption).[67] The prevalence and significance of these information constraints have led insurers to develop sophisticated techniques to minimize their

63 See Skipper and Klein (1999) at 12.

64 Insurance itself is a common response to asymmetric information problems in the financial services industry generally (e.g., deposit insurance or Federal guarantees of pension benefits). See Herring and Santomero (1999) at 7.

65 While regulators also audit and analyze disclosed data, those functions are somewhat less critical since they can be undertaken to some degree by willing consumers, competitors, other service providers and intermediaries, provided they have access to adequate information. Thus, the regulatory authority to compel accurate and meaningful disclosure is one that cannot be transferred or replaced, and, in turn, empowers other market participants in undertaking their own analyses and thereby assuming quasi-regulatory roles that benefit the market.

66 These market imbalances can become particularly pronounced in the insurance industry due to the interplay of underwriting cycles and investment risks.

67 See Grace and Klein (1999) at 6; Varian (1992).

effects. These mechanisms include actuarial and probability analysis, contract stipulations and provisions, risk classification and selection, and pricing.[68] Adequate information for insurers is both comprehensive with respect to particular risks, as well as broad in terms of sample size, to ensure accurate pooling and probability assessments.

With the benefit of adequate information, insurers are able to more accurately underwrite risks, price products and forecast losses, thereby producing corollary benefits in terms of solvency, profitability and overall efficiency. Arguably, affordability and availability also are enhanced. The hallmarks of a well-functioning market include the growth and success of insurers that avoid adverse selection and moral hazard, which, in turn, hinges on their ability to classify a range of risks into a homogenous group. This classification, in turn, is dependent not only on accurate and timely information, but also the freedom to discriminate among risks. It is this discrimination, however, and the disadvantaging of some buyers vis-à-vis others that often serve to generate regulatory attention that seeks to limit the very actions that are essential to insurers' success and ongoing viability.[69]

For consumers, information constraints tend to be technical rather than absolute and center on their inability or unwillingness to obtain, analyze and understand the information required to make optimal purchasing decisions. The essential information required by consumers includes prices, the implications of contract provisions, the quality of service and the ability of the insurer to meet its obligations.[70] It is costly for consumers to obtain and understand this information, in inverse proportion to their size and also in relation to insurers, which produces asymmetry (and potentially, in turn, principal-agent conflicts) in insurance transactions. Regulation seeks to improve consumers' decision-making abilities by requiring sufficient disclosures in a simplified and comparable format, as well as by monitoring insurer solvency and claims-paying ability on behalf of consumers.

To a certain extent, these regulatory goals go beyond merely addressing the information constraints and effectively may relieve consumers of this difficult but essential responsibility. Among smaller and less sophisticated consumers, regulatory oversight may be perceived as a guarantee, which is contrary to the goal of regulation, not to mention the nature of insurance. Of course, that these perceived "guarantees" are further reinforced by actual guarantees (via guaranty fund protections) only exacerbates this weakness in the market.

5. PRINCIPAL-AGENT CONFLICTS

Principal-agent conflicts are present in all markets and the resolution of these conflicts is the prime function of markets. While unavoidable, these conflicts have the potential to disrupt market functioning and lead to reductions in overall welfare. There are three major sources or causes of these conflicts in insurance transactions.

First, as is typical in any market, the fundamental goals of each party in an insurance transaction differ. Insurers seek profits by maximizing premiums and minimizing paid loss claims, while consumers seek savings by minimizing premiums and maximizing benefits and coverage.[71]

Second, both insurers and consumers are limited in their ability to monitor and control the other, giving rise to asymmetry and setting the stage for conflicts between the parties.[72] Insurers may assume risks in transactions with some consumers that threaten contracted benefits to other consumers, or simply

68 See Grace and Klein (1999) at 6. Significantly, all of these techniques generally are subject to close regulatory scrutiny.

69 See, generally, Harrington (2000-2). Notably, one of the key features of LRRA is the preemption of prohibitive or restrictive state laws that preclude insurers from offering preferential rates, terms and conditions to groups, even if they are justified by actual loss and expense experience. See National Risk Retention Association, *Frequently Asked Questions*, downloaded at http://www.nrra-usa.org/about_faq.html.

70 See Grace and Klein (1999) at 6.

71 IBID at 7.

72 See Skipper and Klein (1999) at 13.

refuse to honor presumed or even actual obligations. Consumers, on the other hand, may make suboptimal purchasing decisions or fail to implement and/or maintain sensible measures to control losses.[73]

Third, in both purchase negotiations and disputes over contract terms, insurers typically have a significant advantage over consumers. This advantage stems not only from a better knowledge of risk management and contract terms, but also from having greater resources and bargaining power over individual policyholders.[74]

Principal-agent conflicts lead to suboptimal consumer decisions, excessive insolvency risk, and abusive market practices.[75] Regulation seeks to supplement or even substitute for market mechanisms that are constrained by these conflicts in order to resolve them in a fair and balanced manner. While the first two of these conflicts can be equally detrimental to insurers and consumers, regulation seems most driven by the third type, regarding proficiency and market power, where the consumer is considered most disadvantaged. In an effort to resolve this conflict more in favor of consumers, regulation also tends to mediate the other two types of conflicts in a similar fashion, usually to the detriment of insurers and to the more disputable benefit of consumers. While these conflicts are related, it is not settled that they need to be regulated similarly or that the market is unable to reconcile them more effectively and efficiently on its own.

B. LINKS BETWEEN MARKET FAILURES AND REGULATION

Market failures occur in varying degrees of severity, and are distinct from market problems, not to mention social and political (i.e., non-market) objectives. Market failures are characterized by their persistence and substantial impact, as well as the inability of the market to resolve them satisfactorily — by maximizing the collective welfare of all market participants without bias. At the very minimum, once a failure has become severe enough to warrant regulatory intervention, it should be amenable to being solved by regulation. Surprisingly, this simple tenet is often lost in the process of promulgating and enforcing regulations. Ideally, the goal of regulatory intervention should be to correct rather than offset or control the structural flaw, leading eventually to a market that remains stable, functional and less dependent on regulation to manage its predisposition to the particular failure in the future.

The structural nature of market failures, however, frequently produces failures in groups, due to their typically high degree of interrelatedness. As noted above, information constraints often lead to externalities or principal-agent conflicts; barriers to entry often lead to market concentration; and, principal-agent conflicts can lead to excessive insolvencies. This has important implications for regulation since the interrelatedness of market failures complicates addressing them in an independent manner. Many times, addressing one type of market failure can trigger or exacerbate others if the market and its failures are not viewed more holistically.[76] Most if not all undesirable outcomes in the insurance market can be traced to one or more market failures, as should be expected. Unfortunately, once intervention in the market is deemed warranted and then implemented, there is a tendency to focus on the regulatory response at the expense of the underlying failure, which inevitably leads to additional regulation or a continual fine-tuning of existing regulations.

73 IBID.

74 IBID.

75 IBID at 8.

76 Insurance regulation comprises a loose collection of discrete actions (i.e., licensing, financial regulation, rate and form regulation, market conduct, etc.), each with a particular focus or set of goals. Viewed collectively, these actions may be seen as a holistic approach to regulating the insurance industry and market, although that is not what is meant here. An effective holistic approach demands that the various activities be performed in concert to achieve a desired *overall* outcome in the most efficient manner possible. A better description of insurance regulation is that nearly every aspect of insurance transactions is subject to regulatory scrutiny and that the spectrum of regulatory activities, while broad in the aggregate, tends to involve significant redundancies. While these redundancies arguably provide additional security, they have equal potential to be unnecessary, inefficient and even in conflict with each other.

Regulatory focus often shifts toward the *administration* of a regulation, and away from its *impact* on the underlying failure. This is evident in many areas of insurance regulation. For example, licensing regulations generally are accepted as a proper control over the authority to conduct insurance transactions. Consequently, debates regarding licensing are focused almost entirely on how licensing is best accomplished, rather than on whether licensing is contributing meaningfully to regulatory authority and consumer protection. Even more troubling are instances in which regulatory requirements successfully generate the information needed to identify a problem and trigger intervention, but oversight fails to detect the problem due to inadequate analysis or communication on the part of regulators.[77]

At the extreme, regulation can further embed the very structural problem it seeks to address. Rather than serve as an incentive toward structural improvement in the market, the regulatory effort often encroaches upon the market and ensures that the failure (or threat thereof) persists by thwarting or damping the discretion of the market participants toward resolving the problem. Alternately, this could be described as substituting the judgment of regulators for the judgment of the insurance industry and its customers. Regulatory intervention can become so intrusive that normal market forces are thwarted, leading to a persistence of the threat of failures and, thus, the need for continued or even increased regulatory intervention. In short, regulation can act as a crutch that weakens rather than strengthens market forces and dynamics, which is exactly contrary to the original goal of the intervention.

C. REGULATORY FOCUS

Due to the fiduciary nature of the financial services industry, regulation of product/service providers generally is accepted and considered an effective means of maintaining market confidence and stability — two critical foundations of efficiently functioning markets for financial services. The importance of market confidence and stability, however, go well beyond mere efficiency concerns. In the insurance industry, the weakening of these foundations can introduce severe distortions (e.g., weak companies competing with excessive risk) and substantial externalities (e.g., unpaid loss claims being shifted to other consumers and investors), reduce insurance supply and decrease overall coverage, increase frictional costs by spurring litigation, and adversely impact the businesses and other activities protected or facilitated by insurance.[78] Given the potential for these large and adverse impacts, regulation seeks to minimize threats to these critical foundations, via direct control and limitation of insurers, thereby moderating unfettered market forces that might tend to produce different results. In short, regulation attempts to provide more cost-effective outcomes than the market would produce on its own.[79]

As noted above, regulatory intervention is most effective if it is confined to addressing unambiguous market failures with the goal of correcting those failures and restoring the proper and healthy functioning of the market. Before intervention takes place, the subject failure should meet two basic criteria. First, the failure should be causing substantial adverse effects, whether in terms of actual impacts or via the

77 The United States General Accounting Office (GAO) repeatedly has evaluated insurance oversight in the context of insolvency and fraud problems that have surfaced in recent years. While GAO has recognized other factors unrelated to regulatory oversight that have contributed to these problems (such as business cycles and other macroeconomic pressures), in many cases it attributed significant blame to lax or inadequate regulatory processes that were often unconnected to the specific compliance activities of the regulated entities involved. In particular, the GAO identified time lags in oversight and analysis, insufficient communication and coordination, inadequate reporting standards (regarding reinsurance data, consolidations, holding companies and interaffiliate transactions), budget limitations, jurisdictional complications, and fundamental limitations in NAIC's authority. While GAO recommended *more* regulation and oversight, in most cases it emphasized the need for *better* regulation and oversight via an improvement in processes rather than an increase in regulatory requirements. See, generally, GAO (2000).

78 Certainly, the recent terrorist attacks are being felt by insureds not only with respect to their particular insurance coverages and rates, but also their fundamental ability to conduct business due to an inability to adequately address risk exposures.

79 The natural competitive forces in the insurance industry, as in any industry, produce insolvencies and closures that do not constitute de facto evidence of market failures. To the contrary, the *absence* of failures or insolvencies suggests inadequate competition that likely stems, in part, from excessive regulatory interference and is manifest in reduced supply and increased prices. See Skipper and Klein (1999) at 23-24. While the existence of significant market failures in the insurance industry increases the threat of insolvencies and closures, the same is true for all segments of the financial services industry.

threat of unacceptable levels of risk. Second, the regulation must demonstrate that it is able to lead to a significant improvement in outcomes vis-à-vis free market performance.[80]

Since regulation imposes definitive costs on the market that run counter to consumer welfare,[81] but only speculative benefits (depending upon the amenability of the failure to regulation as well as the effectiveness of the conduct of regulation), the mere existence of market failures is insufficient to warrant regulatory intervention. The failures must have *demonstrable* adverse effects upon market participants. Furthermore, the intervention must generate a sufficient return, via improved market performance and outcomes, on the costs it imposes; otherwise, the intervention merely exacerbates the failure by imposing incremental costs without a corresponding or even demonstrable improvement in market functioning, including, ideally, the restoration of its self-governing and self-correcting capacity. In short, the purported benefits of regulation, no matter how significant or widely-accepted, must be evaluated in conjunction with its costs, both explicit and implicit.[82]

The hallmark of an efficient and competitive insurance market is one that minimizes the *overall cost of risk* (see inset next page), which comprises three elements:[83]

- the cost of losses;
- the cost of loss control (i.e., measures to reduce the frequency and severity of losses); and,
- the cost of risk reduction and transfer.

Regulation of insurance tends to be focused disproportionately on the third element — via regulation of prices, policy forms and market conduct — often at the expense of the other two elements, which have the potential to impact the market much more significantly. Perhaps the biggest criticism of regulation is that by attempting to control the *incidence* of the market's costs — i.e., who bears the costs — by interfering with the market's normal allocating functions, it tends to increase overall costs and, thus, decrease overall welfare even if it manages to reduce costs or loss exposures for a given consumer segment. Competitive and efficient markets are unbiased regarding the incidence of costs and more directed toward minimizing them overall by providing strong incentives for efficient behavior. For insurers, this means classifying risks accurately in order to price them properly and avoid adverse selection. Accurate risk classification, in turn, provides strong incentives to consumers to control losses in order to reduce premiums and uninsured losses.[84] These incentives are the key determinants of the market's efficiency and are often influenced significantly by regulation.[85] Consequently, every regulatory response should be judged based on its effect on these incentives, since any measure that reduces these incentives for solid underwriting and/or loss control tends to increase overall consumer costs, undermine insurer profitability or financial condition, and increase risk to both insurers and consumers.[86]

80 See Grace and Klein (1999) at 5-6.

81 See Harrington (2000-2) at vii. Such costs are passed onto the consumer in a number of different ways. Most generally, they cause an increase in prices and a reduction in output; however, these costs also have other less obvious ramifications, such as reduced service levels and, if not passed onto the consumer, a reduction in insurer solvency margins.

82 This simple construction is belied by the difficulties in establishing the benefits of regulation in an industry that has been regulated extensively for many years. Assessing the benefits of regulation requires speculation as to what might have occurred in its absence, which is, at best, a theoretical exercise. In contrast, the costs of regulation, while also difficult to identify with precision, at least can be assessed more empirically, as discussed in the next section.

83 See Harrington (2000-2) at 23-24.

84 See Harrington (2000-2) at 23-24.

85 In the context of market failures discussed earlier, prices represent the single, most critical type of information between buyers and sellers that permit them to mediate their different preferences in any transaction. Direct regulatory control invariably distorts those prices, thereby producing a new information constraint even as it seeks to resolve an existing one.

86 See, generally, Harrington (2000-2); Grace and Klein (1999).

The Overall Cost of Risk

The concept of the overall cost of risk represents an example of a holistic view of insurance and its regulation. The Risk Insurance and Management Society (RIMS), in conjunction with Ernst & Young, conduct an annual survey of the overall cost of risk in the United States and Canada ("RIMS Benchmark Survey"). The overall cost of risk in the survey is defined as the aggregate of premiums, retained losses, internal administration (including costs associated with an organization's risk management functions) and certain outside services.

The survey indicates that the overall cost of risk to corporations in the United States and Canada has fallen sharply over most of the last decade, from $8.30 per $1,000 of revenues in 1992, to $4.83 per $1,000 of revenues in 2000. The decline was attributed to reduced premiums, higher coverage limits, lower deductibles and lower losses.

While some of these factors can be attributed to general economic conditions, they also reflect a competitive market in which average costs are declining. Costs are expected to rise, however, in 2001 given the hardening in the market coupled with a surge in losses.

See Zinkewicz, Phil. "Research Reports Outline Changing Roles of Brokers, Banks, Insurers and Risk Managers," The Rough Notes Magazine, July 1999; "Cost of Risk Declines for Second Consecutive Year." Insurance Journal – Property and Casualty Magazine, December 10, 2001.

Although nearly every aspect of insurance transactions is subject to regulation, the most effective intervention is limited to solvency or limiting financial risk, and consumer protections or policing market practices, where market failures are most evident and harmful.[87] From a more academic perspective, the rationale for regulating these areas shares a common denominator — the ample evidence that, due to the presence of market failures, the market is unable to render satisfactory outcomes as cost-effectively without regulation, provided it is designed and administered properly.[88] These areas are discussed in greater detail below, along with price regulation, since this is an area of particular concern.

Before turning to these areas, the distinction between extensive regulation and effective regulation bears emphasizing. As noted above, nearly every aspect of conducting insurance transactions is subject to some degree of regulatory scrutiny and control in the United States. There are increasing indications, however, that efforts to regulate so extensively may come at the expense of the ability to regulate effectively. Since regulatory resources are limited, as the number of aspects subject to regulatory control and scrutiny increases, the degree and quality of such control and scrutiny over the most critical elements of regulation necessarily must decrease. At the same time, the insurance market continues to expand and become more complex, which has further strained regulatory capacity.

Consequently, the state system is sometimes criticized for being overly broad but insufficiently exacting. Certainly, the findings of the GAO in its past investigations have tended to underscore the notion that by trying to do too much and without sufficient coordination, state insurance regulators do not always carry out their core functions effectively. More recently, industry observers have pointed to questionable regulatory performance in light of the Frankel fraud case, the insolvency of Reliance Insurance Company

87 See Grace and Klein (1999) at 9-14.

88 In contrast, there is considerably more debate in a third area of intervention — ensuring fair prices (both to insurers and consumers) — where regulation increasingly is considered to achieve less satisfactory outcomes at a higher cost than the market otherwise would achieve. While rate regulation is often categorized within the area of financial risk or consumer protection, it is discussed separately here as a special case.

and the emerging crisis in the property market following the terrorist attacks last year. While few, if anyone, anticipated the terrorist attacks, the other two incidents certainly fall within the bounds of routine regulatory matters that were not adequately prevented or controlled by regulators. Thus, questions concerning the regulators' ability to administer their core functions effectively in the context of new markets, new market participants and new products are reasonable and justified. It should be recognized that the failure or inability of the state-based system to provide reassurances or answers to these questions has led to uncertainty and concerns that, in turn, have led to calls for changes to the regulatory structure.

1. SOLVENCY AND LIMITING FINANCIAL RISK

Information constraints and principal-agent conflicts create inefficiencies in the market that tend to manifest themselves in excessive insolvency costs.[89] For regulation to be effective in this area, it must, at the very minimum, reduce the number of insolvencies and the corresponding losses that would otherwise occur without regulation. This can be achieved through both prevention and timely intervention. Yet, a mere reduction in insolvencies or insolvency losses and related impacts (including those borne outside the insurance market) is not sufficient to justify regulation unless such benefits *exceed* the costs of such regulation. While this is likely to be the case due to the high potential costs and related impacts of insolvencies, it should not be presumed since the regulations themselves engender risks, costs and distortions that potentially undermine insurer solvency.

While there is general agreement on the merit of regulating insurer financial condition, there is much less agreement on the extent and manner in which such regulation should be conducted. The primary elements of a sound regulatory system of financial risk include: 1) maintenance of adequate solvency margins; 2) monitoring of insurer financial conditions including minimum capital and surplus standards; and, 3) early intervention to forestall collapses or minimize the impacts from high-risk or otherwise troubled insurers.[90]

Due to the sensitive nature of the full complement of data considered necessary to evaluate individual company solvency, state regulators, company actuaries and accountants are the key players in achieving effective oversight by virtue of their access to such data. Mandated disclosures provide additional, albeit more limited, avenues of oversight by other market participants. Nevertheless, there is ample evidence that the disclosure of solvency-related information is not sufficient by itself to enable early intervention against troubled insurers. None of the public and private parties involved, including regulators (domiciliary and other), direct market participants, industry and security analysts, company auditors and private ratings bureaus, has an admirable track record in anticipating insolvencies before they occur.[91]

In significant part, this is due to the generally overarching impact of actual versus expected loss costs on insurer financial performance and condition. Certainly, all other elements of an insurer's financial results — underwriting conditions (premium prices and volumes), investment returns and expense ratios — play an important role, but far less so than loss costs, especially in the short-term.[92] Unanticipated and sudden changes in claims frequency and loss severity or experience are usually prime factors

89 See Grace and Klein (1999) at 8-9; Munch and Smallwood (1981). Here, excessive insolvencies do not refer to a specific number, either on an absolute basis or in relation to any baseline. "Excessive" in this context refers to the costs of the insolvencies that might occur in an unregulated market versus those that might occur in a regulated market.

90 See Grace and Klein (1999) at 11.

91 This common criticism highlights the fact that regulators are less frequently given credit for events that do not occur, i.e., preventing insolvencies by identifying troubled insurers and intervening. Regulators have claimed that a large number of troubled insurers subject to regulatory action are never publicly identified because their problems are resolved before more drastic action is required. See Klein (2000) at 55. Moreover, while both state banking and insurance regulators have struggled at times with insolvencies, federal regulators have not proven to be clearly superior in this regard in the banking and securities industries. See Macey and Miller (1993) at 92, 94.

92 See Harrington (1991). In a ten-year analysis of insurer costs in automobile and homeowners lines, loss costs accounted for 81 percent of each premium dollar. In contrast, expenses and commissions comprised 24 percent of each premium dollar, while pre-tax profits and dividends to shareholders combined comprised only 1.5 percent of each premium dollar. See Harrington (2000-2) at 37-38. As noted previously, the property/casualty segment has suffered persistent underwriting losses over the last decade, meaning that loss costs have exceeded premium income in each year, sometimes by significant margins.

in insolvencies, particularly in property-casualty lines.[93] Even rigorous monitoring and the adoption of conservative solvency margins often prove to be insufficient regulatory tools given the vagaries of actual loss costs.[94] The property/casualty segment's experience is illustrative since its insolvency costs have tended to correlate closely with underwriting losses. In fact, the relationship between underwriting losses and insolvency costs is so clear that it is difficult to discern whether regulatory oversight contributes meaningfully to improved solvency performance, or whether such improvement is more a function of improved loss experience, over which regulators have little direct control.

Since 1969, as a fall back to oversight, state guaranty associations have provided a generally well-received mechanism for recapturing and internalizing the costs of insolvencies, and, most importantly, serving as a backstop for market confidence. Administration of receiverships is also an important, if less well-received, regulatory tool that is designed to preserve assets and minimize adverse impacts on the insurance market as a whole. Nevertheless, these measures are subject to their own limitations and inherent weaknesses that undermine their positive contributions.

Guaranty associations introduce distortions in the market by interfering with normal risk-reward dynamics. This interference can produce a "moral hazard" problem by essentially promoting increased risk-taking by insurers and indifference by consumers, since the presence of the guaranty fund protection reduces market concern about such risk-taking.[95] Thus, rather than serve to limit insurer financial risk (the explicit goal of solvency regulation), guaranty associations can, in practice, foster risk-taking while imposing additional costs on the market, thereby exacerbating the problem. While there are a number of mechanisms to offset moral hazard problems, they relate to the particulars of solvency regulation rather than to the structure of regulation.[96]

Regulatory structure plays a key role in continuing issues regarding the limited capacity of individual, state-run guaranty funds and other weaknesses in the coordination of solvency oversight among the states. In large part, this is due to the ability of states effectively to force other states to bear the costs of their lax oversight of companies in their domicile. Because insolvency costs are shared among all the states in which a company does business, when domiciled companies write a relatively small amount of their overall premiums in-state, the other states in which it is active will be primarily responsible for any insolvency costs associated with those companies. This inconsistency sets up a conflict for state regulators, whose interest in the survival of their domiciled companies will be greater than their liability in any subsequent insolvencies. Understandably, this produces a tendency toward greater forbearance and delay

93 These factors are also referred to more generally (and critically) as deficient loss reserves. Other important determinants frequently cited include inadequate rates, fraud and misappropriation of insurer assets, accounting misstatements, reinsurance failures, excessive premium growth, capital losses in investment portfolios, financial pressures from affiliates and general mismanagement. See Klein (2000) at 39-40; Harrington (1991).

94 See, generally, Macey and Miller (1993). The same is not true with respect to fraud, misappropriation and excessive growth. On the other hand, Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. See Harrington (1991). The insolvency and liquidation of Reliance Insurance Company in 2001 caused these concerns to resurface given that the company's problems developed over a period of years, yet met with forbearance from Pennsylvania regulators until the company finally declared bankruptcy and was forced into liquidation. The reasons cited for the company's failure include excessive premium growth, reserve inadequacy, capital depletion, excessive debt, and risky portfolio investments, all of which were evident for a number of years and were subject to regular regulatory review. The failure is expected to be the costliest insurance insolvency in history. See van Aartrijk, Peter, Jr. "Saul Steinberg and the Reliance Debacle." *Insurance Journal*, May 11, 2001.

95 This is particularly evident for companies that are insolvent or threatened with imminent insolvency. A recent study asserts that guaranty funds often provide cover to troubled insurers by permitting them to engage in excessive premium writing as a means of effectively borrowing funds from policyholders at rates that do not reflect their riskiness. As evidence, the study found that a significant proportion of insolvent property-casualty insurers tended to have rapid growth in premiums shortly before failing and that this growth was concentrated in long-tail lines (for which there is a greater lag between premium payments and loss claims). This was a prime factor cited in the failure Reliance Insurance Company. Significantly, the study also found that states that committed greater resources to solvency regulation were less vulnerable to this exploitation. See Bohn, James G. and Brian J. Hall. "The Costs of Insurance Company Failures." *The Economics of Property-Casualty Insurance.* Edited by David F. Bradford, Chicago: The University of Chicago Press, 1998, pp. 139-166.

96 See Grace and Klein (1999) at 12; Klein (2000) at 59. These mechanisms include risk-based and ex-ante assessments, cost-sharing through larger deductibles and co-insurance provisions.

in intervention that ultimately can increase the costs of the insolvencies that nevertheless occur.[97]

Due to these inherent structural limitations in state solvency regulation, proposals for federal involvement in this area have been put forward, including, with variations, replacing the individual state guaranty funds with a single federal fund. There are additional concerns whether state regulators have sufficient regulatory reach and expertise to oversee companies that are operating primarily in other states, not to mention other countries. While federal solvency oversight has the potential to overcome these structural limitations, there are two primary drawbacks to these proposals.

First, from the perspective of scope and effectiveness, there is no evidence that federal solvency oversight would perform better than state oversight; to the contrary, there is significant evidence that federal oversight could be less effective based on its historical track record. On the other hand, solvency oversight has never required as much national and international range as it does today, and there are legitimate questions whether individual state regulators can adequately cover that range.

Second, from the perspective of structure, while a federal solution can overcome the specific limitations identified in the state structure, it can also introduce new structural problems depending on how the solution is implemented. In particular, some of the proposals have called for transfer of solvency oversight to the federal government, while the states retain responsibility for all or part of market conduct regulation. As discussed previously, given the close relationship of solvency and market conduct regulation, separating these two responsibilities between the federal and state governments could create harmful conflicts with perverse market consequences.[98] As a result, a structure that involves shared responsibility between the states and federal government with regard to these discrete areas of oversight could be inherently unstable, unworkable or simply inefficient. Such a structure would likely generate pressures for greater federal involvement or a return to primarily state-based oversight.[99]

The administration of receiverships has also been criticized widely due to its perceived high direct costs which run counter to its express goal of preserving assets. Once again, since jurisdictional conflicts and the high potential for negative externalities among states warrant regulatory intervention in administering receiverships in the first place, the structure of regulation plays a key role in its efficiency. Certainly the combination of domiciliary state forbearance and excessive risk-taking by troubled insurers tends to drive insolvency costs higher. Studies have suggested, however, that insurance industry insolvency costs may be *several times* higher than necessary, due in part to administrative frictions such as a lack of expertise or capacity, and redundancy.[100] As a result, there have been calls for greater state coordination and even federal involvement, particularly for insolvencies involving multi-state insurers. Several states pushed forward on earlier efforts by the National Council of Insurance Legislators ("NCOIL") to address redundancies and capacity issues in administering receiverships via interstate compacts. That effort,

97 This tendency has been a chief finding of federal investigations on insurance industry insolvencies. See U.S. General Accounting Office (1991); U.S. House of Representatives (1990); Macey and Miller (1993) at 91-92. Domiciliary state forbearance (by Pennsylvania) has been cited as a factor in the insolvency of Reliance, the costs of which are being borne primarily by other states, particularly those with the largest markets (California, New York and Texas). See "Louisiana Insurance Guaranty Association Looks at Losses of $175 Million." *Insurance Journal, Regional News — South*, October 9, 2001.

98 For example, if states retained authority over rate regulation without direct responsibility for solvency, they might be prone to suppressing rates for socio-political reasons but to the detriment of insurer solvency. Since the states would not be responsible for solvency, such behavior would externalize risks and costs onto other states and the federal government. See Macey and Miller (1993) at 92-95. As noted below, the autonomous nature of solvency and market conduct regulation *within* a single state agency has been cause for concern. Separating these functions, in whole or in part, between federal and state agencies should, therefore, be cause for even greater concern.

99 IBID.

100 See Klein (2000) at 59 and Grace and Klein (1999) at 34, citing Bohn, James G. and Brian J. Hall, 1995, *Property and Casualty Solvency Funds as a Tax and Social Insurance System*, NBER Working Paper 5206. This study concluded that insurance company insolvencies were three times as costly as bank insolvencies in terms of pre-insolvency assets. While this is a compelling finding, it should not be considered definitive for several reasons. First, given the significant differences in the assets and liabilities between banks and insurance companies (e.g., risk profiles and maturities, liquidity, capital and reserve standards, investment restrictions, federal guaranty), there is no reason to expect that insolvency costs should be comparable if measured in terms of assets. See Macey and Miller (1993) at 79-81. Second, this comparison ignores differences in the "quality" of receivership administration, which would be reflected in the ratio between unfunded costs and pre-insolvency assets. In other words, if unfunded costs are reduced sufficiently, then a higher level of expenditures may be warranted or justified. The "quality" issue could be significant given that insurer solvency oversight has been more effective than bank solvency oversight in terms of the number and total size of insolvencies experienced. See Macey and Miller (1993) at 92.

however, was limited to a handful of states and has since lost momentum due to sovereignty concerns and a lack of uniformity in underlying regulations.

2. CONSUMER PROTECTIONS AND POLICING MARKET CONDUCT

This broad area of intervention includes the following aspects of insurers' activities: prices (discussed separately below), policy forms, marketing, underwriting, policy terminations, claims handling and complaint resolution.[101]

Once again, information constraints and principal-agent conflicts are the primary justifications for intervention in this area. Without intervention, the market would tend toward generating gaps in coverage, noncompliance with mandatory coverages, and disputes that would tend to favor insurers over consumers due to their significant advantages in proficiency and market power.[102] While regulatory intervention can increase consumer protections and constrain deceptive or bad faith practices by insurers, many believe that such intervention is far in excess of the level actually needed to achieve the desired outcomes.[103] Excessive intervention imposes costs that greatly exceed the benefits to consumers and thus, actually reduces consumer protections, largely by putting upward pressure on prices, limiting choices and distorting normal risk-reward relationships.

Complaints that market conduct regulation exceeds the level necessary for consumer protection is a more a matter of regulatory scope than structure. In contrast, regulation in this area tends to be driven by unique state requirements or, even worse, socio-political goals that tend to be divorced from concerns regarding overall market efficiency. Consequently, market conduct is a prime area of regulation where non-uniform rules and regulations beget non-uniform or autonomous oversight, leading to redundancies that do not necessarily contribute to better oversight. For insurers, this potentially means multiple examinations across jurisdictions with varying standards in any given year. As such, the structure of regulation can potentially play an important role in achieving improved outcomes in this area.

The independence of financial and market conduct oversight within regulatory agencies is another structural concern. Prior to the 1970s, market conduct regulation generally was performed as an adjunct to financial regulation. In recognition of the increasing importance of market conduct regulation, NAIC developed a market conduct examination handbook that sought to help states achieve certain minimum standards in their oversight of these areas. While NAIC's efforts were successful in improving the quality of oversight, they also greatly expanded the scope of market conduct regulation to the point where it has become a near-equal pillar to financial oversight. Unfortunately, as market conduct regulation has expanded, it also has tended to diverge and become more independent of financial oversight. As monitoring and oversight in these areas became more discrete, problems invariably ensued as compliance and enforcement in one area tended to impact the other area, due to the often symbiotic relationship between market conduct and financial regulation. More recently, these discrete regulatory units have begun to cooperate more closely in order to avoid causing or transferring problems between these areas.[104]

While the regulation of policy forms (standardization and minimum coverages), risk classification (avoiding unfair discrimination),[105] and general market conduct provides undeniable benefits to the market, the actual degree of regulation likely exceeds that which is necessary to mitigate true market failures in this area,[106] which typically are limited to information constraints and principal-agent conflicts. As reg-

101 See Grace and Klein (1999) at 10.

102 IBID.

103 See Grace and Klein (1999) at 13; Klein (2000) at 52-53.

104 See Klein (2000) at 52.

105 Rate classification restrictions can have a much greater effect on prices than direct rate regulation, which is discussed next.

106 See Harrington (2000-2) at 37-38.

ulation expands beyond this minimally necessary point, it begins to encroach upon otherwise competitive and efficient market functioning, to the detriment of both insurers and consumers. While such expanded regulation continues to generate benefits for the market, it does so at much greater costs that reduces overall welfare.[107] These costs are both direct and indirect in nature. While the direct costs — compliance and enforcement — may be significant by themselves, the significant distortions and other indirect costs that such intervention can introduce are of greater concern, particularly when the intervention is driven primarily by non-market objectives that go well beyond simple consumer protection.

3. PRICE/RATE REGULATION

The traditional rationale for price regulation in any market is to prevent excess profits and welfare losses due to excessive market power of suppliers. While this rationale is applicable to the insurance industry, price regulation of insurance contracts has also been driven by *converse* concerns that inadequate pricing and excessive competition would lead to instability and insolvencies in the market. While recognizing that different segments of the market are subject to different dynamics, as a whole it is difficult to reconcile the coincident threat of *both* excessive *and* inadequate prices, since one should preclude the other from a structural standpoint. These contradictory rationales are discussed separately below.

The historical development of the industry has played an important role in the industry's price regulation, particularly its reliance on rating bureaus and, more recently, on rate advisory organizations. The passage of the McCarran-Ferguson Act spurred states to regulate rating bureau activities, primarily in order to avoid federal antitrust oversight. Since then, price regulation has strayed from its two traditional rationales (limiting excessive and inadequate prices) toward addressing affordability concerns more generally, particularly for compulsory coverages.[108] Regulated affordability is a structurally unsound and unsustainable objective that introduces numerous distortions into the market and ultimately increases rather than mitigates the risk of market failures. History has provided ample evidence of the inefficiency, and often the folly, of strict price controls, especially in otherwise competitive markets.

From a structural standpoint, the combination of mandated coverages and regulated prices can be fertile ground, once again, for the pursuit of social and political objectives that are divorced from market efficiency concerns (and ultimately the best interests of the consumers).[109] Some proponents of change in the regulatory structure believe that the state system exhibits a greater bias toward these non-market objectives than would, for example, a federal structure.[110] This possibility is indeterminate, however, and does not preclude an alternative outcome in which a federal structure could be even more distorting. The very strong restrictions imposed by Congress on health care insurers provide some substantiation for this contention.[111] On the other hand, an optional federal charter may be a more effective approach in this regard, since the ability of companies to move between state and federal charters could create competitive regulatory pressures that help reduce or limit the pursuit of social and political objectives by either state or federal regulators.

107 The fact that expanding intervention produces benefits, therefore, is not sufficient justification unless the incremental benefits exceed their corresponding costs. Since the incremental costs expand quickly once regulation exceeds the level necessary to mitigate only the extent of true market failures, such regulation can be costly, and, ultimately, counterproductive.

108 The justifications for comparatively strict regulation of compulsory coverages are both economic and social. The compulsory nature of coverage is thought to make demand inelastic and thus provide greater pricing leverage to suppliers. While this is a reasonable theory, there is little evidence to support this in the market generally, and no theoretical basis for inelastic demand to have an impact on prices in the long-run, provided there is sufficient competition among suppliers. See Harrington (2000-2) at 27-28. The social justification stems from the notion that coverages that are mandated must also be made affordable. Regulation would likely be more effective in countering the forces of inelastic demand and promoting affordability by ensuring adequate supply. Strict price regulation and suppression are inconsistent with that outcome and tend to limit rather than expand supply, thereby putting upward pressure on prices.

109 The states' frequent mandating of rate decreases in the face of demonstrably rising loss costs is difficult to rationalize except on socio-political grounds.

110 See Grace and Klein (1999) at 8.

111 IBID.

Competitive Deregulation

Not surprisingly, the effort to deregulate generally, but especially on commercial lines, is being spurred by smaller market states seeking to improve the attractiveness of their markets vis-à-vis other states that have the luxury of larger markets. In the past, the effects of differential deregulatory efforts on relative market competitiveness and attractiveness among the states provided much-needed impetus to achieve wider reform in the banking sector.

The same potential clearly exists in the insurance industry. The widespread use of retaliatory taxes and fees, which penalize companies operating in states where such taxes and fees are relatively high, provides a good example.

Late last year, the state of Georgia's largest insurer – AFLAC – redomesticated to Nebraska due to high premium taxes (2.25 percent in Georgia versus 1.0 percent in Nebraska). Over the last decade alone, 10 companies have redomesticated from Georgia. The large carriers that have remained write most of their business in-state.

More constructively, the state of Indiana sharply reduced its premium tax from 2.0 percent to 1.3 percent last year. This action brought Indiana's rate in line with other states in the region, made its market more attractive as a domicile, and reduced the retaliatory taxes faced by its domiciled insurers.

See "Renaissance Regulators," Best's Review, June, 2000. "Georgia Commissioner Complains About Taxes," Insurance Journal – Property and Casualty Magazine, December 10, 2001; "Indiana Premium Tax Veto Overridden; Lower Tax Rate Takes Effect," Insurance Journal – Property and Casualty Magazine, January 24, 2001.

More recently, rate regulation has been relaxed, initially by a movement away from strict prior approval laws and then toward wholesale deregulation of commercial lines for large companies. The sporadic and limited nature of such deregulatory efforts, however, has caused a wide variation in both supply and price across different state markets despite their structurally competitive nature. These price variations provide clearer empirical evidence of the generally harmful effects of price regulation since they appear to be as attributable to differential oversight as they are to underlying market fundamentals. Rather than complementing market forces, regulation essentially has supplanted them.

Another important indicator of excessive regulatory interference is the size of nonstandard (residual, alternative, excess and surplus) markets relative to traditional markets (standard and voluntary). Rapid growth in and size of nonstandard markets is not a desirable outcome if it occurs in response to restrictive regulation, particularly of prices, and results in avoidance of regulatory oversight rather than an overt decision not to regulate.

In sum, it is evident that socio-political influences in rate regulation are harmful to market functioning, regardless of their particular objectives. As discussed further below, the soundness of even the traditional and accepted rationales for price regulation is disputable in practice.

A. FIRM MARKET POWER RATIONALE

There are numerous studies and abundant evidence that the first rationale for regulating prices — the existence of firm market power and excessive prices — is not applicable to the insurance market.[112] This lack of market power is evident across a number of parameters and criteria — *absent regulatory constraints on rates and forms* — including insurer profitability and market concentration, as well as the degree of heterogeneity among products, service levels, prices and underwriting standards.[113] As noted earlier, the bulk of the evidence points to competitively structured markets, with little or no evidence of insurer market power, let alone excessive prices or underwriting profits. In fact, it has been written that insurance is the only major industry in the United States that is both highly unconcentrated — with almost all markets served by a large number of firms with none having sufficient market share to exert market power — and yet still subject to price controls in many states.[114]

With little evidence of an underlying market failure stemming from firm market power, there is considerably less theoretical support for price regulation, except as a means of promoting social objectives. Predictably, the regulation of prices in the absence of the fundamental preconditions of market failure leads to numerous distortions and regulatory costs that likely far exceed any intended benefits, whether economic or social. Most damaging in this respect, is the tendency of price regulation to sever the crucial link between premiums and expected losses, thereby diminishing the incentives for loss control and causing overall losses to increase.[115]

Even if the insurance market were predisposed toward undesirable levels of firm market power, that failure must manifest itself adversely to justify regulation of prices, otherwise the regulation merely imposes incremental costs and reduces overall welfare.[116] Presumably, the chief consequence of firm market power is most properly measured by profitability rather than prices per se.[117] Even if profits were a meaningful indicator of firm market power, there is no clear evidence of excessive profitability in the industry.[118] By extension, if profitability is not excessive under normal business conditions (or warranted due to superior performance), then it is likely that price regulation is not only unnecessary, but counterproductive. Nevertheless, simply measuring profitability of insurers in a regulatory context can be a complex undertaking for several reasons, as follows:[119]

- Investment and portfolio earnings can be a critical determinant of insurer profitability and are not directly tied to premium rates;

112 See Grace and Klein (1999) at 8; see also, more generally, Macey and Miller (1993); MacAvoy, Paul W., ed. 1977. *Federal-State Regulation of the Pricing and Marketing of Insurance.* Washington, D.C.: American Enterprise Institute; Danzon, Patricia M., 1983. "Rating Bureaus in U.S. Property-Liability Insurance Markets: Anti- or Pro-Competitive?" *Geneva Papers on Risk and Insurance* 8: 371-402; Joskow, Paul L., and Linda McLaughlin, 1991. "McCarran-Ferguson Act Reform: More Competition or More Regulation?" *Journal of Risk and Uncertainty* 4: 373-401.

113 See Harrington (2000-2) at 25-26.

114 See Macey and Miller (1993) at 99.

115 See Harrington (2000-2) at 34. These and other distortional costs are discussed further in the next section.

116 NAIC estimates that the annual *direct* costs of property and casualty *rate* regulation are $40-55 million for the state regulators and in excess of $1 billion for the industry. Moreover, these costs are increasing despite efforts to deregulate. See NAIC (1998) at 5.

117 Few firms benefit from higher prices per se, especially in industries with significant economies of scale and a large number of suppliers, as is typically the case with insurance. Economies of scale act to curb unjustifiably high prices by encouraging increased output that, in a market with a large number of suppliers, produces strong competition and a downward bias to prices (ceteris paribus). Most companies, particularly those in developed or mature markets such as insurance, are more concerned with profits rather than revenues. One notable exception is the anomaly of "reverse competition," where insurers may seek to increase or maintain premium levels and, thus, commissions and other allowances paid to brokers, as consideration for business placement. This is a relatively isolated occurrence in the insurance market (limited to credit and title insurance) that seems to receive an excessive amount of attention, especially in the context of supporting broad price regulation. See Feldhaus and Klein (1998) at 68.

118 See Harrington (2000-2) at 19-20; Feldhaus and Klein (1998) at 38.

119 IBID.

- The market values of portfolio holdings can be difficult to assess due to uncertainties related to their current values, and are subject to change, sometimes rapidly or unpredictably;

- Underwriting results are often subject to substantial fluctuations from one year to the next, almost always due to fluctuations in loss costs; and,

- From a regulatory perspective, profitability must be assessed by product line and/or state.

The last point is particularly vexing given the difficulties with measuring overall profitability. Segmenting insurer profitability by product lines or geographical areas is considerably more complicated and potentially arbitrary. As an initial matter, there is no clear basis by which investment income, capital and expenses can be segmented by product lines or geographical areas. Geographical limitations underscore one of the primary weaknesses of the state structure — that relevant determinations often must be made on a state-by-state basis. The fundamental question is whether such state-specific analyses are meaningful in an increasingly national and international market.[120]

Even if profitability could be accurately measured as needed, the determination of an acceptable level of profitability can be arbitrary. If it were based on average or peer levels of profitability, such price regulation would constrain efficient and more profitable insurers more than inefficient and less profitable ones. The effect of such regulation is to dampen the market's otherwise efficient allocations, which clearly fails the test of effective intervention. Unlike geographical limitations, however, the reliance on such benchmarks is a weakness in the scope of regulation rather than characteristic of the state system.

Even the absence of excessive profitability, which normally is dispositive of an absence of market power, is insufficient in practice to preclude price regulation in insurance markets. Presumably, the reasoning is that insurers with market power might not achieve excessive profits if they operate inefficiently with high expense levels (presumably enabled in part by the absence of competition).[121] Thus, when actual profit experience fails to sustain the need for price regulation, insurer expenses and accounting practices often provide alternative grounds for scrutiny.

Any regulation tied to insurer expenses (and presumably firm efficiency) tends to be inherently flawed due to the relative insignificance of operating expenses vis-à-vis loss costs for insurers. Depending on the particular line, loss costs including adjustment expenses typically account for 70 percent or more of total costs (and frequently exceed premium income), thus providing much more fertile ground than expenses (or profits for that matter) for achieving reductions in premiums.[122] Consequently, even if significant reductions could be achieved in insurer expenses or profits, the impact on premiums would still be relatively small than if similar attention were focused on loss costs. Nevertheless, insurer expenses, as a purported driver of premium levels, frequently are deemed to warrant close regulatory attention. At a minimum, this is misdirected. At worst, by interfering with the market's normal allocative function and distorting the incentives for loss control, price regulation focuses on a problem for which there is little evidence in the market, and, therefore tends to impose far greater costs than it yields apparent benefits.

120 IBID. NAIC's model competitive rating law requires a finding that competition is failing in a given market, based on explicit indicators, as a prerequisite to regulatory intervention via rate restrictions. On one hand, this is a step in the right direction since it provides relatively uniform and objective guidance regarding the conditions necessary to justify such intervention. On the other hand, given the difficulties and limitations in making such determinations in the first place, the potential exists that competitive rating laws simply codify a practice that, to some extent, is based on unsound fundamentals or potentially arbitrary judgments.

121 This rationale suggests that firms will use their market power to raise prices not necessarily to increase profits, but more to have the freedom to operate inefficiently. There is no evidence to support this theory in the insurance market. Alternatively, insurers are accused of understating profits by various methods, including the overstatement of loss costs. Even if true or relevant, such problems are more properly and efficiently addressed through accounting standards and financial oversight than through market conduct and price regulation.

122 IBID at 36-38.

B. MARKET INSTABILITY

There also is little or no evidence that the second rationale for price regulation — market instability and insolvencies — is applicable to the insurance market. For the same reasons noted above, recent episodes of instability and insolvencies primarily have been linked to unanticipated increases in loss severity and frequency. While other factors such as portfolio losses, fraud and unrestrained growth have also contributed, price *suppression* due to excessive competition is not readily apparent.[123]

While it might be argued that the type of excessive premium growth that often leads to insolvencies is facilitated by price suppression by competing firms, two distinctions must be made. First, the achievement of rapid premium growth by an individual insurer is indicative of an *absence* of market-wide destructive competition, which, in contrast, is characterized by a collective "race to the bottom" in defense of market share. In the latter case, market shares would not be expected to change as dramatically and premium volume would decrease rather than increase as average rates declined sharply. The fact that an individual company is able to gain market share rapidly requires that the rest of the market refuses to respond in kind. Second, the role that guaranty fund protections play in enabling this type of behavior should be considered, rather than focusing merely on restricting the behavior by imposing broad rate restrictions.

If the market evidenced tendencies toward overly competitive behavior and price suppression, the question again is whether that constitutes a market failure in the first place, and whether price regulation constitutes an effective response. While there is scant evidence that the market is prone to destructive price competition, there are other regulatory tools in place — financial and solvency monitoring in particular — that have proven comparatively effective in maintaining market stability and minimizing insolvencies. Consequently, it is disputable whether further intervention via price regulation is needed or whether it even makes a net positive contribution toward its objectives of market stability and firm solvency.[124]

C. SUMMARY

Regulation would tend to be far more effective if it sought to tighten the link between premiums and expected costs rather than undermine that link by focusing unduly on premiums. Understandably, the tendency toward regulatory rate suppression is often strongest when rapid and widespread increases in claim costs lead to competitive increases in premium rates,[125] which is contrary to normal market signaling. Any improvement in "affordability" stemming from regulated price suppression is only short-lived and tends to produce far greater costs in terms of reduced supply, market instability and deterioration in overall solvency.[126]

Similarly, the fact that certain insurers may engage in excessive premium writing (presumably via under-market pricing) has not given rise to widespread destructive competition. To the contrary, these insurers have tended to fail, which is evidence of proper market functioning. To the extent that these failures are undesirable from a regulatory perspective, other tools such as ongoing solvency monitoring provide regulators with a far more efficient means of controlling such isolated incidents, as opposed to subjecting the entire market to price regulation. Consequently, given the largely adverse market consequences as well as the high direct and indirect costs of price regulation, the deregulation of prices should be considered an important factor in the evaluation of alternative regulatory structures.

123 See Macey and Miller (1993) at 109, citing Joskow (1973) at 375, 423; Harrington (2000-2) at 25. Rather than insolvencies and instability, the ramifications of strong competition in the market seem to be consolidation, especially in property-casualty lines for both underwriters and intermediaries. Arguably, consolidation increases firm market power although there is little or no evidence of that to date. See Klein (2000) at 5-6.

124 In contrast, there is significant evidence that excessive rate regulation can lead to greater instability in the market. The restrictive nature of certain states' rate regulation can produce such uncertainty that it is reflected directly in private ratings for firms with significant exposures in such states. See Macey and Miller (1993) at 103.

125 See Harrington (2000-2) at 8-10, 13, 35; Grace and Klein (1999) at 12.

126 See Harrington (2000-2) at 11, 37-38.

VII Types of Regulatory Costs

Regulation imposes three primary types of costs relevant to this study:

- Direct expenditures by regulators;
- Direct compliance costs incurred by the industry; and,
- Indirect costs on market efficiency.

Understandably, assessments of regulatory efficiency and effectiveness tend to focus on *direct expenditures by regulators* and *direct compliance costs incurred by the industry* because they are tangible and, therefore, most readily analyzed. The third type — *indirect costs on market efficiency* — is likely far greater than the other two both in absolute terms as well as its impact on overall market efficiency. Nevertheless, these indirect costs often fail to receive sufficient attention largely because they are intangible and, therefore, difficult to analyze. A clear understanding of both the explicit and implicit costs of regulation, however, is critical to an accurate assessment of the relative costs and benefits of alternative regulatory structures.

Due to the complexities of measuring these costs, it is challenging even to conclude whether they have been increasing, decreasing or remaining stable, though it is clear they are substantial. Regardless of their trend, changes in the industry's competitive operating environment have increased sensitivity to these costs, whether direct (i.e., expenditures by government and industry) or indirect (e.g., delays) in nature. The operating environment is being transformed by the convergence of financial services, electronic commerce and globalization, all of which have sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints.[127] While this applies to the costs of even minimally necessary regulation, it is most relevant in the case of regulatory constraints that impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales. In the past, excessive regulatory burdens were more tolerable when they tended to impact insurers equally or without discrimination. While they still present the same handicaps, they now have the potential to threaten the industry's ability to compete and thrive against new or restructured competitors that may not face the same restrictions and costs.

A. Direct Governmental Expenditures

Direct governmental expenditures are the most obvious and measurable of the three costs of regulation; they are also the least significant.[128] Like other types of governmental spending, direct regulatory expenditures tend to attract greater scrutiny and understanding than their downstream economic impacts on markets and industries, even though the latter have much greater and potentially hazardous consequences.

127 See ACLI (1999) at II-15; Liberty Mutual (2001) at 1-2, 6, 13; Klein (2000) at 66.

128 See Grace and Klein (1999) at 23.

The relative certainty of these expenditures makes them easiest to summarize and discuss, although analyzing them under alternative regulatory structures still remains a complex endeavor.[129]

1. BASIC FACTS[130]

Total revenues — total revenues collected by the states from the insurance industry totaled $10.2 billion in 1999. The majority of these funds came from three sources, in declining order of importance:

- Business and income taxes (premium, retaliatory and other);[131]
- Fees for regulatory services and other assessments; and,
- Fines and penalties.

Size of state budgets — annual insurance department budgets vary dramatically by state, ranging from slightly more than $1 million (South Carolina) to over $125 million (California).[132] Total state insurance department budgets were $880 million in 2000 and expected to reach $910 million in 2001.

Size of NAIC's budget — the association's budget was $46.9 million in 2001 and 49.8 million in 2002.[133] Expenditures by NAIC complement or facilitate the states' expenditures. The sources of its revenues include, in declining order of importance:[134]

- Fees paid by insurers (voluntary and based on premiums);
- Fees for publications, database products and meetings; and,
- Insurance department member fees.[135]

2. IMPLICATIONS FOR THE INDUSTRY

For purposes of this analysis, total direct regulatory expenditures are estimated at roughly $900 million in 2000.[136] While these direct expenditures are substantial in absolute terms, they are quite modest both in relation to the industry's annual premiums and total revenues collected from the industry by the states. Total direct regulatory expenditures equal 0.1 percent or less of total industry premiums (roughly $900 billion in 1999 and an estimated $970 billion in 2000),[137] indicating that even if such expenditures were eliminated completely, the direct effect on premiums would be minuscule. Thus, substantial

129 While there are detailed and comprehensive data available on *state* regulatory expenditures through NAIC, which conducts an annual survey, similar data on *federal* regulatory expenditures, which are increasing and significant, are not readily available. Examples of federal regulatory expenditures include federal insurance programs (crop and flood insurance), setting of national standards to be enforced or implemented by the states (loss ratio standards for Medicare supplements) or actions otherwise limiting state regulatory control (risk retention groups, employer-funded health plans and, more generally, Congressional oversight). In addition, other general federal regulatory activities have an important bearing on the insurance industry's regulation (antitrust, international trade, law enforcement, taxation and the regulation of other financial services industries). See Grace and Klein (1999) at 17.

130 See NAIC, *2000 Insurance Department Resources Report*, (reporting 1999 data) unless otherwise noted. Data for 2000 were not yet available.

131 Excludes federal income taxes, which are more substantial. In 1998, property and casualty insurers paid an estimated $6.7 billion in federal income taxes (according to the Insurance Information Institute), while life insurers paid $13.3 billion (according to the American Council of Life Insurance).

132 See Grace and Klein (1999) at 24.

133 See "NAIC Subcommittee Approves 2001 Budget," *NAIC News Release*, November 6, 2000; "NAIC Members Approve 2002 Budget," *NAIC News*, December 2001.

134 See Grace and Klein (1999) at 20.

135 Also included within state regulatory expenditures.

136 This figure equals the total of the state budgets ($880 million) plus approximately half of NAIC's budget ($46.9 million). Only a portion of NAIC's budget is included because insurance department member fees already are included in the state budget amounts and otherwise would be double-counted.

137 Estimate reflects the application of the growth rate in total premiums between 1999 and 2000 reported by Swiss Re (8.3 percent) to the total premiums reported by NAIC in 1999.

increases or decreases in direct regulatory expenditures by the states are unlikely to affect premiums significantly through *direct* cost savings.

Direct regulatory expenditures accounted for only 8.8 percent of the $10.2 billion in revenues collected from the industry in 1999. In other words, less than 9 cents of every dollar collected from the insurance industry by the states are dedicated to insurance regulation, with most directed instead to state treasuries. Despite the relatively low ratio between direct regulatory expenditures and total state revenues, the proportion has nearly doubled since 1986, meaning that states are increasing their expenditures relative to the revenues they derive from the industry, as shown in the following table.[138]

PERCENTAGE OF STATE INSURANCE REVENUES DEDICATED TO REGULATION[139]

YEAR	1986	1988	1993	1996	1998	1999
PERCENTAGE	4.5%	5.4%	6.4%	7.2%	7.7%	8.8%

Changes in state regulatory expenditures (due to cyclical or policy reasons) have an indeterminate effect on industry expenses and profits, since expenditures can change with or without accompanying changes to total assessments on the industry (i.e., the *direct* burden on the industry). In other words, states can spend either a greater portion of the assessments on insurance regulation, thereby leaving less to the general treasury (as they recently have been doing), or they can spend a lesser portion, thereby leaving more to the general treasury. Thus, changes in state expenditures only impact industry premiums and profits directly if they are accompanied by parallel changes in the states' assessments on the industry. Given that certain states have been lowering their premium taxes (the chief component of total assessments), it seems likely that total assessments on the industry relative to premiums will continue to decline. Similarly, unless states reduce their direct spending on regulation, the ratio between their expenditures and total insurance revenues will remain at the higher levels observed in recent years.

Increased spending by states has important implications on the efficiency of regulation and its cost to the industry.[140] The critical question is where the additional spending is occurring and what effect it is having on the market. In the broadest terms, increased state expenditures can shift the burden of regulation from the industry to the states, provided that the *scope* and *intensity* of regulation do not likewise expand. In other words, if the scope and intensity of regulation were held constant while regulatory expenditures were increased, then it is reasonable to expect that the states will be able to regulate more efficiently, or at least with less *indirect* burden on the industry.[141] If, however, increased expenditures

138 On an absolute basis over the same period, state regulatory expenditures have nearly tripled from $310 million in 1986 to a budgeted $910 million in 2001. See NAIC, *Insurance Department Resources Reports.*

139 See Grace and Klein (1999) at 25; Consumer Federation of America ("CFA") (2000); Gettlin, Robert H. "State Spending: The Price of Regulation Plateaus." *Best's Review P/C*, March 1998 at 73-74.

140 Despite the steady increases in state spending, both absolutely and proportionally, the Consumer Federation of America has called for significant further increases in spending and asserts that funding of the state regulatory system remains 25 percent below its targeted minimum level. See CFA (2000).

141 Here, indirect burden refers to the effect on the industry's direct compliance costs as well as the indirect effects on market efficiency. The *direct* burden refers to the states' total assessments on the industry, which are assumed not to change.

were used to support expanded and/or more rigorous oversight, then efficiency gains and reductions in the *indirect* burden on the industry would be less certain.[142]

The recent increase in state expenditures has been directed primarily toward expanding staffing and salaries, as well as improving automation.[143] With more and better-paid regulators having increased computer and other automation capabilities, regulation should be more efficient and potentially more effective. Nevertheless, while the efficiency of the states' regulation likely has improved in certain respects, there is evidence that the increase in expenditures has led to expanded financial oversight and consumer protection activities.[144] Thus, it is unclear whether the increased state expenditures have tended to relieve or increase the industry's compliance burdens. In all likelihood, administrative efficiency gains have been offset by expanded and intensified oversight.

Following the recent rise in state regulatory expenditures, both in absolute and relative terms, expenditures in the near-term are expected to remain near current levels.[145] On one hand, state regulators continue to report staffing difficulties, in terms of expertise and retention, that will continue to pressure personnel costs, as well as the need to continue historically high investments in computer and other automation capabilities; on the other hand, ongoing deregulation and simplification efforts will tend to reduce overall costs and keep them closer to current levels. Deregulation and reform efforts, as well as other changes associated with GLBA, could push spending by the states and NAIC higher in the short-term as new initiatives are pursued, although these efforts should achieve cost savings in future years. The possibility exists, however, that the complexities of regulating an increasing number of companies that are diversified across two or more segments of the financial services industry and/or more active internationally could limit these gains.

The critical points when assessing state spending are:

- The net effect of increased state regulatory expenditures on industry compliance costs hinges on whether the expenditures are directed toward improving existing procedures and practices, or expanding and intensifying them — i.e., the trade-off between *better* and *more*. As the states spend more, they can either facilitate and/or replace efforts and compliance costs by the industry (thereby reducing the *indirect* regulatory burden on the industry), or they can increase demands made upon the industry through more rigorous and expanded oversight (thereby increasing the *indirect* regulatory burden on the industry). The same point is true in reverse for *decreased* state spending (i.e., the trade-off between *worse* and *less*).

- Increases or decreases in state spending by themselves, therefore, are not necessarily positive or negative for the industry and market. There are valid arguments on either side that increasing or decreasing state spending is the best way to decrease the indirect regulatory burdens on the industry. Ultimately, the conclusion is dependent not upon how much the states spend, but upon the manner in which they make those expenditures.

142 See Grace and Klein (1999) at 25-26. Direct regulatory expenditures by the states constitute a relatively small proportion (estimated at 20 percent) of the direct compliance costs of the industry (discussed below). Consequently, even large changes in direct regulatory expenditures may only have a relatively minor effect on the industry's direct compliance costs, notwithstanding a possible multiplier effect. Nevertheless, there is a clear link between state regulatory expenditures and total compliance costs of the industry, even though the direction and magnitude of that link is not clear.

143 IBID.

144 IBID. At the same time computers and other automation efforts have greatly reduced costs associated with the generation, submission and dissemination of both raw data and analyses, they also have brought about a sweeping increase in the amount of data required and depth of analysis undertaken, particularly with respect to financial regulation.

145 See Grace and Klein (1999) at 26; Gettlin, Robert H. "State Spending: The Price of Regulation Plateaus." *Best's Review P/C*, March 1998 at 73-74.

- While direct regulatory expenditures may be an important driver of industry compliance costs and indirect market effects (discussed below), they are relatively insignificant by themselves, as well as in relation to state revenues collected from the industry, industry premiums, and industry profits.

- Due to their tangibility and certainty, state regulatory expenditures tend to receive disproportionate attention in evaluations of regulatory efficiency and effectiveness. Given the far greater significance of the other costs of regulation, the attention given to state regulatory expenditures is not commensurate with its impact on the industry (excluding the downstream effects of those expenditures). Thus, attention should be shifted away from these expenditures toward the other regulatory costs discussed later in this section.

3. ANALYSIS OF STATE EXPENDITURES

Significant variations exist among the states in both revenues collected and expenditure amounts. Annual per capita premium taxes range from as little as $8 (Illinois) to as much as $74 (Hawaii), with an average of $34.[146] Most of this variation is explained by the degree to which each state relies on premium taxes to fund its general treasury, as opposed to paying for its conduct of insurance regulation. Consequently, the revenues collected by each state from the insurance industry do not necessarily correlate closely with its particular expenditures.[147]

State regulatory expenditures correlate more closely with the volume of business regulated (premiums written), though the relationship tends to vary by state according to several predictable factors — the number of domiciliary companies, the relative intensity of regulation, and the extent to which the states offer special services such as in-house liquidators.[148]

The data required to evaluate the specific regulatory areas to which the states direct their expenditures are not available, although NAIC does track the states' total *employment* by regulatory function. *Assuming employment is a reasonable proxy for expenditures*, these data suggest that financial regulation alone accounts for nearly half of total expenditures, while consumer services account for nearly one-quarter of the total. The remainder is allocated to company and producer licensing (7-8 percent), rate and form regulation (11 percent) and market conduct (7-8 percent).[149]

Based on these proxy data, financial regulation represents the largest category of state expenditures. This category is the most widely accepted as necessary to correct or offset market failures. Given its relatively large share of the total expenditures, changes in the scope or intensity of financial regulation have the potential to have the greatest impact on overall expenditures.

Consumer protection and market conduct (excluding rate and form regulation) together account for roughly one-third of overall state expenditures. Like financial regulation, this area of oversight generally is considered to be responsive to bona fide market failures, although there is considerably more controversy regarding the effectiveness and efficiency of its conduct. Most of the controversy concerns the extensiveness of regulatory intervention (including redundancies) and whether it exceeds that necessary to address the pertinent market failures. Thus, given the relative size of these expenditures and the costly implications of excessive regulation, reduced intervention in this category could lower overall spending significantly while providing substantial indirect benefits to the market.

146 *The Insurance Industry — A Key Player in the U.S. Economy, 7th Ed.*, Alliance of American Insurers, 2000, using 1998 data from the U.S. Bureau of the Census.

147 According to the CFA, the variation among the states is substantial, but does not fit an identifiable pattern in terms of region, market size or even political leaning. Certain jurisdictions (Washington, DC, Florida, Louisiana, Massachusetts, New York, Oregon and Wyoming) devote 12 percent or more of their premium tax revenues to insurance regulation, while other states (Arizona, Georgia, Indiana, Nevada, South Dakota, Tennessee and Utah) devote less than 4 percent. See CFA (2000).

148 See Grace and Klein (1999) at 24.

149 IBID at 26 (based on NAIC's 1997 Insurance Department Resources Report). Employment in the financial regulation area includes financial examiners and analysts, as well as liquidators.

The case for the other areas of regulation — licensing and rate and form regulation — stands in marked contrast. These areas account for relatively small shares of overall regulatory expenditures (18-19 percent combined),[150] but a seemingly disproportionate share of the complaints and criticisms from the industry. As noted previously, the relatively high level of controversy arises most directly from the absence of a clear rationale for such regulation — i.e., based on clear market failures of demonstrable impact — rather than from its inefficient or ineffective conduct, although the latter tends to receive much of the attention.

Efficiency concerns, however, are critically important to the industry, since they affect its direct compliance costs. Under such circumstances, the efficient conduct of unnecessary or excessive regulation becomes the next best alternative to more effective regulation generally, in order to minimize both its direct and indirect costs. The critical point is that the focus on achieving the next best alternative — making unnecessary regulation less costly and more efficient — may come at the expense of the best alternative — eliminating such regulation altogether. To a certain extent, efforts focused on improving the conduct of, or otherwise curbing, ineffective and unnecessary regulation, while perhaps more achievable than seeking its complete elimination, inadvertently tend to validate the necessity of such regulation in the first place. Nevertheless, this focus is understandable given how firmly entrenched and resistant to change many of these regulatory processes have become.

Due to their relatively small share of total expenditures, incremental reductions in licensing and rate and form regulation can produce only limited savings in direct expenditures overall. Even the elimination of regulation in these areas would reduce state expenditures by only 18-19 percent overall, or by approximately $160-170 million. Nevertheless, the downstream effects on industry compliance costs and indirect costs would be far more substantial, such that any reductions in these areas are worth pursuing, even if the savings are redirected to increase direct expenditures in other, more critical areas of regulation (i.e., financial regulation and consumer protection).

B. DIRECT INDUSTRY COMPLIANCE COSTS

1. EMPIRICAL EVIDENCE[151]

As noted above, the direct burden of state assessments on the industry was $10.2 billion in 1999, or 1.1 percent of total industry premiums.[152] The latter ratio has been declining steadily from 1.7 percent in 1988, to 1.3 percent in 1997, and to 1.1 percent in 1999.

This decline is very significant for the industry. If this ratio had stayed steady at the rate prevailing in 1988 (1.7 percent), total assessments paid by the industry would have been $15.3 billion, or approximately $5 billion *higher* than they actually were in 1999.[153] Clearly, the states' direct assessments of taxes and fees are the most obvious of the burdens of state regulation on the industry.

In addition to state assessments, the industry incurs substantial costs for its internal and external compliance efforts, which are reflected in its administrative and staff expenses. There is plenty of anecdotal evidence and little doubt that the state-based regulatory system imposes significant compliance costs upon

150 As noted previously, state regulatory expenditures on rate regulation of property and casualty lines alone is estimated at $40-55 million per year. Similarly, state regulatory expenditures on producer licensing and enforcement are estimated at $30-60 million per year, or 5 to 10 percent of each state's insurance department budget. See NAIC (1998) at 5, 17.

151 See NAIC, *1999 Insurance Department Resources Report*, and Grace and Klein (1999) at 23-26, unless otherwise noted.

152 The bulk of the total is derived from state premium and retaliatory taxes. See also, Alliance of American Insurers, *The Insurance Industry — A Key Player in the U.S. Economy* at 12, which reports state insurance taxes by themselves totaled $9.2 billion in 1998.

153 Based on a figure of $900 billion for total industry premiums in 1999, the rate of assessment of 1.7 percent in 1988 would have resulted in total taxes and fees of $15.3 billion, compared to the industry's *actual* taxes and fees of $10.2 billion paid in 1999. The difference is $5.1 billion.

the industry that could be reduced without compromising the integrity of oversight. Most evaluations of the administrative efficiency of the state system focus on the redundancy and lack of uniformity among the states' requirements. These requirements typically include:

- Submitting licensing applications and making appointments;
- Submitting financial and statistical reports;
- Undergoing independent audits and regulatory examinations;
- Preparing rate and form filings, including advertisement approvals;
- Ensuring internal compliance with state regulations;
- Responding to regulatory inquiries; and,
- Paying taxes, fees and assessments.[154]

These general requirements are greatly condensed and each encompasses a range of specific actions. Moreover, these requirements must be performed continuously (whether on an ongoing or periodic basis) and, in many cases, for each state in which a firm operates or conducts business.

Despite widespread agreement on the significance and inefficient nature of these direct costs, only limited empirical evidence is available, including the extent to which they are inflated by inefficiencies and redundancies. It is known that overall insurer expenses unrelated to losses and loss adjustments or commissions are relatively low compared to total premiums.[155] Industry-wide expenses not attributable to loss payments and related expenses or commissions, are likely on the order of 14 to 21 percent of total premiums. The majority of these expenses, in turn, is directed to routine selling/marketing, general corporate and administrative ("SG&A") activities, rather than to compliance activities.

One academic study estimated the industry's total direct compliance costs at $4.5 billion.[156] Given the indirect and approximate nature of the derivation of this figure, however, it is not clear how comprehensive this estimate was intended to be and whether it includes the cost of all the direct compliance activities itemized above or otherwise undertaken by the industry. Nevertheless, taking the figure at face value, it comprises only 0.5 percent of total industry premiums, but nearly 10 percent of net income.[157] The study presents additional data based on regressions of NAIC annual statement data to compute average insurer expense ratios, which are presented in the table on the following page.[158]

Based on these data, SG&A expenses (less commissions) account for 16-19 percent of each premium dollar, or roughly $110 billion per year. In comparison, the industry's estimated direct compliance costs of $4.5 billion account for 4.1 percent of these expenses.[159] While these data indicate that industry compliance costs are substantial in absolute terms, but less so in relation to SG&A expenses, the critical question is what portion of these costs is attributable to compliance with inefficient, redundant or unnecessary regulation? Moreover, how might these costs be impacted if structural changes were made

154 See Grace and Klein (1999) at 30.

155 In an analysis of automobile and homeowners insurance premiums for the ten-year period 1988-1997, losses and loss-adjustment expenses accounted for nearly 81 percent of premiums, while commissions paid accounted for nearly 10 percent of premiums. In contrast, all other expenses, which include direct compliance expenses, accounted for 14 percent of premiums. See Harrington (2000-2) at 36-42. As shown below, NAIC data indicate that these expenses are in the range of 16-19 percent of total premiums written, on average, for all insurers.

156 See Grace and Klein (2000) at 124. The figure was estimated grossly using the assumption of an average cost of $100,000 to be licensed in a given state, with 3,000 companies writing business in multiple states and an average of 15 licenses per company. The authors qualified the reliability of this figure given its gross methodology.

157 Net income based on NAIC nationwide "Quick Stats" for Property/Casualty and Life and Health insurers in 1999 and 2000.

158 Data from Grace and Klein (2000) at 117-125, unless otherwise noted. Percentages are expressed in relation to net premiums written.

159 Derived by dividing the industry's estimated direct compliance costs ($4.5 billion) by the total expenses (less commissions) shown in the table ($61.5 billion for property/casualty plus $49.4 billion for life/health).

AVERAGE U.S. INSURER EXPENSE RATIOS

EXPENSE TYPE	PROPERTY/CASUALTY	LIFE/HEALTH
TOTAL EXPENSES	40.2%	26.3%
CLAIMS ADJUSTMENT	10.9%	NA
NET LESS CLAIMS ADJ.	29.3%	26.3%
NET LESS COMMISSIONS[160]	19.3%	16.3%
SALARY	8.5%	9.1%
LICENSES AND FEES	0.4%	0.6%
ALL OTHER	10.4%	6.6%
NET PREMIUMS WRITTEN *(IN $BILLIONS)*[161]	**$318.7**	**$303.3**
NET EXPENSES LESS COMMISSIONS *(IN $BILLIONS)*	$61.5	$49.4

to the regulatory system to enhance uniformity and reciprocity, and eliminate unnecessary redundancies and other requirements?[162]

In relation to industry premiums, however, estimated compliance costs are not substantial, implying that even significant reductions would have little or no impact on premium prices or overall insurance affordability. Thus, it may be difficult to persuade *regulators* that reducing the industry's compliance expenditures will generate significant benefits for consumers *directly*, at least in terms of the potential cost savings that could be passed on to consumers.[163]

Nevertheless, reducing the industry's direct compliance costs is important to the industry, since they have a more significant impact (representing nearly 10 percent) on industry profits (roughly $50 billion in both 1999 and 2000[164]). Once again, the critical question is by how much these expenditures can be reduced by eliminating redundant and unnecessary requirements. Using the $4.5 billion figure cited above, a substantial 25 percent reduction in compliance costs would save the industry $1.1 billion before taxes, or an estimated $600-700 million after taxes, equal to about 1.5 percent of industry profits in the 1999-2000 period.

160 Commissions assumed to equal 10 percent of net premiums written.

161 NAIC "Quick Stats, 2000." Includes annuity consideration for Life/Health.

162 In the academic and trade literature, most references to the incremental direct compliance costs due to inefficient or redundant state regulation are vague at best. Some analyses cite the estimated market value or average cost of obtaining licenses in each state (generally $50,000-100,000 per license per state). Other analyses point to the industry's SG&A expenses as the upper bound for direct compliance costs, although this is not revealing since the majority of SG&A expenses likely is attributable to costs unrelated to direct compliance activities.

NAIC has provided rough estimates of certain specific compliance costs. NAIC estimates that the industry's direct compliance costs for rate regulation exceeds $1 billion per year, while licensing-related compliance costs for *producers* alone (including appointments, terminations, applications and renewals, but excluding state fees) are approximately $350 million per year. See NAIC (1998) at 5 and 17. It is difficult to reconcile these estimates with the data presented in the table above. Nevertheless, if these figures (totaling more than $1.35 billion) are subtracted from the estimate of total industry compliance costs above ($4.5 billion), then the costs of all other compliance activities combined (i.e., financial reporting, company licensing, audits and exams, et. al.) are roughly $3.15 billion per year.

163 By the same token, it is difficult to make a compelling case based on this evidence that the industry's direct compliance costs substantially harm consumers, assuming they are passed on in the form of higher premiums. Note that this does not include the substantial indirect costs of regulation, which are believed to be generally harmful to consumers, as discussed in the next section.

164 NAIC "Quick Stats, 2000." Figure represents after-tax net income.

2. ANALYSIS OF INDUSTRY COSTS

In assessing where savings in direct compliance costs might be achieved, it is useful to divide compliance activities between *financial* regulation and *market* regulation, as was done previously for state regulatory expenditures. Financial regulation, which is directed primarily at solvency, is characterized by a far greater degree of uniformity across the states than market regulation, which is directed primarily at consumer protections.[165]

As noted above, financial regulation has benefited from a number of external and internal developments that has improved its functioning, although questions remain regarding its overall effectiveness and capabilities. Certainly, the widespread adoption and application of computer technology have facilitated the entire process of information storage, compilation, analysis, and reporting. Companies and regulators are able to gather, monitor and access much more information at faster speeds and lower costs than was previously possible.

Perhaps even more importantly, NAIC's accreditation and codification efforts have led to encouraging improvements in financial regulation. Although significant variations and redundancies in state-by-state standards and processes persist, financial regulation is far more uniform than it once was and generally far more uniform than market-related regulation. In addition, the achievement of better uniformity has enabled a greater degree of reciprocity, as non-domiciliary state financial exams have been nearly eliminated.[166]

Thus, for financial regulation, more sensible ground rules combined with technology have laid the foundation for more efficient processes. While further structural improvements are needed, particularly with respect to coordination and communication among the states, the bulk of industry complaints in this area pertains to scope issues (what is regulated) and conduct issues (how it is regulated), rather than to structural issues.

In contrast, market regulation is characterized by substantial variations across the states that are often difficult to justify fully. Here, regulation has tended to fall prey to overriding concerns for state preferences and sovereignty, at the expense of efficiency and necessity. Consequently, market regulation is often needlessly redundant and inefficient, and also self-sustaining in that regard.[167] Substantial differences in licensing requirements and rate and form filings generate the need, or at least the justification, for the states to conduct multiple and largely duplicative market conduct exams on both domestic and foreign companies. Moreover, these underlying differences in requirements frustrate efforts to evolve toward unified or coordinated market conduct exams since essentially customized state-by-state assessments still will be necessary to ensure compliance. Finally, increasing criticism regarding the inefficiencies of market-

165 The costs of insolvencies to the industry, in terms of ex-post guaranty fund assessments, are not included in the costs of financial regulation. For purposes of this study, such costs are considered to have occurred *after* the failure of regulation or market forces to prevent insolvency. Consequently, insolvency costs are treated as an indirect cost of regulation since they do not tend to be predictable or otherwise knowable in advance. Therefore, they are discussed in further detail in the next section on indirect costs.

Licensing requirements are often considered financial- rather than market-related regulations. Although unlicensed or otherwise unqualified individuals can contribute to solvency problems, licensing regulations are more focused on professional standards and consumer protections (i.e., market conduct) than financial strength and solvency. For purposes of this study, therefore, licensing requirements are treated as market-related regulations, as are rate and form filings.

166 Grace and Klein (1999) at 31.

167 Indeed, the primary structural weakness of a state-based regulatory system within an increasingly multi-state or broader market is its inherent tendency toward inconsistency and non-uniformity. This is evident in both positive (promulgation) and negative (deregulation) regulatory contexts. When new regulations are mandated, such as the privacy provisions of GLBA, the state-by-state approach has tended to produce multiple, conflicting, inconsistent and, ultimately, inefficient standards. See Morris, Barbara A. "CPCU Teleconference Debate over Gramm-Leach-Bliley Act Focuses on National Agent Registry and Privacy Concerns." *The Rough Notes Magazine*, July 2000.

Even federal guidelines have proven insufficient to promote uniformity if they grant the states significant discretion to enact their own specific requirements beyond the minimum standards. State legislatures have, in fact, exercised such discretion by enacting new privacy regulations under GLBA with unique and state-specific requirements. While NAIC's model law process helps promote uniformity generally whenever regulatory changes are being pursued, in many instances states have been unwilling to quickly adopt model laws as proposed, and frequently diverge by enacting additional requirements. The same tendency is evident in the deregulatory context. The intended benefits of decreased regulation are significantly undermined when the resulting deregulated standards are inconsistent across the states, as is evident in the varying eligibility criteria for exempt commercial policyholders.

regulation may even serve to spur the states to maintain or increase their unique requirements in order to preserve the underlying rationale for their independent action.

On a proportional basis, the industry's compliance costs for financial regulation likely are not as large as state regulatory expenditures on financial regulation. In part, this is due to the industry's comparatively high compliance costs for market regulation, which are believed to be much higher than for the states on a proportional basis. Market regulation is plagued by problems that extend across its scope, conduct and structure, such that substantial improvements in efficiency and effectiveness are possible. In light of the extent of the scope problems (see next section), however, it is uncertain whether the states can make meaningful headway with these problems given the structural weaknesses that lie beneath them. The evidence is not particularly encouraging, as manifest in the disparate pace and nature of the reforms to date.

Arguably, problems of scope can exacerbate problems of structure. In effect, regulatory overreach provides greater opportunity for regulatory structure to exert an adverse impact. Stated differently, as market conduct regulation expands, the opportunities for non-uniformity and redundancy increase commensurately in terms of both compliance and enforcement, such that scope problems may be magnifying the structural problems. If this is the case, then efforts by the states to address the scope problems could produce corollary improvements in at least the perception, if not the substance, of the structural problems.

As a starting point, better balance among regulatory priorities likely would be achieved if the industry's compliance costs were more symmetrical to the states' expenditures.[168] This means giving greater emphasis to core solvency and consumer protection compliance activities and less emphasis to other market-related compliance activities such as licensing, and rate and form approval. Even if the industry's total compliance costs remained unchanged, significant gains in efficiency and effectiveness likely would result from merely shifting the industry's costs among these areas. Nevertheless, the ideal approach involves a combination of reducing the industry's compliance costs overall, as well as reorienting the balance according to regulatory priorities that are focused on true market failures.

The critical points when assessing the industry's direct compliance costs are summarized below:

- The industry's direct compliance costs likely are several orders of magnitude higher than the states' direct regulatory expenditures;

- The industry's direct compliance costs likely have decreased significantly in relation to total premiums, paralleling the sharp decrease in state assessments paid by the industry vis-à-vis its total premiums;

- The industry's direct compliance costs likely are substantial in absolute terms and in relation to total industry profits, but not substantial in relation to total industry premiums and overall SG&A expenses;

- Even if a 25 percent reduction in industry compliance costs could be achieved, the effect on after-tax profits (if retained) would be small, while the effect on premium prices (if passed on to consumers) would be insignificant.

- In comparison to state regulatory expenditures, the industry's compliance costs appear to be much more heavily weighted toward market regulation (particularly licensing and rate and form approval). This may be due in significant part to the comparatively less uniform and redundant nature of compliance with market-related regulations vis-à-vis financial regulations.

168 For instance, based on the data provided above, 11 percent of the states' expenditures are directed toward rate *and* form regulation, while more than 20 percent of the industry's costs are tied to rate regulation alone.

C. INDIRECT COSTS OF REGULATION

1. INTRODUCTION

Since *direct* expenditures by regulators and direct compliance costs of the industry are tangible and easier to grasp, they tend to receive the most attention in evaluations of regulatory scope and structure. The *indirect* costs of regulation to the industry and consumers, however, are undoubtedly far greater, by many orders of magnitude, than these direct costs, even though their exact size is much more theoretical and difficult to pinpoint.[169] Many insurance regulations, based on both the conclusions of numerous empirical studies as well as anecdotal evidence, exhibit a clear tendency to cause unnecessary and/or unintended, but potentially very costly, distortions in key areas of market functioning and efficiency. Primary examples include the tendency of solvency regulation to promote *moral hazard* problems on the part of both consumers and insurers, and the tendency of price regulation to increase price variability, reduce availability and ultimately undermine solvency. While the exact mechanisms that produce these distortions are varied and complex, they often share two fundamental and interrelated characteristics:

- They undermine competitive market forces that generate incentives for loss control; and,

- They interfere with the normal relationship between premium levels and expected loss costs.

As a threshold matter, the overall cost of risk to the economy over the long-run, as opposed to consumer costs in the short-run, is the most relevant criterion for assessing market efficiency. From a different perspective, the cost of risk to the economy is reflected in the overall level of social welfare or combined consumer and producer surplus taken as a whole.[170] Generally, regulation can either:

- increase the cost of risk and decrease overall welfare by imposing costs without corresponding benefits or by distorting the market's allocating function; or,

- reduce the cost of risk and increase overall welfare by correcting or offsetting market failures and improving market efficiency.

In practice, regulation produces both of these outcomes in part. Setting aside social goals that may or may not have economic merit, regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate if not promote market failures, and increase the overall cost of risk. They are extraordinarily costly and fall far short of providing a commensurate level of benefits to the market, and especially to consumers, even when consumers appear to accrue some benefit.

While these regulations may exist to serve some other well-intentioned and perhaps economically justified regulatory purpose (which may or may not be achieved), their indirect or unintended effects often can be far greater and seriously detrimental, on balance. While it is certain that the indirect and unintended effects are far more substantial than the direct costs of regulation, they also are much more vague or obscured behind the more proximate rationales for the regulations (e.g., improving affordability). Although the costs of these effects are difficult, if not impossible, to measure with precision, the effects

169 The same is true for the indirect *benefits* of regulations, which manifest themselves in terms of improved solvency, market conduct, affordability, returns on investments, system stability and consumer confidence.

170 See Grace and Klein (1999) at 32-33. For example, increasing affordability at the expense of insurer profits or surplus provides no net gains to the *overall* economy, but rather merely shifts the burdens of the cost of risk among market participants (i.e., from consumers to insurers). Moreover, such a shift can potentially increase the overall cost of risk (thereby reducing economic welfare) by reducing the availability of coverage (which increases the potential for uninsured losses), reducing insurer claims-paying ability (which increases potential insolvency costs), and reducing loss control incentives for insureds (which increases loss costs).

themselves are numerous and usually observable. This section of the report provides a summary and abbreviated discussion of some of these effects and interrelationships.

2. SUMMARY OF DISTORTING EFFECTS

A. RATE REGULATION AND SUPPLY AVAILABILITY

The explicit goals of rate regulation are to promote affordability and coverage for consumers, and prevent destructive competition among insurers. These goals are complexly interrelated, which often can cause them to conflict with each other. Like the story of Goldilocks, rate regulation seeks to maintain prices that are "just right" — neither so high as to restrict affordability, nor so low as to reduce availability (and potentially threaten insurer solvency if accompanied by regulated exit barriers). There is considerable evidence, however, that rate regulation accomplishes neither goal, especially in the long-run. Within the confines of a fast-moving market that is structurally competitive, this outcome is not surprising. By attempting to control or limit prices, such regulation interferes with normal market-clearing dynamics, thereby triggering a chain of generally adverse or undesirable reactions in the behavior of both insurers and consumers.[171]

While constraining prices through price ceilings and discretionary approval may improve nominal affordability in the short-run, consumers do not benefit if, in response, insurers limit supply or withdraw from such markets entirely. Other effects include: deterioration in product quality and service (as insurers try to compensate for price suppression); reduced entry or incentives to innovate, invest and expand; reduced profits, as well as increased operating and insolvency risk for insurers; and perhaps most importantly, reduced incentives for loss control.[172] Thus, even though rate regulation is intended to promote more parties to insure and greater insurance coverage overall, the downstream or indirect effects tend to undermine if not frustrate that goal entirely. Regardless of the outcome, the result is neither efficient nor consistent with market principles within a structurally competitive industry.[173]

Similarly, given the lack of evidence that insurance markets are prone to destructive competition, *price floors* and other supports tend to reduce competition (or inefficiently shift it to non-price factors), advantage less efficient insurers over more efficient insurers, and, ultimately, harm consumers. Other effects include: discouraging entry of low-cost providers (who are limited in capitalizing upon their cost advantages); promoting excessive loss control by insureds; and, discouraging other parties (those with low-risk or affordability issues) from insuring.[174] Thus, while rate regulation is intended to limit destructive price competition and ensure supply, in practice it tends to limit competition overall and reduces the amount of insurance coverage either offered or purchased. Ultimately, the better approach likely centers on regulatory restraint to the extent possible, and redirecting regulation to help minimize barriers to entry and exit and ensure adequate profit levels, which together will promote adequate supply at competitive prices.

B. RATE REGULATION AND RATE LEVELS

As it should be, the primary influencing factor on rates is insurer loss ratios, which do not appear to be

171 Historically, rate regulation schemes developed following the move away from bureau pricing, as regulators sought to ensure the fairness of rates, particularly in compulsory lines (to promote affordability in mandated coverages) and personal lines (where information constraints and principal-agent conflicts are perceived to uniquely disadvantage individual consumers).

172 See Harrington (2000-2) at 31-43.

173 The states and NAIC have attempted to set bounds on regulatory discretion to control rates by requiring more rigorous and objective determinations of market failures as a precondition for such intervention. These "competitive rating" systems are a distinct improvement over generally more restrictive "prior approval" systems and have led to greater reliance on market forces in rate-setting and, therefore, represent a step in the right direction. Nevertheless, the competitive rating approach adds another layer of regulatory discretion with regard to making determinations of the competitiveness of a given market. Moreover, the stringency with which competitive rating laws are applied in practice can vary across the states.

174 IBID.

affected by rate regulation.[175] Among individual states, however, there is a clear relationship between the stringency of rate regulation and average rate levels. States with the highest insurance costs are most likely to regulate rates in the first place, while those with prior approval and conditional prior approval systems have higher than average expenditures for insurance.[176]

Although strict rate regulation would be expected to contribute to rate stability, the opposite is generally true in practice. The variation in rates over time is much greater for states with rate regulation than those without it.[177] There may be a number of legitimate reasons for this outcome, but clearly one factor is the tendency for rate regulation to produce fewer but larger rate changes. Due to the time and expense of new rate filings, insurers are less likely to adjust rates either higher or lower until changes in expected costs become significant enough to justify new filings. Thus, filings are less frequent but usually involve larger changes than they would if prices were allowed to change freely, particularly when insurers are seeking rate increases. Moreover, given the constant threat of regulatory suppression, rates are likely to become rigid as insurers defer timely rate decreases when loss-costs decline.[178]

A few states continue to maintain excess profit laws, which constitute an indirect form of rate regulation with similarly distorting effects.[179] Arguably, such restrictions are less stringent than direct rate regulation since they are not binding until presumably excessive rates yield excess profits. Nevertheless, such laws have the potential to be *more* distorting since they tend to be more binding on efficient firms, which effectively can be penalized if their higher profits stem from favorable expense ratios that have nothing to do with premium levels. Thus, rather than rewarding insurers for operating efficiencies, effective risk classification and selection, or generating above average investment returns, excess profit laws redirect the benefits back to insureds, who may have done little, if anything, to help produce the "excess profit."[180]

In addition, excess profit laws are unidirectional and, therefore, penalize insurers during their relatively low loss-cost years, while providing no relief in relatively high loss-cost years. Moreover, as noted above, the measurement of insurer profits is subject to considerable complexity due to difficulties related to portfolio valuation and attributing profits to particular lines and state jurisdictions.[181]

C. RESIDUAL VERSUS VOLUNTARY MARKETS

Since residual markets serve both economic as well as social goals, they cannot be expected to meet strict efficiency criteria, although they still should be administered as efficiently as possible. Residual markets are a product of regulatory intervention (due to compulsory coverages and the desire to minimize uninsured losses) and have the ability to impact the voluntary market directly.[182] They also reflect the tendency of regulation (i.e., compulsory coverages) to beget more regulation (i.e., residual markets).

Clearly, compulsory coverages and mandated supply are directly at odds with normal market forces,

175 IBID at 37-38.

176 IBID at 38-42. Due to the overriding importance of loss-costs, this does not mean that every state with prior approval or conditional prior approval regulations has higher rates than states without such regulations. In addition, the nominal classification of a state's regulatory process does not necessarily distinguish for different degrees of regulatory stringency. For example, some competitive rating states regulate more stringently than some prior approval states. See Feldhaus and Klein (1998) at 52.

177 See Harrington (2000-2) at 31-43.

178 IBID at 33.

179 IBID at 11.

180 The potential for regulated rate refunds provides strong disincentives for insurers to generate excess profits. Rather than reduce rates as the regulations intend, however, insurers instead may increase non-price product factors by providing additional services (thereby generating higher expenses) or relaxing claims-paying criteria (thereby increasing loss costs and rewarding claimants).

181 IBID at 19-20. In addition, evaluations of portfolio values and unrealized gains and losses may differ significantly from realized gains and losses.

182 See, generally, Harrington (2000-2); see also Feldhaus and Klein (1998) at 59-60, 85-86. State- and federally-sponsored or administered insurance plans represent the extreme form of this type of regulatory intervention, and more clearly exemplify the public welfare goals of residual markets.

although they accomplish certain social and economic benefits that the market might not otherwise achieve. First, compulsory insurance increases incentives for loss control, since it requires individual insureds to bear a greater portion of their risks that might otherwise go uninsured.[183] Second, compulsory insurance reduces the amount of uninsured losses ultimately borne by others.[184] The critical question is whether regulation provides the most efficient way of accomplishing these desirable goals.

In addition to the direct costs (state regulatory expenditures and industry compliance costs), residual market regulations impose significant indirect costs on the market through their tendency to distort conditions in the voluntary market, as follows:

- Residual market rates constrain voluntary market rates;
- Residual markets can limit supply in voluntary markets ("crowding out"); and,
- Residual markets can derive effective cross-subsidies from voluntary markets if they interfere with the normal relationships between premiums and relative risks or expected loss costs.[185]

Given the purpose of the residual market in the first place, it should always be relatively small and limited. A large and/or rapidly growing residual market constitutes de facto evidence of regulatory failure. The evidence is clear and most directly tied to distorting rate regulation in voluntary markets, as states with prior approval regulations have comparatively large residual markets, as insurers reduce supply in response to regulated rate suppression in the voluntary market.[186] Similar distortions can occur when residual market rates are suppressed by regulation at the expense of rates in other markets (i.e., in voluntary markets in the same state, or in both voluntary and residual markets of other states).[187]

D. ALTERNATIVE VERSUS TRADITIONAL MARKETS

The existence of expanding alternative markets and increasing use of non- or lesser- regulated products is symptomatic of failures in the regulated market and its traditional products.[188] These failures reflect product cost inefficiencies and product/coverage inflexibilities. Although other factors certainly have contributed to this shift, when direct and indirect regulatory costs exceed their corresponding benefits, regulated products and markets are disadvantaged vis-à-vis alternative markets and other financial

183 See Harrington (2000-2) at 27-29.

184 IBID.

185 See, generally, Harrington (2000-2). While the subsidization of certain insureds can be an acceptable social goal, especially if it ultimately increases overall economic welfare, the method by which the subsidization occurs is an important consideration since it determines to whom the subsidies are provided and by whom the costs will be borne. The critical issue here is the efficiency with which the subsidies are actually conferred from the bearers to the receivers, and whether this type of regulation, by causing cross-subsidies between markets, accomplishes the desired subsidization at the lowest cost. Alternatively, the subsidization might be accomplished more efficiently if direct payments were made to lower premium costs as desired, rather than by controlling market mechanisms. See Harrington (2000-2) at 29.

186 IBID at 20-22.

187 IBID at 13-14, 32.

188 Liberty Mutual (2001) at ii, 6, 13-14. While this evolution may mark failures in the traditional regulated insurance market, it may produce overall welfare gains in terms of the cost of risk, and reflected in consumers' preference for less governmental regulation (whether in terms of pricing or product features). Nevertheless these "gains" are not strict improvements as much as they are an avoidance of the potential losses imposed by regulations and other perceived limitations in the traditional regulated market. See also Feldhaus and Klein (1998) at 28, 40-41.

189 Certainly the greatest stimulus to alternative markets, particularly captives, has been the expense or lack of availability of certain coverages in the commercial market. Related reasons include the desire to recapture underwriting profits and investment income, to gain access to the reinsurance market, to diversify into insurance services, and to obtain customized coverages based more on specific *risk-driven* rather than *market-driven* factors, enhanced services and reduced frictional costs. See, for example, Ostermiller (A.M. Best); NAPSLO; NAPSLO/KPMG; Marsh.

service products that are not similarly constrained.[189] Inevitably, these imbalances lead able consumers to avoid regulated products and markets in order to minimize their costs and maximize their individual welfare by obtaining more suitable products.

Significantly, all segments of the insurance market — reinsurers, primary underwriters, agents and brokers, and consumers — are participating in this shift, indicating that the adverse and indirect effects of regulation are widespread and well- known. The participants tend to be larger and more sophisticated and, therefore, more capable of assessing the differences between traditional and alternative markets, including understanding the effects of regulation on premiums, coverages and the overall cost of risk for various products. While efforts to deregulate commercial lines seek to narrow incentives to move into alternative markets, they are proving to be "too little, too late" given the significant withdrawal from the traditional market by the largest commercial buyers.[190] Nor is deregulation expected to lure these buyers back to the traditional market, although it is hoped to slow or limit withdrawals by middle-market accounts which have begun to occur.[191] Although hard market pricing and limited capacity in the mid-1980s spurred shifts to the alternative market, the extended soft market of the mid- to late-1990s did little to reverse or even slow this flow, indicating that pricing, while important, has not been the sole motivating factor.[192]

No matter what the motivations, a clear trend away from traditional markets is in place and will likely overcome regulatory efforts to slow or reverse the trend. This is due to much larger forces at work, including financial services convergence (which will introduce new capital and products for risk-financing), reductions in trade barriers, and increased globalization. When these forces are coupled with a relatively favorable regulatory climate, the alternative markets should continue to exhibit improved efficiency and control as well as innovation and flexibility vis-à-vis traditional markets. It is estimated that alternative markets now account for nearly half of the U.S. commercial property and casualty primary business[193] and their growth continues to outpace that of traditional markets.[194]

While certain U.S. states led by Vermont and Hawaii have passed legislation to allow formation of captive insurance companies, much of the current activity and expected future growth is concentrated in overseas and offshore markets, which enjoy distinct advantages over domestic captives in terms of taxes and less complex/stringent regulation. There are numerous reasons to expect that alternative markets, led by captive insurance and risk securitization instruments, will continue to grow at the expense of traditional regulated markets:[195]

- Greater access and opportunities being provided to middle- and small-market accounts;
- Recent hardening in most P/C lines since late 1999;
- Department of Labor ruling in 2000 that liberalized the insuring of employee benefits through captives;
- The increasing degree of financial services convergence, as well as multistate and global operations; and,
- The uneven pace of state regulatory reform and modernization.

The catastrophic losses due to the recent terrorist attacks (and related life, business interruption and workers' compensation claims) have caused very significant increases in premium costs, as well as limited the availability and coverages in affected traditional markets. Consequently, these events will provide

190 See NAIC (1998) at 2, 10 (citing Conning & Company, "Alternative Markets — Evolving to a New Layer," 1996).

191 IBID.

192 See Bowers (1999).

193 Liberty Mutual (2001) at 6. Another factor cited is the lack of reinsurance capacity.

194 See A.M. Best (2001) at 15.

195 IBID.

further impetus toward alternative markets. As noted above, similar conditions prevailed in the 1980s in the liability market leading to the LRRA of 1986, which spurred significant growth in risk retention groups (RRG) and purchasing groups (PG). As of 2001, total RRG premiums had reached $895 million, while total purchasing group premiums had reached an estimated $3.0 billion.[196] Due to pricing and coverage problems in the property market following the terrorist attacks, a number of industry interest groups have called for an expansion of the LRRA to cover property risks.[197]

The states, led by NAIC, are attempting to slow the exodus to alternative markets by deregulating commercial lines or, failing that, promoting the use of domestic captives. Nevertheless, the continuing migration to alternative markets has important implications regarding the existence (or absence) of market failures, the effectiveness of regulation in addressing those failures versus causing distortions and inefficiencies, and the extent of regulatory reach or control over the business of insurance. Simply put, more and more insurance business is migrating away from state regulatory control, which raises several important questions:

- What are the implications on the insurance market as a whole of the increasing and significant proportion of transactions beyond the control of state regulators?

- While alternative markets have provided gains in cost efficiencies and specific coverages, are solvency and market conduct conditions generally as sound?

- What does the increasing use of non-admitted, excess and surplus and alternative markets collectively say about consumers' preferences for regulatory protections vis-à-vis product cost and availability?

- To what extent can structural reforms narrow the disadvantages inherent in the traditional regulated markets vis-à-vis alternative markets?

E. RISK CLASSIFICATION RESTRICTIONS

Risk classification restrictions, in effect, act as indirect rate regulations, since they dictate the permissible variations in rates for buyers of the same coverage.[198] While there may be valid social reasons for such restrictions (such as avoiding unfair discrimination and promoting affordability), the resulting interference between expected costs and premiums adversely impacts market efficiency and produces similar distortions as direct rate regulations. As is the case for rate regulation, competitive markets provide strong incentives for accurate risk classification, which, in turn, provides incentives to higher-risk insureds to control losses, but only if premiums are permitted to reflect expected costs.[199]

While rate and risk classification regulations seek to control the insurer's behavior, ultimately they distort relationships between higher- and lower-risk insureds by generally decreasing costs to the former while increasing costs to the latter. This distortion in relative costs extends to normal incentives for loss control by raising them for low-risk insureds while lowering them for high-risk insureds. Ultimately, this

196 See Risk Retention Reporter, *RRG Statistics and PG Statistics*, downloaded at http://www.rrr.com/education/growth.cfm.

197 Some proponents of expanding the LRRA do not believe the expansion should be limited to property risks, but should include any line of insurance that might benefit from increased competition, greater product flexibility and reduced regulatory constraints. The lines that are not considered appropriate for such coverage generally include personal lines and workers' compensation, although increasing problems in the latter market may generate similar proposals. Two of the main problems faced by RRGs have been continued friction with state regulators (notwithstanding the preemption features of the LRRA) and shortage of fronting capacity following the demise of several important fronting carriers for captive groups. Expanding the LRRA to cover other risks may help attract new fronting capacity by expanding the potential premiums at stake. See Pilla, David. "Risk Retention Groups Lobby Congress for Expanded Role." *BestWire Services*, April 4, 2002.

198 See Harrington (2000-2) at 1.

199 IBID at 18-19, 23-24.

results in adverse selection for insurers as more high-risk buyers insure (or insure more) while more low-risk buyers do not insure (or insure less/self-insure).[200]

While rate classification restrictions can improve nominal affordability for some buyers, their overall benefits likely fall far short of their costs. In addition to the direct costs to the states for monitoring and enforcement and industry compliance costs, the artificial improvement in affordability for selected classes of consumers causes affordability overall to *decrease*. This has been described as a "negative-sum system of cross-subsidies," which also applies to rate regulation, whereby limited benefits to a minority portion of the market come at high costs to the overall market. The impeding of normal loss control incentives inexorably leads to higher claims costs overall.[201]

F. REGULATION OF POLICY FORMS

The regulatory goals of requiring policy form approvals are substantively sound, although it is less clear whether they are efficient. The goals are to compensate for purchasers' information and bargaining power deficiencies vis-à-vis insurers and to facilitate comparison shopping, thereby promoting competition. Insurers likewise benefit from more standardized bases for the development of loss experience and cost information.[202] The relevant questions are: 1) whether these deficiencies constitute a market failure; 2) whether policy form approvals are the best way to accomplish the stated objectives; and, 3) whether the benefits of such regulation are sufficient relative to their costs.

Purchaser information and bargaining power deficiencies are neither uniform nor insurmountable, which has led at least some states to deregulate policy forms for large commercial buyers. The degree of customization permitted in policies for large buyers essentially precludes both insureds and underwriters in this segment from receiving significant benefits from the regulation of policy forms, which instead simply imposes additional costs.[203]

The indirect costs of policy form regulation can be significant, however, while its benefits can be questionable, the primary of which is that coverages may be more consistent with minimum standards established by the states.[204] Those standards, however, may not be relevant to many buyers even as administering those standards imposes costs upon them. In addition, such standards can prevent or significantly delay buyers from obtaining more suitable products,[205] particularly under conditions of rapidly changing markets and insurance needs. Consequently, purchasers of regulated policy forms often over-insure in certain areas and under-insure in other areas.[206] Form approval restrictions also undermine insurers'

200 IBID at 32.

201 IBID at 43.

202 IBID at 44-45. Arguably, consumers and insurers could also benefit from economies of scale in the production of standardized policies. Given the relatively low level of insurer expenses, however, the economies would have to be substantial in order to exert a significant impact on premiums. Moreover, while the benefits of pooled loss data to insurers are unmistakable, there is little empirical evidence concerning the actual efficiency benefits to insurers of the improvements in the accuracy and reliability of expected loss costs derived from these data. It is not clear, therefore, the extent to which these data would suffer with less perfect standardization and/or smaller sample sizes. Even if the accuracy of pooled loss data deteriorated as a result of less stringent regulation and greater product differentiation, the question remains whether such deterioration would be significant enough to impact the market adversely, or whether alternative methodologies and other adjustments could be employed by insurers to increase the reliability and use of the data.

203 The customized nature of their policies indicates that large insureds have both sufficient information and bargaining power vis-à-vis insurers. In addition, such customization essentially precludes the ability of regulation to facilitate standardization and comparison shopping on behalf of insureds, as well as the development of standardized loss experience and cost information on behalf of insurers.

204 In large part, these standards are derived directly from specific state differences and variations in insurance and related laws that define or govern losses and fundamental contractual obligations.

205 Here, regulation has the potential to introduce a significant market failure to the extent that it prevents insureds from obtaining the particular products they want and are willing to purchase. Any other result diminishes security and predictability, and raises the cost of risk to individual insureds.

206 The bulk of the evidence points to the tendency for parties to over-insure and thus bear increased costs for unwanted or unnecessary insurance contained in ancillary coverages and mandatory endorsements enforced by individual states, particularly for multi-state insureds. See NAIC (1998) at 11-13.

incentives to develop and market new products, leaving them unable to fully satisfy their clients (except through alternative means) and at risk of missing important market opportunities. In some cases, such restrictions can cause insurers to withdrawal partially or completely from markets that they believe cannot be served by approved products.[207]

G. LAGS AND DELAYS

Though regulatory lags (e.g., for rate approvals) and delays (e.g., for form approvals) may not impose any tangible costs on regulators or the industry, they impose substantial intangible costs. These costs stem from distortions in the timing between changes in loss costs and premiums, maintenance of excessive and/or inadequate insurance coverage by individual buyers, lost market share or opportunities for insurers, increased risks for both insureds and insurers, and a reduction in overall supply.[208]

Since these costs are difficult to quantify even grossly, they are easily overlooked. A recent study asserts that new product approval delays constitute a "hidden tax." Using econometric modeling, the study estimates that new products effectively face an implicit tax of approximately 9 percent due merely to delays in their approval.[209] These delays cause losses in overall welfare that stem primarily from consumers' inability to obtain the products desired in a timely fashion. Thus, these regulatory frictions are not simply frustrating or inconvenient, but potentially quite costly and distorting. Indeed, the costs may be comparable to typical commissions paid and several times higher than state premium taxes. Unfortunately, such quantifications of such intangible costs are difficult to make and generally unavailable, which obscures them from consumers.

While the costs of regulatory lags and delays to consumers are substantial, they can be even more threatening to insurers. This is true in any environment, but particularly in the current, very competitive conditions. Never before has the industry faced such a combination of threats to existing markets and opportunities in new and emerging markets. The prevailing trends in financial services modernization, electronic commerce, global trade and alternative markets and products share a common denominator — speed and flexibility — two of the primary weaknesses often cited with regard to the current regulatory system.

The causes of regulatory lags and delays frequently are attributed to structural problems of the regulatory system, namely the inefficiencies and redundancies of having to obtain regulatory approval in multiple jurisdictions. Clearly, redundancy is a prime generator of indirect costs and other distortions, such that changes in structure that reduce the number of discrete regulatory jurisdictions could reduce indirect costs significantly.

Nevertheless, the contribution of regulatory scope to these costs must not be overlooked, since scope is where these costs originate before they are magnified by structure. In short, all regulatory decisions require time and generate costs. As those decisions become more extensive (i.e., as regulatory scope increases), the corresponding delays and costs increase proportionally. As those delays and costs are then repeated across numerous jurisdictions, they become more and more intolerable.

Consequently, in the context of evaluating alternative regulatory structures, this interplay must be kept in mind so that scope considerations do not overwhelm structure considerations, and vice-versa. The salient point for the industry is that both scope and structure problems make significant contributions to the overall problem.

207 The supply availability problems in the property market following the terrorist attacks and in the Texas homeowners' market following the onset of toxic mold claims are directly linked to regulated rigidity in policy forms. In both cases, insurers appealed to regulators to approve and allow needed adjustments and endorsements to reflect these risks. The failure or delay of regulators to accommodate these changes, however, contributed to the eventual problems that developed as insurers responded to the lack of product flexibility by withdrawing supply. Thus, this market problem also could be included under the next distorting effect discussed — regulatory lags and delays.

208 See Harrington (2000-2) at 33.

209 See Unnewehr (2001) at 3 (citing Butler, Richard. "Form Regulation in Commercial Insurance." *Working Paper.* Department of Economics, Brigham Young University).

H. RESTRICTIONS ON MARKET EXIT

In response to market and product restrictions (i.e., rate, form and classification restrictions) and other regulatory frictions, the industry has limited options within a given state. In the short-term, the industry simply can tolerate higher levels of direct compliance costs, reduced operating flexibility and lower growth and profits. In the longer term, the industry can undertake more substantive adjustments by reducing costs, reducing service and quality, or making other permitted product-related adjustments (such as adopting higher claims payment standards).[210] If those measures are not sufficient to compensate, then reductions in supply become a more viable alternative, beginning with nonrenewals and cancellations and ending with complete market exit.

Thus, even before any restrictions are placed on the industry's responses to excessive regulation, its range of options is limited. The most extreme option — market exit — constitutes a powerful moderator of excessive or inefficient regulation by exposing its consequences to the market in terms of reduced supply and ultimately higher prices to consumers. While this is an extremely costly option for the industry to employ, less drastic alternatives likewise are fraught with limitations, if not peril. For example, reducing product quality and attendant services or raising claims payment standards can reduce goodwill and impact company reputations, as well as trigger increased litigation.[211] Moreover, nonrenewals and cancellations can attract greater regulatory scrutiny and, by extension, increased compliance costs. In comparison, market exit entails substantially higher costs and disruptions that tend to limit the use of this option, except as a last resort, whether by multi-state insurers seeking to maintain a national presence, or by local or regional insurers who can ill-afford to lose access to any market or line.

Given the limited appeal of market exit or even limited withdrawal, the fact that the industry regularly undertakes these actions or credibly threatens to take them underscores the significance of unnecessary regulatory restrictions and their costs to the industry. The threats are prevalent enough that many states employ second-tier restrictions on the industry's freedom to exit, including constraints on nonrenewals and cancellations, "lock-in" rules and even restrictions on the modeling of loss costs.[212] These further restrictions remove a legitimate check on excessive or inefficient regulation and constitute another example where inefficient or distorting regulation tends to beget more regulation.

In the broadest sense, regulatory exit barriers are directly contradictory to the fundamental rationales for regulation. It is difficult to reconcile the imposition of one clear-cut market failure in the interest of resolving another market failure, whether actual, potential or purported. Furthermore, if exit barriers are imposed in response to market conditions that do not constitute true failures, then they simply cannot be justified.

While imposed exit barriers are undesirable by themselves, they can lead to secondary problems. Initially, the presence of exit barriers also can serve as barriers to entry, as the threat of capital and income expropriation by regulation has a dampening effect on the willingness of new suppliers to enter such markets. Once entered, suppliers who are unable to respond to excessive or inefficient regulation will likely delay exiting due to its high cost, thereby sustaining losses while attempting to salvage investment principal or finding other ways to compensate. In the meantime, they will certainly limit further capital commitments, which increase the possibility of financial distress.[213] Once the costs cannot be sustained, market withdrawal increases costs even further. Finally, the exodus of capacity tends to force

210 See Harrington (2000-2) at 50. Perversely, efficiency gains and other cost improvements achieved by insurers in response to these restrictions can provide the basis for even greater rate suppression, since rates are based, in part, on insurer expense ratios.

211 IBID.

212 IBID at 10, 35-36. Lock-in rules can significantly increase the costs of exit by requiring exiting insurers to abandon all lines of business and subjecting them to residual market assessment surcharges. These costs are in addition to the losses of investment principal that often occur when a market is abandoned.

213 IBID. Exit barriers provide greater incentives to reduce investment than to reduce costs and expenses.

more consumers into residual markets, which, as noted above, is evidence of a malfunctioning market environment.

In the context of evaluating alternative regulatory structures, the imposition of exit barriers is primarily, if not exclusively, attributable to problems of the scope and conduct of regulation rather than of its structure.

I. EXTERNALITIES

The structure of the state regulatory system in an increasingly interstate or even international market makes it prone toward generating externalities.[214] While state-by-state variations in regulatory requirements (i.e., *scope*) are a product of the system's structural weaknesses, they also exacerbate the state system's inherent tendency toward non-uniformity, redundancy, and generating externalities. The generation of negative externalities — when other states accrue a cost without a corresponding benefit as a result of the regulatory actions of another state — is key in this context. While variations in the scope and conduct of regulation often appear to be the root cause of many externalities, in most cases, they are facilitated by the structural limitations of the regulatory scheme.

In some cases, the negative externalities may be intentional, as in the exclusion of large commercial buyers from guaranty fund protections, but not from guaranty fund assessments.[215] Other examples include any situation in which the *incidence* of costs or benefits in insurance transactions specifically is controlled or dictated by regulation. The more regulatory control alters the incidence of the costs and benefits that would otherwise occur, the greater the potential for externalities to occur.

As discussed above, rate and risk classification, as well as residual markets and exit barriers, all have the tendency to produce distorting cross-subsidies among different parties individually, or across different states more generally. In some cases, costs are transferred to insurers, thereby providing benefits to insureds; in other cases, costs are transferred to low-risk insureds, thereby providing benefits to high-risk insureds. It should be clear, however, that the transferring of costs and benefits within the market does not increase overall welfare — i.e., there is no free lunch — unless it corrects a prevailing market failure. Otherwise, consumers simply pay for the benefits shifted to insurers, while insurers pay for benefits shifted to consumers. In the process, however, the distortions that result tend to reduce overall welfare.

Given the state specificity of many areas of regulation prone to externalities, adverse effects stem directly from the differences among the states' regulations and do migrate across state lines. Although these effects are often indirect and unintended, they are easy to overlook even though they are no less harmful or distorting.

Cross-state externalities occur because the avoidable costs of both excessive and lax regulation in one state are easily passed to other states.[216] Excessive regulation increases compliance costs that the industry will seek to recover any way it can, whether in the state where those costs are generated, in other states, or, most likely, in both. Lax regulation can increase the risks of insolvency or fraud/misrepresentation that likewise impact all markets rather than just the market where the lax regulation occurred. The other side of externalities, which is of equal concern, is lack of jurisdiction or regulatory reach. States are limited

214 To reiterate, externalities are costs or benefits that arise from an economic transaction which are borne by parties not involved in the transaction and results from the failure of the transaction price to account for the externality. See Spulber (1989) at 46. Previously, it was noted that externalities involve the unfair or inadvertent shifting of costs and benefits such that a single event gives rise to both positive externalities (to the recipient of the benefit) and negative externalities (to the bearer of the cost). The immediate discussion is focused on negative externalities and omits consideration of the corresponding positive externalities that also are generated.

215 To some extent, these externalities are being offset by the relaxing of regulatory oversight of large commercial buyers. Nevertheless, the imbalance created by the differential treatment of these insureds with respect to guaranty fund protection and assessments inevitably creates distortions that generate indirect costs to the market beyond the obvious costs to this class of policyholders. Such intentional externalities are typically the product of non-market objectives, as evidenced by their tendency to act like direct subsidies, which are generally distorting in nature. One of the primary problems that arises with externalities (unlike direct subsidies), however, is that their costs and benefits usually are not clear to either the bearer or the recipient, respectively.

216 See Harrington (2000-2) at 41-42.

in their ability to control the activities of other states and thus, the extent to which poor operating performance or distortions can be isolated in the state where they arise.

As the foregoing illustrates, structural weaknesses and limitations in the state system tend to facilitate the generation of externalities in the first place, and then magnify them once they arise. Consequently, structural changes to the regulatory system have the potential to reduce the distorting and ultimately costly effects of externalities on the market. The same mechanism that gives rise to externalities in the market, however, can also help control systemic risk, either by providing (through migration) a relief valve or by the internal disciplining forces that develop among states through regulatory competition.

J. SOLVENCY AND MORAL HAZARD

Moral hazard is an issue that arises frequently in the context of all financial services and is not specific to insurance. A good definition of the term is:

> A MORAL HAZARD EXISTS WHEN A DECISION MAKER TAKES RISKS THAT HE OTHERWISE WOULD NOT HAVE TAKEN, BECAUSE THE ADVERSE CONSEQUENCES OF THE RISK-TAKING HAVE BEEN TRANSFERRED TO A THIRD PARTY IN A MANNER THAT IS ADVANTAGEOUS TO THE RISK-TAKER AND, MORE IMPORTANT, IS DISADVANTAGEOUS AND POTENTIALLY EVEN DESTRUCTIVE TO THE PARTY TO WHOM THE RISK HAS BEEN SHIFTED. INSURANCE IS SUCH A RISK-TRANSFERRING DEVICE; THEREFORE, THE POTENTIAL FOR MORAL HAZARD EXISTS IN ANY FORM OF INSURANCE, NOT JUST IN DEPOSIT INSURANCE.[217]

Thus, the very concept of insurance is said to give rise to moral hazard by changing the behavior (i.e., reducing the incentives to minimize losses) of those who purchase it. Within the insurance industry, the topic arises frequently in the context of guaranty funds and the potentially adverse effect they can have on the behavior of both insurers and consumers. They permit both insurers and consumers to take risks that they otherwise might avoid in the absence of such protections.

Insurers may employ risky operating strategies in the interest of increasing market share, achieving above-market profits or simply trying to stay afloat once they become troubled. Similarly, consumers fall prey to moral hazard by becoming more insensitive to insurer financial condition, for example, when they purchase insurance on the basis of price alone without regard to risk (i.e., the claims-paying ability of the insurer). Neither insurers nor consumers are penalized for their own risky behavior. In some respects, they are rewarded for it. Risky insurers can grow premiums by underwriting and pricing aggressively, while risky consumers can pay lower premiums for broader coverages.

Regulation is likewise vulnerable to moral hazard if the presence of guaranty fund protections causes oversight to be less rigorous under the presumption that losses will be restored should oversight fail. Indeed, the tendency of moral hazard to undermine market vigilance is applicable to all components of the insurance market, whether they are insurers (i.e., competitors), brokers and agents, other service providers (e.g., rating organizations, securities analysts, actuaries and auditors), consumers or regulators.[218]

217 See Ely, Bert, "Regulatory Moral Hazard — The Real Moral Hazard in Federal Deposit Insurance," *The Independent Review*, Vol. IV, No. 2 (Fall 1999) at 241.

218 See Macey and Miller (1993) at 89-90.

Intuitively, insolvencies represent the worst possible outcome and, for that reason alone, financial monitoring is a critical area of regulation that deserves the highest priority and attention. The establishment and maintenance of guaranty funds provide important benefits by serving to reinforce market confidence and stability, and help limit systemic risk not only in the insurance sector, but within the entire financial system.

From a purely economic standpoint, however, guaranty funds achieve these important goals at very high costs. As with other regulatory actions, the direct costs of guaranty funds (i.e., assessments, net payouts and administrative expenses) are large and draw most of the attention. In contrast, the distortions and other indirect costs that result likely are far more substantial yet more prone to be overlooked because they are relatively difficult to measure and attribute.

By spreading the cost of losses among parties not directly involved in the transactions giving rise to those losses, guaranty fund protections produce significant externalities.[219] As was the case with regulated exit barriers, guaranty fund protections anomalously seek to alleviate one or more *potential* market failures that contribute to insolvencies (e.g., information constraints and principal-agent conflicts) by imposing an alternate but more *definitive* market failure (i.e., externalities).

When coupled with corporate personal liability protections, guaranty fund protections help ensure that the parties most directly responsible for the insolvency bear relatively little of its cost, particularly when multi-state insurers fail. In such cases, the parties most responsible for the insolvency are, arguably, the management of the failed insurer and its domiciliary regulators. Yet, the costs of the insolvency are borne primarily by others — i.e., the *shareholders* of the failed insurer, as well as all the insurers, policyholders and taxpayers located not only the domiciliary state, but also in all the other states in which the failed insurer wrote business.[220]

By shifting the burden to other policyholders and taxpayers, the guaranty funds also effectively shift normal loss control incentives (in this case for monitoring the insurer) to these parties as well. Ultimately, policyholders and taxpayers who have no relationship with the insurer have equal or greater incentive to monitor the insurer as its own policyholders. The same incongruity is evident in the exclusion of large commercial insureds and high net worth parties from guaranty fund protections. Since these parties are presumed to be able to afford unfunded losses, they are penalized by having their loss control incentives *raised*. Meanwhile, those who cannot afford such losses and, therefore, should be more sensitive to insurer solvency, are rewarded by having their loss control incentives *lowered*.

Left to run its course, this mechanism tends to produce a bifurcated market whereby those with normally low loss control incentives gravitate toward the strongest, most solvent insurers (i.e., those that underwrite conservatively), while those with normally high loss control incentives gravitate toward the weakest, riskiest insurers (i.e., those that underwrite aggressively). This is contrary to market functioning and likely results in greater overall loss costs, if not greater insolvencies.

The direct costs of insolvencies and guarantee fund protections are relatively straightforward to evaluate. For property/casualty lines, since the inception of the state guaranty funds in 1969, net assessments on the industry have totaled $6.6 billion through 1999.[221] Breaking this period into decades, annual assessments averaged $17 million in 1969-1979 (11 years), $282 million in 1980-1989, and $325 million in 1990-1999.[222]

219 One caveat is relevant here. While other parties may bear the cost of insolvencies without being directly involved, they receive some value in return — i.e., similar protections in the event that their coverages fail. The same is not true, however, for consumers who are exempted from guaranty fund protections.

220 Shareholder equity investments are not covered by guaranty fund protections. Insurers are affected initially by guarantee fund assessments, but are permitted to recoup assessment costs from their policyholders through future premium surcharges and/or from taxpayers via offsetting credits to their state premium taxes. The costs of any unreimbursed assessments are also transferred to taxpayers via permitted federal income tax deductions. See Feldhaus and Klein (1998) at 48-49 and Klein (2000) at 58, both citing Barrese, James and Jack M. Nelson, 1994. "Some Consequences of Insurer Insolvencies." *Journal of Insurance Regulation*, 13: 3-18.

221 See National Conference of Insurance Guaranty Funds (NCIGF), *Assessment and Financial History Reports.*

222 IBID. In the five-year period leading up to the 1989-1990 investigation by the House Committee on Energy and Commerce headed by John Dingell, assessments averaged $577 million per year. Since then, assessments have not reached that level again in any year, even in the 1993-1995 period when they were inflated by special assessments related to the numerous insolvencies caused by Hurricane Andrew.

The states limit annual assessments in a range of one to four percent of covered premiums, with most states utilizing a cap of two percent.[223] In actuality, annual assessments nationwide have averaged less than 0.3 percent of covered premiums historically.[224] For life, health and annuity lines (generally administered separately), assessments called since 1988 have totaled $5.6 billion, or an average of $465 million per year.[225]

Thus, the direct costs of insolvencies are fairly modest relative to total premiums, averaging $865 million per year over the last decade. In contrast, the indirect costs, while immeasurable, are substantial. As noted, the overall distortion in loss-control incentives not only increases insolvencies, but increases losses overall, including those that are covered and paid by all the insurers that remain solvent. Given that loss claims total several hundred billion dollars each year, even a modest reduction in such incentives have the potential to generate additional loss claims that dwarf the direct costs of regulating insolvencies and providing for guaranty fund protection.

There are numerous other problems cited with respect to solvency regulation and guaranty funds that cut across both scope/conduct and structural weaknesses in the current system, although none is as significant as the moral hazard problem and the potential for generating externalities. Examples of other scope problems include the lack of a risk-based adjustment in assessments (which would offset some of the moral hazard problem) and arbitrariness in eligibility and benefit standards.[226] Structurally, the major weaknesses pertain to the lack of uniformity in eligibility and benefits, the limited capacity of individual state funds and their lack of cost sharing provisions among other states, and general coordination issues.[227] While these problems are important and potentially correctable through alternative structures, structural changes alone may be insufficient to remedy the adverse effects arising from externalities and cross-subsidies, or the distortion in loss-control incentives.

223 See Feldhaus and Klein (1998) at 48. Annual assessments can be omitted if the state fund has sufficient unused capacity to meet guaranty fund payments.

224 IBID.

225 See National Organization of Life and Health Insurance Guaranty Associations (NOLHGA).

226 See Macey and Miller (1993) at 86-87.

227 See Feldhaus and Klein (1998) at 49-50.

VIII Additional Market and Reform Considerations

A. Interstate Markets

As outlined previously, the industry's primarily state-based regulatory structure developed when insurance markets largely were localized to state jurisdictions. As insurance markets expanded alongside the economy at large, the development and regulation of insurance was kept functionally distinct from other financial services. Today, some of those elements remain, while others have been discarded or fundamentally changed. The insurance industry has internally segmented along numerous dimensions from different lines of coverage to the types and size of its customers. At the same time the industry has splintered into specialized niches, it has also internally consolidated.

The fundamental rationale for the state-based regulatory structure is the desire to address particular needs and preferences of discrete state markets. Setting aside the multitude of other factors shaping the industry and challenging the regulatory structure, it is instructive to test how strong this foundation remains today. While state regulators may continue to have strong preferences for local control, do market dynamics still support this segmentation along state lines? If not, then the maintenance of a state-based regulatory structure under these conditions will be prone to generating a number of distortions and inefficiencies. In fact, the state-based regulatory structure not only might be distorting and inefficient, but also might be institutionalizing state differences that are no longer relevant and, therefore, hindering the development of a broader national market.

A relatively straightforward method of testing this foundation is to analyze each state's market and determine empirically how much business is written by insurers domiciled in that state. If state markets remain largely discrete, then insurers will tend to write a large proportion of their overall business within their state of domicile. Alternately, the number of domestic companies in each state can be compared to the total number of companies conducting business in that state. Once again, if state markets remain largely discrete, then domestic companies should comprise a large proportion of the total number of companies conducting business in each state.

This analysis was undertaken in a previous study using annual NAIC data tapes from the financial statements filed each year by insurers.[228] While the data are from 1995, the general findings are still applicable today, although there likely have been some changes and shifts in the interim. The relevant information is summarized on the following page.

These data support the following conclusions:

- On average only 21 percent of property/casualty premiums and 12 percent of life/health premiums in each state are written by domestic companies. Thus, a substantially higher volume of premiums are written by *foreign* companies (i.e., 4 to 8 times *higher*) in each state than by *domestic* companies.

- Within each state, there are a far greater number of *foreign* companies conducting business than *domestic* companies. For property/casualty lines, there is an average of 16 *foreign* companies conducting business in the state for each *domestic* company, while the ratio is nearly 30:1 for life/health lines.

228 See Grace and Phillips (1999) at 8-9, Table 1-2.

INTER- OR INTRA-STATE MARKETS?

MEASURE	PROPERTY/CASUALTY	LIFE/HEALTH	TOTAL PREMIUMS
PERCENT OF STATE INSURANCE PREMIUMS WRITTEN BY DOMESTIC COMPANIES			
AVERAGE, ALL STATES	21.3%	11.8%	16.6%
MINIMUM, ALL STATES	1.8%	0.0%	1.4%
MAXIMUM, ALL STATES	57.2%	48.5%	38.0%
RANGE OVER 1 STANDARD DEVIATION	8.2% – 34.4%	0.1% – 23.5%	6.7% – 26.5%
PROPORTION OF INSURERS DOMICILED WITHIN EACH STATE			
AVERAGE, ALL STATES	6.3%	3.4%	4.9%
MINIMUM, ALL STATES	0.2%	0.0%	0.2%
MAXIMUM, ALL STATES	25.8%	21.4%	21.4%
RANGE OVER 1 STANDARD DEVIATION	0.4% – 12.2%	0.0% – 7.3%	0.2% – 9.6%

- While all lines have a low *intra-state bias*, the bias is distinctly more pronounced in life/health lines than property/casualty lines. In other words, property-casualty lines exhibit more of a local concentration than life/health lines.

- Larger market states are more likely to have a stronger *intra-state bias* than smaller market states. In other words, domestic companies tend to account for a greater proportion of the overall business conducted in larger market states than in smaller market states.

These data have important implications regarding the regulation of the industry. As the scope of the market becomes increasingly interstate or national, structural limitations of the state-based regulatory system potentially become more problematic. While each given state assumes primary responsibility for its domestic insurers, it increasingly relies on the other states to regulate the foreign companies that account for the majority of the business conducted within that state. Similarly, while each given state retains primary oversight of its domestic companies, the majority of the business conducted by those companies occurs in other states.

Thus, through its reliance on domiciliary states as primary regulators, the state system's tendency to generate externalities is magnified, as *spill-over* and *free-rider* effects become more pronounced. In addition, each state's jurisdictional reach becomes more limited as the market becomes increasingly interstate in scope, thereby increasing the need for coordination and comity among the states.

Finally, given their stronger intrastate bias, the larger market states would be expected to be less receptive to efforts to increase uniformity and reciprocity, or generally undertake any regulatory reforms geared to improving market efficiency and functioning. With the benefit of a large market in which its own domestic companies have a relatively high degree of participation, such states may be less driven to undertake reforms to make their markets even more attractive. The size of their markets alone is sufficient to attract both domestic companies as well as foreign companies. In contrast, smaller market states tend to have much lower participation by domestic companies due to size and scale considerations and, therefore, are more likely to undertake reforms to make their limited markets as attractive as possible. This suggests that regulatory competition among the states may be somewhat limited as smaller states tend to take the lead while larger states are content with the status quo, or may even resist efforts to increase uniformity and efficiency.

As discussed in greater detail below, this polarity between large and small states with respect to reforms is evident in the producer licensing initiatives undertaken following passage of GLBA. The states that have resisted enacting fully compliant legislation have tended to be among the largest markets in the country. The experience to date suggests that seeking reciprocity as a stepping stone toward uniformity may be misdirected, as the lack of complete uniformity (even if improved) ultimately undermines the states' willingness to grant and accept full reciprocity. Moreover, since the degree of willingness of the states tends to be inversely proportional to market size, efforts to increase reciprocity without uniformity will tend to be undermined by reduced participation by the largest markets, whose absence seriously degrades the potential benefits of such efforts.

8. GLOBALIZATION AND FOREIGN TRADE

International trade and globalization will continue to grow in importance for the industry due to two prevailing trends. First, international trade in both goods and services generally continues to expand both broadly and quickly. This is a product of many factors, but is particularly a result of increased market access and transparency. These prerequisites for effective foreign market penetration are, in turn, becoming better established and protected by virtue of the entrenchment of the World Trade Organization, with its ever-expanding membership and trade protections, as well as the proliferation of bilateral and multilateral trade agreements.[229]

Second, trade in financial products is being greatly facilitated by the growth and development of electronic commerce, which can significantly reduce barriers to entry and operating costs for such products.

It has been suggested that the existing state regulatory system in the United States acts as a potentially illegal barrier to trade and will frustrate efforts to expand into foreign markets. While this is true to an extent, certain extenuating factors should be considered, as follows:

- First, the United States is, by far, the largest insurance market in the world. Several individual state markets are larger than most other national markets around the world.

- Second, while the state system may hamper entry to a degree, substantial evidence is lacking that these entry barriers discriminate against foreign companies vis-à-vis domestic companies. In many respects, the U.S. system may be no more burdensome than other country markets. Provided that there is no differential treatment of U.S. and foreign insurers in the U.S. market with respect to regulatory matters, foreign insurers do not have a strong cause for complaint. The relevant criterion is not whether the U.S. market is more or less open than its trading partners, but whether U.S. regulators discriminate against foreign companies.

- Third, there is significant participation in the U.S. market by foreign companies, indicating that any entry barriers and other regulatory hurdles are navigable. The next largest world market — Japan — has negligible foreign participation.

- Fourth, arguably the separation of the financial services segments posed a much more significant barrier to trade than the state system, and that separation largely has been addressed by the Gramm-Leach-Bliley Act.

229 While the United States has completed and continues to pursue additional free trade and other trade liberalizing agreements, it has generally lagged behind many other developed countries in the rest of the world. There is evidence that the United States is moving to avoid falling further behind, although economic turmoil in the Western Hemisphere outside North America (the logical starting point for such expansions), as well as political difficulties in obtaining the so-called "Fast Track" authority believed to be instrumental in completing such agreements, has slowed the process.

One potentially favorable effect of increased foreign participation in the U.S. market is that it adds interest groups that might increase pressure on state regulators to enact reforms to improve the efficiency of regulation. On the other hand, the federal government has typically maintained a strong deference to states' rights in trade negotiations and related affairs. Often, the lack of strong political support or presence of controversy regarding trade agreements and other negotiations tend to limit the federal government's willingness to pressure the states in the context of trade agreements and negotiations.

C. EXCESS AND SURPLUS LINES

For many reasons, the excess and surplus (E&S) lines reflect a microcosm of the many regulatory and efficiency issues relevant to the broader insurance market and industry. Depending on the perspective, the E&S market can be seen as the bridge between the admitted and alternative markets, or, as the market of last resort that accepts risks that are declined in the primary market. Like alternative markets, E&S lines reflect, in part, the purposeful avoidance of regulation by the industry and consumers, and the increasing loss of direct regulatory control by state regulators.

E&S lines exhibit many interesting characteristics of interest that could be useful in evaluating the possible effects of less or differently structured regulation under alternative systems.

- The improvements stemming from less or more efficient regulation in terms of many important market parameters — stability and solvency, product innovation, speed and flexibility in responding to market demands, underwriting and investment portfolio performance, and customer satisfaction.

- The significant difficulties and inefficiencies stemming from even the reduced level of regulatory control that is exercised over E&S lines, including variations in state eligibility and licensing criteria, diligent search requirements, and the collection and remittance of premium taxes.

- The creation of distortions through structural distinctions between E&S lines and either admitted voluntary or residual markets that parallel the distortions noted previously between voluntary and residual markets. In addition, restrictions on E&S lines can limit the ability of insureds to obtain the coverages they desire and are willing to purchase, as often occurs with product form regulation.

- E&S lines have a significant self-governing dynamic that is administered via the National Association of Professional Surplus Lines Offices (NAPSLO), as well as individual state stamping offices, which help regulate solvency, eligibility and qualifications, tax collection, information gathering and dissemination.

It should be noted, however, that although regulatory oversight of E&S lines is reduced overall, a substantially larger portion of the reduced regulatory burden is borne by brokers, who serve as a primary leverage point for regulatory contact. This has important implications in connection with the broader deregulation effort being undertaken among traditional regulated lines. As the market moves toward greater deregulation, there may be a temptation to shift or assign greater regulatory responsibilities to agents and brokers as has been done in E&S lines.

The transfer of regulatory responsibilities from regulators to agents and brokers is misguided from several perspectives. First, agents and brokers face their own difficulties in adjusting to the fast-moving and competitive market that need not be complicated by increased regulatory responsibilities that are better handled by regulators. Agents and brokers' role in the market place is expanding rapidly as they assume more and more functions that were previously handled by insurers, outside consulting firms or other financial services companies. At the same time agents and brokers are expected to perform these wide-ranging and additional services, they are not receiving additional compensation from insurers and are facing a sharp increase in competition from both traditional and nontraditional sources that include insurers and reinsurers that are writing premiums directly, banks, accounting organizations and investment houses.[230]

Second, while agents and brokers play a vital role in assisting their clients to obtain and understand the information needed to complete insurance transactions, the actions of insurers are beyond their control. Unlike regulators, agents and brokers lack the means and the ability to compel disclosures by insurers or intervene in the operations of insurers, making them inappropriate substitutes for direct supervision by state regulators or even as ancillary leverage points for regulatory control.

Agents and brokers are neither designed nor equipped to make financial and solvency judgments either on an absolute basis or in relation to state regulators and other market participants. Relying on them to do so likely will decrease regulatory efficiency *and* effectiveness. In the context of the market failures discussed previously, such a role places agents and brokers in the middle of the principal-agent conflicts between insurers and consumers. These conflicts are inevitable and agents and brokers serve an important role in helping to mediate and minimize them. The addition of explicit regulatory responsibilities, however, will hamstring agents and brokers in that role, to the detriment of consumers and overall market functioning, since they lack sufficient capability to undertake such responsibilities.

D. REFORM CONSIDERATIONS

The industry faces numerous factors that rest upon a quickly evolving landscape as it contemplates its future regulation. Consequently, it is easy to become entangled in the complexity of these many complementary and often conflicting considerations. In that vein, it is import to remember that the industry should be operating from a position of strength that is derived from a competitively structured market. While excessive or unnecessary regulation causes numerous distortions and other inefficiencies, the market and its participants have shown the ability to overcome these problems, as well as the normal competitive forces they face.

1. DEREGULATION OF COMMERCIAL LINES

There is considerable evidence that many of the market failures and other problems evident in the insurance market generally apply with much less force, if at all, to the property/casualty segment, as the following quote broadly underscores:

> THE PROPERTY-LIABILITY INSURANCE INDUSTRY POSSESSES THE STRUCTURAL CHARACTERISTICS NORMALLY ASSOCIATED WITH THE IDEALIZED COMPETITIVE MARKET: A LARGE NUMBER OF FIRMS, OPERATING IN A MARKET WITH LOW CONCENTRATION LEVELS, SELLING ESSENTIALLY IDENTICAL PRODUCTS, PROVIDED AT CONSTANT UNIT COSTS AND WITH EASE OF ENTRY OF NEW AND POTENTIAL COMPETITORS. . . . IT IS . . . DIFFICULT TO FIND . . . MANY OTHER INDUSTRIES WHICH CONFORM MORE CLOSELY TO THE ECONOMIST'S IDEALIZED COMPETITIVE MARKET STRUCTURE.[231]

230 See Schiff, Samuel. "Agency System Lives but Continued Agency Survival Will Require Adapting to Changes." *The Rough Notes Magazine*, February 1999.

231 See Joskow (1973) at 375, 391.

Accordingly, the broad deregulation effort being undertaken with respect to commercial lines is the ideal approach, as opposed to incremental changes in particular regulations or even more dramatic changes in the regulatory structure, unless changes in the regulatory structure facilitate deregulation. The extent to which NAIC and state regulators embrace deregulation could mark a departure from their more traditional approach of protecting consumers and maintaining solvency "above all else." This traditional perspective often disregards the attendant costs of achieving a nominal regulatory objective. When conditions of strong structural competition are present, as they are with respect to commercial lines, then the market will be the most effective and efficient means of moderating undesirable behavior or outcomes — such as excessive risk taking and price gouging — that regulators have tended to claim as their province.

Nevertheless, the deregulation effort, like other modernization and reform efforts, has shown susceptibility to weakness in the state regulatory system, as favorable changes in scope are undermined by structural limitations that tend to produce standards that vary significantly across the states.[232] While non-uniform deregulation is better than none, its benefits are significantly undermined by the lack of uniformity, which also hampers the achievement of improved reciprocity and comity among the states.

2. NARAB AS A LITMUS TEST[233]

A. NEED FOR ADDITIONAL PRESSURE

The state-based regulatory structure is capable of dramatic changes. NAIC's accreditation effort, for example, was a massive undertaking and accomplishment that has led to material improvements in the critical area of financial regulation. Nevertheless, it must be recognized that these changes occurred under pressure of Congressional oversight and the direct threat of federal intervention.

Unfortunately, without external pressure, reform efforts typically suffer from the same inertia that plagues the more routine regulatory activities within the state structure. With so many jurisdictions and specific or individualized preferences, reform, like licensing or form approval, easily becomes subject to long delays and complications that cause it to lag behind the industry's needs and fall short of more ideal outcomes. While the state structure has proven fairly responsive to the industry's development and evolution, history has proven time and again that there is no greater impetus than the threat of federal intervention in pushing the states beyond the proposal and limited adoption stage to achieving effective implementation of reforms.

The recent forces of market expansion (e.g., financial services convergence, electronic commerce, globalization and international trade) have increased the industry's sensitivity to regulatory frictions, particularly now that these frictions have transformed from merely unnecessary costs and inconveniences to potential competitive disadvantages and even threats to the industry's longer-term health. It is reasonable for the industry to question whether these evolutionary forces have raised the stakes sufficiently to impel the state system forward, or whether additional external pressure will have to be brought to bear to achieve meaningful and timely reforms in the future.

There are several additional voices in the market that have the potential to generate additional pressure on the states that appears necessary. Conversely, however, these voices also could serve to expand, diffuse and complicate the debate, which might engender more hesitation or delay on the part of Congress and the regulators. These new market entrants include banks and foreign companies that bring with them

232 A secondary weakness stems from partial or piecemeal deregulatory efforts in which deregulated standards are restricted to parties deemed to meet certain eligibility criteria. While establishing such criteria is necessary to administer the new standards as intended, the benefits of deregulation are offset to a certain degree by the increased burdens of making individual eligibility determinations, which may not be clear cut in many cases and, therefore, potentially arbitrary or unfair. In such cases, the adoption of a self-certification approach with regard to eligibility can significantly preserve or restore those benefits.

233 NARAB refers to the National Association of Registered Agents and Brokers.

regulatory competition that the states are already beginning to face directly. Moreover, as the market finds new and creative ways to conduct its business, the states' regulatory reach is ever-shortening, which is an obvious cause of concern for the market overall, but especially state regulators.

Finally, the complexity of markets and products is increasing while the ability to conduct transactions is accelerating and expanding, which raises the potential for significant regulatory missteps that could lead to increased federal attention, whether in anticipation of, or in reaction to, problems that might develop. Under these conditions, therefore, if the states' efforts to achieve meaningful reforms remain mired, calls for wholesale changes in regulatory structure will gain even greater traction.

B. EXPERIENCE TO DATE

Against this backdrop, the states led by NAIC are undertaking an unprecedented number of parallel reforms spanning many different areas of oversight, including the reform of producer licensing to improve uniformity and reciprocity. Since this is an area of particular interest to agents and brokers, it serves as a good litmus test of the capability of the state system to undertake needed reforms.

While the states have made significant progress in licensing reforms, at this juncture the effort nonetheless appears beleaguered by many of the traditional obstacles *even in the face of federal intervention*. As a starting point, despite its significance and importance, GLBA set the bar fairly low in relation to the broader objective of achieving a truly uniform system of producer licensing. In effect, it serves more as a catalyst than a blueprint in allowing the states considerable latitude and discretion in implementing its requirements. It provided a three-year time frame and required only 29 states to achieve compliance in order to forestall the creation of NARAB. NAIC responded by indicating on one hand that its revised model law went well beyond the minimum requirements of GLBA, while, on the other hand, that it would begin by pursuing the lesser goal of achieving the multi-state reciprocity requirements of GLBA as a more achievable and necessary first step towards full uniformity.[234]

According to NAIC, 44 states have passed legislation or adopted regulations seeking to satisfy GLBA reciprocity provisions as of May 20, 2002.[235] Accordingly, NAIC appears to have reached its interim goal of forestalling NARAB. A closer examination of the implementation to date, however, is less encouraging. The 44 states account for roughly 85 percent of the total number of states, but less than 75 percent of the total premiums written.[236] Significantly, several large market states are included within the group that has failed to pass legislation to date, including California, Pennsylvania and New York, all of which are among the top five state markets.[237] Even among the states that have passed relevant legislation, there remains some uncertainty whether such legislation is fully compliant with NARAB reciprocity requirements, as NAIC has yet to confirm compliance or there are disputes regarding the exact nature of those requirements.[238] These states represent an additional 14 percent of the market including the states of Texas and Florida, the country's second and third largest markets, respectively. This information is summarized on the following page.

While NAIC continues to work diligently to add states to the roster and several months remain until the formal deadline, it is difficult to declare victory even though the minimum requirements appear to

234 See NAIC, *Statement of Intent: The Future of Insurance Regulation*; Testimony of George Nichols III Regarding State Insurance Regulatory Modernization and Implementation of the Gramm-Leach-Bliley Act, *Before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, United States House of Representatives*, July 20, 2000. A fundamental question that remains unanswered is whether true reciprocity can be achieved without uniformity.

235 See NAIC — NARAB Working Group, *Producer Licensing Model Act Implementation*. (May 20, 2002) downloaded at http://www.naic.org/GLBA/narab_wg/PLMA.htm

236 See *NAIC, 2000 Insurance Department Resources Report*.

237 See NAIC — NARAB Working Group, *Producer Licensing Model Act Implementation* (May 20, 2002); *NAIC, 2000 Insurance Department Resources Report*.

238 See "The Council, NAIC Review State Licensing Reforms," *The Council Advocate*. (Winter 2001). The states in dispute include Alaska, Idaho, Washington and Texas. The areas of dispute include the retention of surplus lines bond requirements and fingerprinting requirements for nonresident producers. Additionally, Florida has recently enacted licensing reform legislation that will continue to require fingerprinting of nonresident producers.

SUMMARY OF U.S. LICENSING REFORMS

STATE/COMPLIANCE STATUS	2000 DIRECT PREMIUMS *(IN MILLIONS)*	PERCENT OF TOTAL DIRECT PREMIUMS	OVERALL STATE RANK
IN COMPLIANCE — 39 STATES	$549,000	57.4%	NA
NOT IN COMPLIANCE — 7 STATES	$271,118	28.3%	NA
CALIFORNIA *(NOT APPROVED)*	$88,795	9.4%	#1
NEW YORK *(UNDER CONSIDERATION)*	$84,865	6.2%	#2
PENNSYLVANIA *(UNDER CONSIDERATION)*	$58,279	6.1%	#4
TENNESSEE *(NOT APPROVED)*	$19,694	1.9%	#18
SOUTH CAROLINA *(UNDER CONSIDERATION)*	$8,440	0.9%	#29
NEW MEXICO *(NO ACTION TAKEN)*	$6,044	0.5%	#33
DISTRICT OF COLUMBIA *(UNDER CONSIDERATION)*	$5,001	1.1%	#39
COMPLIANCE IN DISPUTE — 5 STATES	$136,436	14.3%	NA
TEXAS	$63,468	6.8%	#3
FLORIDA	$51,713	6.3%	#5
WASHINGTON	$16,924	1.8%	#22
IDAHO	$3,007	0.3%	#45
ALASKA	$1,324	0.2%	#50

be satisfied. While having 39 to 44 states adopt the reciprocity requirements is an improvement over 50 different state standards, this result falls far short of a fully uniform national market. Compared to that objective, the absence of as many as 12 states comprising more than 40 percent of the market is unsatisfactory. Thus, even under the threat of federal intervention, NAIC and the states have struggled to clear the lowest rung with respect to producer licensing reforms.

Optimistically, the reciprocity measures may constitute a difficult first step that will help achieve uniformity more quickly as NAIC has posited. This could be the case if the benefits of reciprocity draw the non-compliant states into the fold, although the resistance of so many major market states does not appear to validate that dynamic. To the contrary, it suggests that due to the relative attractiveness of the market in these states, they tend to have a higher proportion of domestic insurers and producers, which, in turn, makes them less willing to cede their prerogative to license as they specifically desire. Thus, after 2- years' time with limited progress and even some disagreement as to what constitutes true reciprocity, it is reasonable to expect that true national uniformity could require many more years to achieve, if it can be achieved at all under the current circumstances.

In fairness to the states and NAIC, no conclusions should be made until the deadline passes and the outlook for achieving uniformity is more visible. Nevertheless, the view from here is not encouraging, as uniformity represents a far more ambitious goal that is not subject to any further deadline or threat of federal intervention. Additionally, NAIC and the states already have a full plate, and it is clear that the pace of new challenges — financial services convergence, electronic commerce, globalization and emerging market problems — is accelerating and could cause resources and attention to be shifted elsewhere on short notice. Until the states and NAIC demonstrate otherwise, therefore, there are valid reasons to believe that the state structure is incapable of responding quickly enough to these challenges without sufficient incentive.

1) IMPLICATIONS FOR FEDERAL MINIMUM STANDARDS

The NARAB provisions represent an example of limited federal minimum standards implemented and enforced by the states. By requiring only a slight majority of states to achieve compliance, the measure falls short of fully national standards. The experience to date, however, suggests that minimum standards are not sufficiently constraining on the states, and permits them to add ancillary, state-specific elements that frustrate goals of achieving better uniformity and reduced redundancy. Implementation and enforcement provide another avenue for additional state discretion and variation beyond the difficult task of adopting conforming legislation.

If the opportunity for individual state discretion is not foreclosed, the states have difficulty resisting the tendency to tailor minimum standards to local market concerns and objectives. Thus, the application of minimum standards appears to be better geared toward improving the conduct and effectiveness of regulation rather than making it uniform and less redundant.

2) IMPLICATIONS FOR NAIC EMPOWERMENT

Two key shortcomings of the current state system under conditions of reform are NAIC's lack of authority and the resulting tendency of the individual states to modify and expand specific regulatory requirements thereby preventing the establishment of more uniform standards.

NAIC performs much of the "heavy lifting" by mediating individual state differences in framing reasonable compromises in the form of model laws. Due to its lack of authority, the success of its efforts is ultimately dependent upon the willingness of the states to adopt NAIC's concepts of uniformity and reciprocity, which has proven to be limited and variable. In the interest of achieving a broader consensus, there is an inherent tendency in the model law process to follow one of two extremes — either to dilute the relevant standards to avoid imposing any new requirements on any individual states (i.e., least common denominator) or to raise those standards to the highest possible level in order to ensure that the states with the most rigorous requirements need not fear any diminution in the quality of their oversight (i.e., highest common denominator).

With the least common denominator approach, achieving a consensus is easier but of less value since individual states will adopt additional requirements as they see fit. With the highest common denominator approach, achieving a consensus is much more difficult and runs the risk of significantly increasing the overall scope of oversight. Thus, it is not clear that either approach provides sufficient incentives to individual states or adequate outcomes to regulated entities.

NAIC's ambitious and generally well-received accreditation program provides a good example of this mechanism in practice. As an initial matter, there is no apparent substantive reason why this program cannot be applied to other areas of regulation. If NAIC was able to achieve adoption of accreditation standards in the relatively critical, complex and sprawling area of solvency regulation, there seems to be no valid reason why this approach cannot work in other relatively less critical and simple areas such as producer licensing.

While the accreditation program is far from perfect and still lacks complete "participation" after 10 years in existence, the program did manage to galvanize the states in a manner that was clearly lacking prior to the program. Two factors have been identified as keys to the success of the accreditation program, which are instructive should this approach be applied to other areas such as producer licensing: 1) centralization of the review of regulatory data (but not enforcement); and, 2) the states seem more willing to accept uniform standards if they are more stringent and improve the quality of oversight, rather than reduced standards that are more directed toward improving the efficiency of oversight.[239]

With regard to the first factor, NAIC essentially facilitates the review by state regulators by collecting the relevant information centrally and then performing preliminary analyses ("IRIS" and "FAST" ratio

239 See GAO (2001) at 5-6, 8.

analysis) that are reported back to the domiciliary state for further review and enforcement.[240] The dynamic is that NAIC shares rather than assumes responsibility for oversight with the states and does so by using regulatory tools and performing analyses that the states cannot do on their own. These same considerations are present with respect to producer licensing. NAIC is able to centrally collect information on a national basis that an individual state cannot easily obtain on its own. Moreover, NAIC brings certain regulatory tools to the process, namely its Producer Database and Producer Information Network, that the states lack. There seems to be no reason why NAIC could not serve as a central repository where producer licenses are first screened and reviewed before being passed onto the states for further action.

With regard to the second factor, improving the stringency rather than the efficiency of regulatory standards is where the case for producer licensing is weaker. While there certainly is potential for uniform licensing standards to improve the conduct of oversight in this area, the focus primarily has been on improving the efficiency of such oversight by reducing redundancies and state-specific requirements. Consequently, the effort to "streamline" producer licensing might be met more receptively if the benefits to the quality of such oversight were emphasized as opposed to its efficiency benefits.

While NAIC seems to be positioning itself as a potential future regulatory authority, from a structural standpoint, empowering NAIC could be similar to inserting a new federal regulator or making it the source of minimum or explicit national standards that are left to the states to implement, the shortcomings of which were discussed above. As it stands, NAIC merely suggests minimum standards to the states without true authority, but derives some leverage by offering ancillary services and support in conjunction with the adoption of such standards.

3) IMPLICATIONS FOR INTERSTATE COMPACTS

The idea of using interstate compacts continues to be debated in the context of several different regulatory areas. This structure has been tried on a limited but not particularly successful basis with respect to receivership administration and is currently under consideration by NAIC in terms of implementing its Coordinated Advertising Rate and Form Review Authority (CARFRA) initiative. The major obstacles to this structure include the unwillingness of individual states to cede authority to the designated compact commission or to adopt identical laws.[241] Other criticisms include that the structure fails to achieve uniformity, maintains inefficiencies and redundancies in administration, and that business is not written on the basis of proposed compact regions.[242]

While these are all valid points, they also are applicable in even greater force to achieving broader uniformity and reciprocity on a national basis. If states are unwilling to cede authority to a regional compact (from which they can withdraw easily), then it does not seem likely that they would readily submit to a national authority or to national standards unless compelled. Similarly, if a finite group of geographically proximate states is unwilling to adopt identical laws, the prospects of 50 different states doing so must be considered more remote.

Thus, while segmenting the market into four to six compact regions does not fully address uniformity and redundancy concerns, it certainly marks an improvement over 50 different state jurisdictions. The compact structure represents a compromise or an interim step that enables states to test uniformity and reciprocity on a limited and trial basis. If successful, individual compacts could then be merged in moving toward a national market in discrete steps rather than all at once. While this is certainly less ideal than moving directly to uniform national standards, as well as subject to other difficulties, individual states may be less resistant to an incremental approach.

240 IBID.

241 See Reinsurance Association of America. "Interstate Compacts." *Policy Update.*

242 IBID.

In the context of the current reforms, the number of states unwilling to comply with the NARAB reciprocity provisions raises two points. First, in the pursuit of national standards, if a sufficient number of states (particularly large market states) are unwilling to participate, then the effort ends up producing a compact-like structure, albeit a distinctly imbalanced one. At this time, there are 35 to 39 states willing to grant reciprocity, potentially resulting in one large jurisdiction and 12 to 16 additional ones that are dominated by larger market states. Second, the concentration of larger market states in the non-complying group suggests that these states strongly prefer to exercise more discretion over their own markets. If individual compacts were oriented around these large market states, then they might be more willing to participate under the assumption that, by virtue of their large market size, particularly in relation to the regional compact, they would tend to exert leadership within that regional compact.

IX Principal Views and Recommendations

A. General Considerations

- Regulation is inherently more oriented toward its outcomes — solvency and consumer protection most importantly — than its processes and secondary effects. A more holistic and empirical approach forces closer consideration of regulatory processes and their secondary effects, which can be costly and distorting.
- The indirect and unintended effects of regulation often are adverse and undermine the benefits accruing from the achievement of stated regulatory goals, or frustrate the achievement of those goals altogether.
- At the very minimum, alternative regulatory structures must demonstrate adequate performance on the core regulatory objectives of solvency and consumer protection. Most of the potential efficiency gains, however, will come from improved performance in the secondary or peripheral areas of regulation (e.g., licensing and rate and form approval), ideally by reducing the scope of regulation (deregulation) rather than by re-engineering existing processes.
- While agents and brokers may be affected uniquely or discretely by regulation vis-à-vis other segments of the industry, the regulatory structure that best serves the industry as a whole likely will prove optimal for agents and brokers as well. While agents and brokers play a key role in the market by helping to mediate and minimize conflicts between insurers and consumers, as well as reduce information constraints on both sides of insurance transactions, they are neither designed nor equipped to undertake direct regulatory responsibilities for either insurers or consumers. Transferring such responsibilities to agents and brokers will decrease the effectiveness and the efficiency of regulation.

B. Cost Considerations

- The indirect costs of regulation (market efficiency and distortions) are, by far, the most significant of the different types of regulatory costs. For the most part, these costs are a function of regulatory *scope* and *conduct*, rather than regulatory *structure* per se. If the existing regulations were transferred to a different structure, many of the indirect effects would persist unless the change in structure also led to changes in scope and conduct.
- While difficult to measure and assess, these indirect costs should take priority over direct regulatory expenditures and industry compliance costs in evaluations of alternative structures due to their far greater significance. The industry, consumers and regulators would benefit if these costs were more visible and quantifiable.
- The industry's direct compliance costs are substantial in absolute terms, but much less significant in relation to industry profits and premiums. Industry compliance costs likely are driven more by excessive and distorting regulation (in terms of scope and conduct) than merely inefficient or redundant regulation. Structural reforms by themselves will not reduce excessive and distorting regulation unless they involve changes in the scope and conduct of regulation generally.

C. POLICY/PERSPECTIVE CONSIDERATIONS

- The market has the inherent capabilities of performing its functions much more efficiently and competently if permitted, while still remaining within the bounds of effective regulation.

- Both regulators and politicians have demonstrated increased awareness of the fact that unnecessary regulatory distortions, frictions and costs have become less tolerable to the industry given the competitive and fast-changing market conditions in which it is operating. These factors have been transformed from being costly and inconvenient to potential competitive disadvantages that threaten the long-term health and performance of the industry.

- While it is important to distinguish between scope and structure, it is also important to recognize their interrelationships. Structure becomes more determinative of scope under conditions of change or reform, as is the case currently. Similarly, problems that arise due to the scope of regulation can be magnified by the structure of regulation.

- The hallmark of an efficient and competitive insurance market is one that minimizes the overall cost of risk, which is comprised of the cost of losses, the cost of loss control and the cost of risk transfer. Efficient markets are more focused upon minimizing costs and maximizing benefits overall than in mediating the incidence of those costs and benefits. In contrast, regulation often seeks to alter the incidence of those costs and benefits, sometimes to the detriment of overall market welfare.

- An increasing proportion of insurance transactions is migrating beyond the reach and direct control of state regulators to alternative markets and other non-traditional risk-financing mechanisms, with little evidence of adverse ramifications. This shift has important implications regarding the cost/benefit profile of regulation, whether information constraints still constitute a legitimate market failure, whether such constraints can be overcome by the industry and consumers, and whether the overall system faces greater or lesser risk as a result of this migration.

- The operating environment is being transformed by financial services convergence and modernization, e-commerce and globalization, all of which have accelerated and sharpened competitive forces. Under these conditions, the costs of regulation are magnified, particularly given their potential to produce significant disadvantages vis-à-vis new domestic and foreign competitors (or products) that are not subject to the same regulatory constraints. While this applies to the costs of even minimally necessary regulation, it is most relevant when regulatory constraints begin to impose significant burdens and inefficiencies without attendant benefits or even suitable underlying rationales.

- The tendency of insurance regulations to produce distortions and other unintended effects, regardless of the structure in which they are administered, can generally be attributed to two fundamental causes — the undermining of competitive market forces that generate incentives for loss control and the interference with the normal relationship between premium levels and expected loss costs.

- Thus, regulations that interfere with incentives for loss control or with the relationship between expected loss costs and premium levels go far beyond the basic rationale for regulation — to correct or minimize market failures. In fact, such regulations tend to exacerbate if not promote market failures, and increase the overall cost of risk to the overall economy.

D. CURRENT STRUCTURAL CONSIDERATIONS

- The limitations of traditional regulatory structures under current competitive conditions have tended to increase jurisdictional and functional disputes among the regulating agencies and other authorities as they compete to either protect their turf or try to reestablish clear dividing lines among their responsibilities. In addition, however, regulating agencies and authorities are recognizing the need for a more flexible and holistic approach to regulating financial services that relies more on cooperation, information exchange and shared responsibility. Regardless, the continuing trend toward convergence in financial services has shifted the burden of adjustment to the regulators.

- As the insurance industry becomes less functionally distinct and more national and international in breadth, interim and incremental improvements in regulation along traditional functional and geographic lines may prove to be only temporarily palliative. Even worse, limited reforms may tend to further entrench structures and practices that may not be suitable or optimal for the industry in its new competitive environment.

- Two of the primary rationales for maintaining the state regulatory structure of insurance are its abilities to tailor products and services to unique state market conditions and requirements, and to offset consumer information problems and deficiencies. These advantages are offset by inefficiencies related to redundancies and diseconomies of scale that are characteristic of decentralized authority.

- The state-based structure's primary weakness may be its susceptibility toward generating negative externalities. Consequently, assessments of alternative structures must address this issue and the extent to which this particular susceptibility can be reduced or minimized. A related problem concerns geographical limitations within the state structure, which often require that regulatory determinations be made on a state-by-state basis. It is uncertain whether such state-specific analyses are meaningful in an increasingly national and international market.

- Congress has focused repeatedly on the industry's solvency problems, citing numerous and persistent examples of ineffective solvency oversight by state regulators as prime factors. State regulators have been quick to respond by undertaking reforms and other actions to avert direct federal involvement. Nevertheless, past insolvencies have raised the question of whether regulators can identify company-specific problems, such as aggressive pricing and the understatement of reserves, on a reliable and sufficiently early basis. Corollary issues include concerns regarding the regulatory reach and expertise of regulators with respect to foreign markets and insurers, nontraditional markets and products and reinsurers (who play a relatively low profile but key role in market functioning).

- All of the major reforms accomplished under the existing state structure have occurred only in response to major external threats of federal intervention or wholesale dislocations in the regulated markets. Based on these precedents, there is no assurance that the state-based system will enact meaningful further reforms absent a significant level of continuing threat and pressure. The experience with NARAB and producer licensing to date supports this conclusion.

- The imposition of minimum standards within the existing state system could potentially improve uniformity. There is considerable evidence, however, that when these standards are set relatively low or when they continue to permit significant state discretion and variation, much of the potential benefits are undermined. There also is increasing evidence that the lack of uniformity among the states acts as a shaky foundation for improvements in reciprocity.

- Regardless of whether the states undertake significant further reforms, the inexorable trend seems to lead away from continued state regulation. If states fail to undertake significant reforms, the state system will become increasingly unsuitable to the current environment and generate tremendous pressure for wholesale change. If, on the other hand, the states undertake significant reforms and achieve a greater degree of uniformity, reciprocity and comity, those reforms will help set the stage for a further move toward federal regulation. Nonetheless, the state structure will remain under pressure whether the states move ahead or obfuscate.

E. ALTERNATIVE/FUTURE STRUCTURAL CONSIDERATIONS

- The optimal regulatory structure must meaningfully address the most problematic regulatory areas identified — primarily company and producer licensing as well as rate, risk classification and form regulation — even though these are less critical areas than solvency and consumer protection. Regulatory conduct in these areas is generally excessive, inefficient and often ineffective, if not harmful, to market functioning. In this context, deregulation likely is preferable to lesser reforms, even though the latter may constitute a necessary interim step.

- Convincing support for one structural alternative or another must be characterized by an improvement in regulatory effectiveness as a threshold matter, particularly given the growing indications that the current structure may lack the capacity to manage its functions adequately, particularly under adverse business conditions.

- In evaluating alternative regulatory structures, the industry is advised to give greater weight to alternatives that facilitate deregulation rather than those that facilitate specific changes in existing regulations. In theory, a more dramatic change in structure offers the *potential* for more rapid and extensive deregulation on a wholesale basis. While the state structure has shown it can achieve deregulation, it tends to occur on a non-uniform and piecemeal basis. Moreover, such efforts have been most successful under the threat of federal intervention.

- Universal options and regulatory perspectives — the net benefits of each of the regulatory alternatives (including maintaining the existing system) would tend to be maximized if the alternative incorporated certain universal options or approaches that are not specific to each structure. These include broader versus narrower application of changes and participation by regulating entities, the degree of self-certification or self-regulation permitted, the reorganization of regulation along distinct product or consumer segments and the adoption of prescriptive versus prudential approaches to regulation more generally.

- Any alternative that reduces the number of potential jurisdictions (e.g., interstate compact, mandatory or optional federal regulation in any form, or financial services super-regulator) has the potential to achieve rapid or wholesale deregulation, as well as improvements in uniformity (or even make uniformity cease to be an issue).

- The Gramm-Leach-Bliley Act, while offering significant near-term regulatory improvements, also has set the industry upon a potentially conflicting course in the longer-term. While the Act simply synthesizes and embodies a number of forces already at work, it likely will trigger further changes in the financial services industry as a whole that will continue to strain the regulatory structure. The Act encourages less functional differentiation within the industry while maintaining functionally distinct oversight. Without further changes, maintaining functional regulation as the industry continues to converge, integrate and globalize will produce many of the same problems as maintaining state regulation in an increasingly interstate and even international market.

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STATEMENT OF TOM MINKLER
ON BEHALF OF THE
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA

BEFORE THE

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

July 29, 2008

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Tom Minkler, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA). Thank you for the opportunity to provide our association's perspective on insurance regulatory reform. I am currently Chairman of the IIABA Government Affairs Committee and was recently elected to IIABA's Executive Committee. I am also President of Clark Mortenson, a New Hampshire-based independent agency with 51 employees that offers a broad array of insurance products to consumers and commercial clients across the country.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a broad range of personal and commercial insurance products.

Introduction

From the beginning of the insurance business in this country, states have carried out the essential task of regulating the insurance marketplace to protect consumers. State insurance regulators have done an excellent job of ensuring that insurance consumers, both individuals and businesses, receive the insurance coverage they need. Unlike some federal regulators of other financial industries, state regulators also have done an excellent job in the area of financial and solvency regulation, which ensures that companies meet their obligations to consumers. However, some inefficiencies do exist in the state-based system and it has become clear that specific areas in the current insurance regulatory system should be reformed and modernized. When considering such limited and targeted reform, we must remember that during the recent turmoil in various sectors of the financial services industry, the insurance industry has remained healthy and stable. Unlike other financial services markets, there is no "crisis" in the insurance market that necessitates a risky, massive overhaul of the current regulatory system. Therefore, when considering any reform, we must recognize, and we ignore at the marketplace's peril, that the current system does have great strengths – particularly in the areas of consumer protection and solvency regulation.

IIABA supports state regulation of insurance and we oppose the imposition of a pervasive federal regulation scheme. Yet despite our historic and longstanding support of state regulation, we believe that Congress has a vital role to play in helping to modernize the state regulatory system and overcome the obstacles to reform that currently exist. Through targeted federal legislation in areas such as surplus lines and agent licensing, the state-based system can be streamlined and modernized without taking the drastic step of creating a new federal agency. Additionally, such a targeted approach would not risk seriously disrupting a stable insurance marketplace and displacing the components of state regulation that work well as could occur under proposals for "optional" federal regulation.

To explain the rationale for our support of targeted legislation to achieve insurance regulation reform and our opposition to federal regulation and its potential to unsettle the insurance market, I will first offer an overview of both the positive and negative elements of the current insurance regulatory system. I will then provide a more complete explanation of the approach that we believe offers the most appropriate vehicle to modernize and improve the state-based regulatory system, including a proposal to reform insurance agent licensing. I will then outline the reasons for our strong opposition to measures to create an "optional" federal charter for insurance.

The Current State of Insurance Regulation

The current state insurance regulatory framework began in 1851 when my home state of New Hampshire appointed the first insurance commissioner. Insurance regulators' responsibilities have grown in scope and complexity as the industry has evolved, and state regulatory personnel now number approximately thirteen thousand individuals. As recently as the 1999 Gramm-Leach-Bliley Act (GLBA), Congress reaffirmed its confidence in state insurance regulation. Specifically, Title III of GLBA unequivocally provides that "[t]he insurance activities of any person (including a national bank exercising its powers to act as agent . . .) shall be functionally regulated by the states," subject only to certain exceptions that are intended to prevent a state from thereby frustrating the affiliation policy adopted in GLBA. The GLBA provisions collectively ensure that state insurance regulators retain regulatory authority over all insurance activities, including those conducted by financial institutions and their insurance affiliates. These mandates are intended in large part to draw the appropriate boundaries among the financial regulators, boundaries that unfortunately continue to be challenged.

Benefit of State Regulation: Consumer Protection

Most observers agree that state regulation works effectively to protect consumers, largely because state officials are best-positioned to be responsive to the needs of the local marketplace and local consumers. Unlike most other financial products, which are highly commoditized, the purchaser of an insurance policy enters into a complex contractual relationship with a contingent promise of future performance. Therefore, the consumer will not be able to determine fully the value of the product purchased until after a claim is presented – when it is too late to decide that a different insurer or a different product might have been a better choice. When an insured event does occur, consumers often face many challenging issues and perplexing questions; as a result, they must have quick and efficient resolution of any problems. In these circumstances, a local telephone call to the state insurance regulator works better than a call to an 800 number at a federal call center.

Unlike banking and securities, insurance policies are inextricably bound to the separate legal systems of each state, and the policies themselves are contracts written and interpreted under the laws of each state. Consequently, the constitutions and statute books of every state are thick with language laying out the rights and responsibilities of insurers, agents, policyholders, and claimants. State courts have more than 100 years of experience interpreting and applying these state laws and judgments. The diversity of underlying state reparations laws, varying consumer needs from one region to another, and differing public expectations about the proper role of insurance regulation require local officials "on the beat."

Benefit of State Regulation: Solvency Regulation

Protecting policyholders against excessive insurer insolvency risk is one of the primary goals of state insurance regulation. If insurers do not remain solvent, they cannot meet their obligations to pay claims. State insurance regulation uniformly gets very high marks for the financial regulation of insurance underwriters. State regulators protect policyholders' interests by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. The states, through the National Association of Insurance Commissioners (NAIC), have developed an effective accreditation system for financial regulation that is built on the concept of domiciliary deference (the state where the insurer is domiciled takes the lead role). When insolvencies do occur, a state safety net is employed: the state guaranty fund system. Proposals such as an "optional" federal charter to separate solvency regulation and state guaranty fund protection are impracticable and would be detrimental for insurance consumers.

Targeted Insurance Regulatory Reform

While the existing system does have many benefits, at times it can be slow and inefficient with divergent laws and regulations in some areas that may add unnecessary expense. These criticisms are accurate, and there is a need for a common-sense solution. While IIABA does continue to strongly support the state system, we don't believe that the states will be able to resolve their problems on their own. We believe that focused congressional action is necessary to help reform the state regulatory system and that two overarching principles should guide any such efforts in this regard. First, Congress should attempt to fix only those components of the state system that are broken. Second, no actions should be taken that in any way jeopardize the protection of the insurance consumer, which is the fundamental objective of state insurance regulation and of paramount importance to IIABA and its members. IIABA believes that effective solvency regulation and a disciplined guaranty system that does not require the potential support of federal tax dollars are essential to such protection.

The best method for addressing the deficiencies in the current system is a pragmatic, middle-ground approach that utilizes targeted legislation or federal legislative "tools" to establish greater interstate consistency in key areas and to streamline the often redundant oversight that exists today at the state level. By using targeted and limited federal legislation on an as-needed basis to overcome the structural impediments to reform at the state level, we can improve rather than dismantle or grievously injure the current state-based system and in the process produce a more efficient and effective regulatory framework. Rather than employ a one-size-fits-all regulatory approach that could unsettle the market, this can be accomplished through enactment of legislation dealing with particular aspects of insurance regulation in most need of reform, where bipartisan consensus can be established. Such an approach would not jeopardize or undermine the knowledge, skills, and experience that state regulators have developed over decades.

While IIABA believes such a proposal or series of proposals must modernize those areas where existing requirements or procedures are outdated, it is important to ensure that this is done without displacing the components of the current system that work well. In this way, we can assure that insurance regulation will continue to be grounded on the proven expertise of state regulators at the local level and not subjected to the risky proposition of unproven federal insurance regulation. Targeted federal legislation addresses limited aspects of state insurance regulation only where uniformity and greater consistency is truly necessary and is the least intrusive option. Unlike other ideas, such as an "optional" federal charter, this approach does not threaten to remove a substantial portion of the insurance industry from state supervision.

Agent Licensing Reform

The most serious regulatory challenges facing insurance producers (agents and brokers) are the redundant, costly, and sometimes contradictory requirements that arise when seeking licenses on a multi-state basis, and the root cause of these problems is the failure of many states to issue licenses on a truly reciprocal basis. State law requires insurance agents and brokers to be licensed in every jurisdiction in which they conduct business, which forces most producers today to comply with varying and inconsistent standards and duplicative licensing processes. These requirements are costly, burdensome, and time consuming, and they hinder the ability of insurance agents and brokers to effectively address the needs of consumers. In fact, the current licensing system is so complex and confusing for our members that many are forced to retain expensive consultants or vendors in order to achieve compliance with the requirements of every state in which they operate.

Some observers of our industry mistakenly believe that most insurance agents operate only within the borders of the state in which they are physically located and that the problems associated with the current licensing system only affect the nation's largest insurance providers. The reality is that the marketplace has changed in recent decades, and the average independent insurance agency today operates in more than eight jurisdictions. There are certainly agencies that have elected to remain small and perhaps only service the needs of clients in one or two states, but that is no longer the norm. Our largest members operate in all 50 states, and it is increasingly common for small and mid-sized agencies to be licensed in 25-50 jurisdictions as well. For smaller businesses, which lack the staff and resources of larger competitors, the exorbitant cost and unnecessary complexity of licensing is especially burdensome.

Congress recognized the need to reform the industry's multi-state licensing system back in 1999, when it incorporated a National Association of Registered Agents and Brokers (NARAB) subtitle into GLBA. GLBA did not provide for the immediate establishment of NARAB and instead included a series of "act or else" provisions that encouraged the states to reinvent and simplify the licensing process. In order to forestall the creation of NARAB, at least a majority of states (interpreted to be 29 jurisdictions) were required to license nonresidents on a reciprocal basis. In short, GLBA required compliant states to accept the licensing process of a producer's home state as adequate and complete, and no additional paperwork or requirements would be required (no matter how trivial or important they may seem). The NAIC maintains that approximately 45 states have met the reciprocity standard established in the GLBA, but the suggestion that so many states license nonresidents on a truly reciprocal basis would come as a surprise to the real-world practitioners who must regularly comply with the extra hurdles and requirements imposed by states. Unfortunately, it has become apparent that true reciprocity remains elusive.

Our diverse membership of small and large agents and brokers hoped meaningful and tangible reform was imminent following GLBA's passage and the subsequent enactment of at least elements of the NAIC's Producer Licensing Model Act (PLMA) by most jurisdictions, but we are still awaiting the promised benefits almost nine years later. Although Congress's action did spur some activity and modest state-level improvements, insurance producers have been disappointed by the lack of meaningful progress that has been made over the last decade.

To rectify this problem, IIABA strongly supports federal legislation that would update and give full and immediate effect to the NARAB approach of GLBA. Such a measure would streamline nonresident insurance agent licensing but would be deferential to states' rights as day-to-day state insurance statutes and regulations, such as laws regarding consumer protection, would not be preempted. By employing the NARAB framework already passed by Congress and utilizing the experiences and insights obtained over recent years to modernize this concept, Congress can help policyholders by increasing marketplace competition and consumer choice through enabling insurance producers to more quickly and responsively serve the needs of consumers. Such reform would eliminate barriers faced by agents who operate in multiple states, establish licensing reciprocity, and create a one-stop facility for those producers who require nonresident licenses.

Federal legislation would establish NARAB as a private, non-profit entity that would be managed by an eleven-member board of directors comprised of state insurance regulators and private sector representatives. NARAB's simple and limited mission would be to serve as a portal or central clearinghouse for nonresident license issuance and renewal. A NARAB member agent would identify the state(s) in which he/she sought the authority to operate, and NARAB would collect and remit the state licensing fees back to the appropriate jurisdiction(s). States would be prohibited from denying a nonresident license to any NARAB member who correctly completed the process and paid the fees.

In order to join NARAB, an insurance producer would have to be licensed in good standing in his/her home state, undergo a criminal background check (long a priority of state insurance regulators but currently required by less than 14 states), and satisfy independent membership criteria established by NARAB, which would include standards for personal qualifications, training and experience. NARAB also would establish continuing education requirements comparable to the requirements of a majority of the states as a condition of membership, and the term of membership would be two years.

The NARAB Reform Act, which was introduced in the House earlier this year, incorporates these principles and accomplishes the goal of agency licensing reform. This legislation, H.R. 5611 or "NARAB II," has broad industry and bipartisan congressional support and recently passed the House Financial Services Capital Markets Subcommittee. The bill ensures that any agent or broker who elects to become a member of NARAB will enjoy the benefits of true licensing reciprocity. It only addresses marketplace entry and leaves regulatory authority and marketplace oversight in the hands of state officials. Additionally, the NARAB Reform Act does not affect resident licensing requirements or producers who are satisfied with the current system. Again and most importantly, it does not displace state regulation and oversight of producers and does not preempt state consumer protection laws, but instead achieves many of the public policy objectives that have been pursued by regulators. In recognition of this, the NAIC recently endorsed the NARAB Reform Act.

Surplus Lines Reform

IIABA also supports targeted legislation to apply single-state regulation and uniform standards to the nonadmitted (surplus lines) and reinsurance marketplaces. As with the admitted market, surplus lines agents and brokers engaging in transactions that involve multi-state risks currently must obtain and maintain general agent or broker licenses and surplus lines licenses in many if not every jurisdiction in which the exposures are located. Some states require that these agents and brokers obtain and maintain corporate licenses as well. This means that a surplus lines broker or agent could potentially be required to obtain and maintain up to 100 separate licenses in order to handle a single multi-state surplus lines transaction. Moreover, each state has different licensing requirements and renewal schedules. These duplicative licensing requirements cause administrative burdens which impede the ability of agents and brokers to effectively and efficiently service their customers' policies. Perhaps most importantly, these onerous licensing requirements create expenses which ultimately impact policyholders. The Nonadmitted Insurance and Reinsurance Reform Act alleviates the burdens of duplicative licensing requirements by relying on the insured's home state for licensing and encouraging states to participate in a national insurance producer database without diminishing the quality and expertise of the surplus lines insurance distribution channel.

Other Potential Targeted Reform Measures

An additional area ripe for targeted reform is the product approval process. For life products, federal legislation could build upon the progress made by the Interstate Insurance Product Regulation Commission (which now includes more than 30 jurisdictions) in the approval of life, disability, and long-term care products. For property/casualty products, targeted legislation could facilitate the establishment of a coordinated electronic system for nationwide single point of filing, common filing nomenclature to reduce unnecessary forms filings and deviations, eliminate all unpublished desk-drawer rules, and expedite review of forms through established and enforceable time deadlines. We also welcome targeted measures to establish a federal knowledge base with a role in international insurance matters, but without regulatory power, to help solve any purported global competitiveness concerns.

"Optional" Federal Charter

I would be remiss if I did not discuss briefly our strong opposition to another suggested method to achieve insurance regulatory reform – the proposal to create a parallel and duplicative federal system of regulation by providing for an "optional" federal charter (OFC) for insurance. We are very concerned about this proposal for full-blown "optional" federal regulation of the insurance industry and believe that it would not reform the current system but would supplant and eviscerate the state system of insurance regulation. We also fear that such an approach has the potential to negatively impact an industry that has been relatively unaffected by the recent crisis afflicting financial markets that are federally regulated.

Creating an industry-friendly "optional" regulator, as current OFC legislation provides, is at odds with one of the primary goals of insurance regulation, which is consumer protection. The best characteristics of the current state system from the consumer perspective would be lost if some insurers were able to escape state regulation completely in favor of wholesale federal regulation. As insurance agents and brokers, we serve on the front lines and deal with our customers on a face-to-face basis. Currently, when my customers are having difficulties with claims or policies, it is very easy for me to contact a local official within the state insurance department to remedy any problems. If insurance regulation is shifted to the federal government, I would not be as effective in protecting my customers. I am very concerned that some federal bureaucrat will not be as responsive to a consumer's needs as the local cop on the beat – that is, the state insurance regulator.

This is because the federal regulatory model proposes to charge a distant federal regulator with implementation and enforcement. Such a distant federal regulator will be poorly positioned to respond to insurance consumer claims and concerns. As a consumer, personal or business, there would be confusion as to who regulates policies, the federal government or the state insurance commissioner, and how coverages apply. I could have a single client with several policies with one company regulated at the federal level, while at the same time having several other policies which are regulated at the state level. As an agent representing clients with policies regulated at the federal and state level, though, I would be forced into the federal system, even if I wanted to remain licensed only in my home state.

Even though it is commonly known as "optional," current federal legislative proposals to allow for such a federal insurance charter would not be at all optional for agents. Independent agents represent multiple companies, and, under this proposal, presumably some insurers would choose state regulation and others would choose federal regulation. In order to field questions and properly represent consumers, independent agents would have to know how to navigate both state and federal systems, therefore making them subject to the federal regulation of insurance – meaning OFC would not in any way be optional for insurance producers. Even more importantly, "optional" federal charter would not be optional for insurance consumers. The insurance company, not the insurance consumer, would make that determination.

Again, IIABA believes that local insurance regulation works better for consumers and the state-based system ensures a level of responsiveness to consumers that could not be matched at the federal level. We are also concerned that OFC could create an environment in which the state system could not survive. OFC supporters believe that this proposal would create a healthy regulatory competition that will force state regulators to cooperate and be more receptive of the role of market forces. However, when state resources are siphoned off by a new federal bureaucracy, state insurance departments could be prevented from functioning at their current capacity and the ability of state insurance departments to function and approve products in a timely manner could be diminished. Thus, companies who continue to operate under the current system might be forced to become federally chartered. Additionally, much of state insurance fees and taxes are important sources of general use revenues used for state treasuries to fund various state proposals. In 2006, state governments received almost $2.75 billion from non-premium tax revenues (e.g. fees and assessments) and $13 billion in premium taxes. Current legislative proposals would fund a new federal regulator from industry fees and assessments, so examination and other fees for federally-regulated entities will certainly shift from state to federal coffers resulting in a significant loss of state revenue. There is no doubt that state revenue will decrease. We also believe that eventually a significant portion of state premium tax revenue will be lost to the federal government.

OFC supporters like to point to the dual banking system as an example of how regulatory competition could work, but this is an analogy that should raise many concerns. Primarily, there are fundamental differences between banking and insurance. The banking industry has no distribution force like the insurance industry, nothing similar to the claims process exists in the banking industry, and unlike many insurance products, banking products are commoditized and national in scope. Additionally, as we have seen in recent years with the Office of the Comptroller of the Currency's (OCC) forceful assertion of preemption, federal regulatory schemes can do grave harm to state consumer protection regulations. The recent crisis in certain sectors of the financial services industry also has shown us that federal regulation is not a panacea for market ills.

Current OFC proposals also would create a confusing patchwork of solvency/guaranty regulation, and would not replicate the significant structural (and prudential) improvements that were made in the banking model in the aftermath of the S&L failures and the banking crisis of the 1980s and 1990s, where the federal government had to bail out these struggling financial services markets. The dual structure proposed under current OFC measures could have disastrous implications for solvency regulation by largely bifurcating this key regulatory function from guaranty fund protection. OFC not only would hamstring the state system and not allow for time-tested and proven state financial regulation of insurers, but it also would require that the state system pay for any insurer insolvencies. In other words, the state system could not keep insurers from going insolvent on the front end, but would be required to backstop failed insurers on the back end. With the recent failures in federal financial oversight, this is a tremendous risk to take. In essence, these proposals would create an insurance version of the OCC without the integration of an FDIC into that supervisory system. Such proposals cherry-pick the features from several of these federal banking laws to come up with a model which lacks the consumer protections found in any one of them, and which ignores the problems it would create for state insurers, guaranty funds, and their citizens.

Proponents of OFC assert that a federal regulator also is important if the U.S. is to remain a global financial services leader, in that an OFC would allow insurers to compete more freely and effectively. IIABA believes that any decline of U.S. capital markets competitiveness for insurance companies is due less to state-based regulation and more from other U.S. competitiveness concerns such as disparate tax treatment, diverse financial reporting standards, and the costs of excessive litigation. However, targeted proposals to provide for a federal base of insurance knowledge with authority on international matters and without regulatory power would allow these purported problems to be addressed without creating a new federal regulator.

In the end, IIABA feels that an OFC would disrupt the insurance market to the detriment of consumers while leading to a needless federal bureaucracy and unnecessarily infringing on states' rights. Unlike GLBA, which effectively empowers the states through uniform regulatory standards, an OFC weakens the states through the use of regulatory arbitrage. IIABA therefore believes that the risks of an OFC substantially outweigh any alleged benefits.

Conclusion

IIABA has long been a supporter of reforming the insurance marketplace. While GLBA reaffirmed state functional regulation of insurance, some continue to push for an "optional" federal charter. State regulators and legislators, many consumer groups, independent insurance agents and brokers, some life insurance companies, and many property-casualty companies are strongly opposed to federal regulation. The state system has proven that it best protects consumers and can be modernized to work effectively and efficiently for the entire insurance marketplace with the right legislative pressure from Congress.

Targeted, federal legislation to improve the state-based system presents Members of Congress with a pragmatic, middle-ground solution that is achievable – something we can all work on together. The enactment of targeted federal legislation to address certain, clearly identified problems with state regulation is not a radical concept. We encourage the Senate Banking Committee to consider targeted reform, specifically in the area of agent licensing reciprocity. It is the only approach that can bring the marketplace together to achieve reform.

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STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

BEFORE

UNITED STATES SENATE
COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

July 29, 2008

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.

I am pleased to appear before you today to provide the reinsurance industry's perspective on the need for insurance regulatory reform. I commend Chairman Dodd and Senator Shelby for calling this important hearing and welcome the opportunity to address the Committee about why the current state system for regulating the reinsurance marketplace is in need of reform, particularly in those areas that affect the ability of US reinsurers to compete in the global marketplace and for needed reinsurance capacity. My testimony will highlight how US and foreign reinsurers doing business in the United States are regulated; why the current state-based insurance regulatory system does not work well for the sophisticated global marketplace; and explain the RAA's position in support of an optional federal charter for the reinsurance industry, or alternatively, federal legislation that streamlines the current state-based 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. Reinsurers have assisted in the recovery from every major US catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11 were absorbed by the global reinsurance industry and 61% of the 2005 hurricanes Katrina, Rita and Wilma were ultimately borne by reinsurers.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential to providing the much needed capacity in the US for both property and casualty risks. This can be best illustrated by the number of reinsurers assuming risk from US ceding insurers. In 2007, more than 2,500 foreign reinsurers assumed business from US ceding insurers. Those 2,500 reinsurers were domiciled in more than 70 foreign jurisdictions.[1] Although the majority of US premiums ceded offshore is assumed by reinsurers domiciled in a dozen countries, the entire market is required to bring much needed capital and capacity to support the extraordinary risk exposure in the US and to spread the risk throughout the world's financial markets. Foreign reinsurers now account for 56% of the US premium ceded directly to unaffiliated reinsurers; a figure that has grown steadily from 38% in 1997.

b. US Reinsurance Regulation – Direct and Indirect

Reinsurance and US reinsurers are currently regulated on a multi-state basis, a system which is cumbersome and inefficient for a global marketplace. Complying with varying regulatory laws in fifty states makes compliance unnecessarily burdensome and expensive for this global business. While the current state-based insurance regulatory system is primarily focused on regulating market conduct, contract terms, rates and consumer protection, reinsurance

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market 2007 Data (2008).

regulation focuses on ensuring the reinsurer's financial solvency so that it can meet its obligations to its ceding insurers.

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 for 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 that a primary insurer is subjected to.

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.

For several reasons, including the cumbersome nature of a multi-state licensing system, capital providers to the reinsurance market have in recent years opted for establishing a platform outside the US and conducting business through a US subsidiary or by providing financial security through a trust or with collateral. Following the 1992 hurricane season, eight new reinsurers were formed with $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 this new capital came from US capital markets yet no new reinsurer was formed in the United States. Other than the US subsidiaries of some of these new companies, no new US-domiciled reinsurer has been formed since 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-US jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in multiple US states.

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

The RAA 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-based framework for reinsurance regulation, which has led the RAA to advocate a federal role.

a. A Need for a Single Federal Voice for the Global Reinsurance Industry

The recent US Treasury's Blueprint for Financial Regulatory Reform ("the Treasury Blueprint") noted that the US state-based insurance regulatory system creates increasing tensions in this global marketplace, both in the ability of US-based firms to compete abroad and in the allowance of greater participation of foreign firms in the US market. Foreign government officials have continued to raise issues associated with dealing with 50 different US insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies.

"The Treasury Blueprint" also noted that while the NAIC attempts to facilitate communication among the states on international regulatory issues, it is not a regulator. "The Blueprint" further noted that because of the NAIC's status as a non-governmental coordinating body and the inherent patchwork nature of the state-based system, it will be increasingly more difficult for the US to speak effectively with one voice on international regulatory issues.

This lack of a single voice is already adversely impacting US reinsurers. "The Treasury Blueprint" points out that the interaction between the US and its foreign counterparts on issues like the European Union's Solvency II will likely impact not only the ability of US companies to conduct business abroad, but also the flow of capital to the US. For US reinsurers, Solvency II will set forth a process for determining which countries are "equivalent" for purposes of doing business in the European Union. Although this issue is still being discussed, it is our understanding that the European Parliament recently obtained a legal opinion that stated that the European Commission cannot grant equivalence to a US state under Solvency II. The possibility that the entire 50-state system in the US will be deemed "equivalent" appears questionable. Thus, without federal involvement by a knowledgeable entity tasked with responsibility for international policy issues, the US reinsurance industry will continue to be disadvantaged in these equivalence discussions.

An informed federal voice with the authority to establish federal policy on international issues is critical not only to US reinsurers, which do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the US marketplace. The fragmented US regulatory system is an anomaly in the global insurance regulatory world. As the rest of the world continues to work towards global regulatory harmonization and international standards, the US is disadvantaged by the lack of a federal entity with authority to make decisions for the country and to negotiate international insurance agreements or federally enabling legislation which empowers a single state regulator to do so.

b. Mutual Recognition

US states impose a highly structured and conservative level of regulation on licensed reinsurers. However, it has long been recognized that the level of reinsurance regulation varies substantially throughout the world.

While some countries impose what has been characterized as "equal or nearly equal treatment" of "professional" reinsurers[2] and direct insurers,[3] other countries employ a "reduced regime" of direct supervision.[4] And still others combine some elements of direct supervision with indirect supervision.[5] There are several globally recognized methods of conducting reinsurance regulation.[6]

The RAA is encouraged by the inclusion of a system of mutual recognition among countries in S. 40 (The National Insurance Act of 2008). 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

[2] The term "professional reinsurers" is used here only for clarity. It is not typically used in the U.S.
[3] Denmark, United Kingdom, Finland and Portugal.
[4] Id. Austria, Italy, Spain and Sweden.
[5] See id. Germany, France and the Netherlands.
[6] Id.

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 federal statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of trust and confidence with 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.

c. **Credit for Reinsurance**

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[7] on the NAIC model law and regulation governing credit for reinsurance.[8]

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 increasingly global. US primary insurers have generally 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

[7] There are significant deviations among the states, particularly in the area of extra-territorial application of state laws as discussed below.
[8] 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).

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. Currently, 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 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 S.40 (The National Insurance Act of 2008) for proposing an optional federal charter for insurers. In large part, this will address the RAA's concerns over uniformity of applicable law. We are also encouraged by the ongoing efforts of the NAIC to develop a framework for reinsurance regulation which seeks to streamline regulation through a national system for US reinsurers, a port of entry for non-US reinsurers and a system of trans-border regulatory recognition. We have encouraged the NAIC to seek federal legislation to achieve this system.

d. 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. Multi-state systems add extra costs to transactions, and these are ultimately reflected in the premiums paid by consumers. 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; yet, this has not prevented some 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, an insurer domiciled in a state other than New York, but licensed in New York, 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 allow US reinsurers 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. We applaud the sponsors of S.929 (The Non-Admitted and Reinsurance Reform Act of 2007) for proposing legislation that will eliminate the extraterritorial application of laws.

III. GOALS OF EFFECTIVE REINSURANCE REGULATION AND CORE CHARACTERISTICS OF A REINSURANCE REGULATORY REGIME

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.

Technologies, global events and 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 currently provided for 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 to achieve these goals and core characteristics, include but are not limited to: (1) 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 (2) 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; and (3) federal legislation that streamlines the current state system. The RAA has a strong preference for a modified optional federal charter.

At its December 2007 meeting, the National Association of Insurance Commissioners embraced change along the lines the RAA proposes. The NAIC's Reinsurance Task Force acknowledged that "in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the US is warranted." The new framework being developed would "facilitate cross-border transactions and enhance competition within the US market, while ensuring the US insurers and policyholders are adequately protected." The Reinsurance Task Force proposes to modernize the US reinsurance regulatory system through a system of regulatory recognition of foreign jurisdictions, a single state regulator for US licensed reinsurers, and a port of entry state for non-US based reinsurers. Concerned with the challenges of implementing changes in all 50 states and questions of constitutional authority for state action on matters of international trade, the RAA has encouraged the NAIC to embrace federal legislation to accomplish their proposed framework.

The RAA thanks Chairman Dodd and Ranking Member Shelby for this opportunity to comment on reinsurance regulation, and we look forward to working with all members of the Committee as it considers this most important issue.

United States House of Representatives

Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:

Franklin W. Nutter
President

2. Organization or organizations you are representing:

Reinsurance Association of America

3. Business Address and telephone number:

1301 Pennsylvania Avenue, NW
Suite 900
Washington, DC 20004-1701

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2005 related to the subject on which you have been invited to testify?

☐ Yes ☒ No

5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2005 related to the subject on which you have been invited to testify?

☐ Yes ☒ No

6. If you answered "yes" to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.

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Richard M. Bouhan
Executive Director

Testimony Of
The National Association Of Professional Surplus Lines Offices

Before The
Senate Committee On Banking, Housing And Urban Affairs

Regarding The
State Of The Insurance Industry: Examining
The Current Regulatory And Oversight Structure

July 29, 2008
Washington, D.C.

TESTIMONY OF
THE NATIONAL ASSOCIATION OF PROFESSIONAL SURPLUS LINES OFFICES
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
REGARDING THE "STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE"

July 29, 2008

Chairman Dodd, Ranking Member Shelby and Members of the Committee, my name is Richard Bouhan and I am Executive Director of the National Association of Professional Surplus Lines Offices (NAPSLO). I am pleased to be before you today to offer testimony on the state of the insurance industry with focus on its current regulatory structure and oversight. My particular emphasis will be on the regulatory structure and oversight of the "surplus lines" industry or non-admitted market which NAPSLO represents.

NAPSLO is the national trade association representing the surplus lines industry and the wholesale insurance marketing system. NAPSLO is unique in that both surplus lines brokers and surplus lines companies are full members of the association; thus NAPSLO represents and speaks for the surplus lines wholesale marketplace.

Founded in 1974, NAPSLO is an informed and knowledgeable voice about the surplus lines market and the vital role it plays for consumers. NAPSLO has over 800 broker/agent/producer and insurer members with 1,100 offices representing 10,000 to 15,000 individual brokers, agents, company professionals, underwriters and other industry professionals in all fifty states and the District of Columbia.

NAPSLO commends the Committee under leadership of Chairman Dodd for holding this hearing and examining the state of the regulatory structure and oversight of the insurance industry. Insurance is an essential component to a modern economy. It protects assets, it protects savings and it compensates individuals and business when unforeseen events take a financial toll. The product the insurance industry offers is simple --- it is a "promise to pay." In order to assure that promise is kept by the insurer and that the promise is made to the consumer in a fair and proper manner, insurance has become one the most heavily regulated businesses in the country. But the regulatory structure and process must be efficient and effective and promote, not hinder or prevent, the purchase of the protection insurance offers.

Unfortunately, our current system is neither efficient nor effective. Indeed, as I will explain, today's regulatory system is out of touch with the realities of an increasingly complex, sophisticated, and multi-jurisdictional insurance marketplace. Reform – practical solutions that fix real marketplace problems – is critical for the long-term health of our industry.

Though my colleagues today may discuss a number of legislative option to reform the insurance market, only one bill has the support of the entire insurance industry – the Nonadmitted and Reinsurance Reform Act (NRRA). In support of this legislation, NAPSLO has helped lead the Surplus Lines and Reinsurance Coalition which includes virtually every major insurance company and trade association including the Risk Insurance Management Society (RIMS). Indeed, even the National Association of Insurance Commissioners has taken a positive position on Title I of the Nonadmitted and reinsurance Reform Act. NAPSLO appreciates the leadership of NAIC Chairwoman Sandy Praeger of Kansas, Commissioner Jim Donelan of Louisiana (chairman of the NAIC's Surplus Lines Task Force), and Illinois Insurance Director Michael McRaith on this important reform for our industry.

Already passed by the House, the NRRA is a legislative solution that can provide immediate relief to an industry burdened by a regulatory inefficiencies. NAPSLO commends Senators Mel Martinez and Bill Nelson of Florida for introducing the NRRA in this chamber and Senator Jack Reed for his support of the bill. NAPSLO encourages the Senate to pass S.929 in recognition of the marketplace need and the industry-wide support for this reform legislation. Before digging into the details of why this reform is so critical today, some background on surplus lines insurance may be helpful.

Background on Surplus Lines Insurance

Surplus lines is a key component of this nation's insurance marketplace. However, surplus lines is not a *type* of insurance such as liability or property or homeowners or automobile insurance. And while found primarily in the commercial arena, surplus lines is not one specific *line* of insurance such as commercial lines or personal lines. Rather, surplus lines is a special *marketplace* in which virtually all lines and types of insurance are available, and it is defined by the regulatory rules and structure that govern access to the marketplace and how the transactions in the marketplace occur.

The surplus lines market is important and vital to the insurance buying public. Surplus lines essentially cover many types of risk which a standard insurer does not focus upon. In theory, surplus lines fills in the gaps when standard insurance is not easily available. When the admitted market withdraws coverage for a certain risk, the surplus lines market steps in and provides coverage. Surplus lines insurance is often referred to as the "safety valve" of the insurance industry because it expands the market by ensuring consumer access to insurance. In this way, surplus lines helps balance out the ebb and flow of the admitted insurance market. Examples of situations in which surplus lines might provide insurance coverage include:

an entrepreneur trying to bring a product to market;

a manufacturing concern looking to insure your product line for products liability;

a drug company wanting coverage for a new and innovative drug;

a financial institution in need of directors and officers liability;

a professional –a doctor or lawyer—in a "high risk" specialty in need of professional liability insurance;

a residential or commercial contractor building a new structure;

the director of a political campaign trying to secure coverage for the campaign;

a municipality, hospital or airport;

a home or commercial property owner in a hurricane or earthquake prone area;

an automobile owner with a "classic" or high performance vehicle.

Further examples include the industry's response to 9/11 and Hurricane Katrina.

There is no one in this room that is not, in some way, impacted by the surplus lines or non-admitted insurance market.

Size and Growth of the Surplus Lines Market

Surplus lines or non-admitted insurance is a significant segment of the property/ casualty insurance industry. Its $40 billion annual premium represents, according to AM Best's most recent report on the industry, nearly fifteen percent of the commercial insurance marketplace.[1]

The surplus lines market has grown dramatically in past few years. In the ten year period from 1996 to 2006, the surplus lines premium grew, again according to AM Best, from $9.2 billion to just under $40 billion., a better than four fold increase.[2] As a percentage of the commercial insurance market, surplus lines has expanded from 6.3 percent to just under 15 percent in that time period.[3] (Surplus lines primarily fill needs for commercial clients, although there are a few instances, such as storm coverage on coastal areas, in which individual consumers may use surplus line coverage.)

The reasons the surplus lines industry has grown so significantly in recent years reflect the growth in our economy and its increasing complexity. As the nation's economy has evolved from one based on large manufacturing and industrial enterprises to an economy that is more diverse with the mix of service, high-tech, financial and construction businesses, many of which are entrepreneurial in nature, there has been more need for a flexible insurance marketplace that can adapt insurance coverage to the needs

[1] *2007 U.S. Surplus Lines Review (Special Report)*, AM Best Company, Oldwich, N.J., Oct. 1, 2007, p. 5
[2] Op. Cit., p. 4
[3] Op. Cit., p. 4

of a changing economy and can analyze effectively the growing number of new and unique risks.

The surplus lines market, with its freedom of rate and form, is that market and has expanded to meet the needs of our nation's changing economy. As the nation's economy continues to expand and change, NAPSLO sees a continuing need for the surplus lines market to meet these challenges of providing coverage for a more complex and dynamic economy.

As the surplus lines industry has expanded over the past decade and the risks it insures have become more complex, the interstate nature of the surplus lines business has also expanded. Currently, around one third of the policies written in the surplus lines market have multi-state exposures. Given the current regulatory structure, under which surplus lines works in the states, the compliance with the various state tax and surplus lines regulations is problematic and virtually impossible.

Surplus Lines Regulatory Structure

Surplus line brokers are generally comfortable with the state-based system of insurance regulation. There are, however, two specific contexts, premium taxation and broker licensing, in which the states have been unsuccessful and unwilling to coordinate, despite the direction to do so given by Congress in the Gramm Leach Bliley Act. In those specific areas, Congressional attention is welcome by the surplus lines industry. To understand the difficulty surplus lines brokers have in complying with regulatory requirements on multi-state surplus lines risks, a description of the surplus lines regulatory structure is necessary.

In contrast to how the standard, admitted or licensed market where the "licensed insurance company" is subject to the state's jurisdiction, its insurance laws and regulations), the regulated entity in a surplus lines transaction is the specially licensed "surplus lines" broker. The insurance company is typically neither licensed nor does it have a presence in the state. It is "non admitted."

As the "regulated entity," the licensed surplus lines broker is responsible for compliance with all state laws including qualifying the risk as eligible for surplus lines placement through: 1) assuring that a "diligent search" for an admitted carrier is properly conducted and processed, 2) assuring that the non-admitted company with which the insurance is placed or procured is an "eligible" surplus lines insurer, 3) providing the insured with the proper statutory notice that the insurance is placed with a surplus lines insurer, 4) filing an affidavit or report of the transaction with the state insurance department and 5) remitting surplus lines premium tax on the transaction to the tax authorities of the state.

Premium Tax Allocation and Remittance Problems

This latter responsibility continues to be a difficult and problematic responsibility for the broker. The difficulty is that the states have inconsistent and often conflicting laws regarding the allocation and remittance of surplus lines premium tax monies. As an example, while forty-eight states require the broker placing a multi-state risk to allocate the premium based on the exposure in the state and pay the tax on the allocated premium to the state, a few states impose the tax on the entire premium irrespective of the fact the some exposures may be located in another jurisdiction. This conflict can cause a portion of a premium to suffer double taxation.

A more significant problem is that there are no standard and accepted allocation formulas among the states for brokers to use to assure that the calculation of tax due each of the states is proper and accurate. On a particular risk, one state may use a formula based on "square footage" and another state may use "gross receipts." Another state may use a third formula such as "number of employees." A surplus lines broker placing business under his or her license in State A, with exposures in states A, B and C, is faced with a dilemma of which state's formula to use for calculating the tax due in each state when the formulas differ, which is quite often.

As a consequence of this confusion, the allocation and remittance of surplus lines premium tax, which is the surplus lines broker's responsibility on multi-state risks, is replete with confusion and acrimony between states and the brokers as to whether the correct amount of tax has been paid. Since the tax is collected in most cases from the insured, the insured on occasion gets caught in these disputes.

The brokers and insureds are not the only ones that are ensnared in these tax battles. The surplus companies who are not subject to the tax are looked to as source of data in order reconcile the broker filings. As a condition of eligibility, surplus lines companies are often required to provide detailed premium information to the states regarding surplus lines exposures written by that company in their state.

The problem with this "reconciliation" of broker filings with company premium data is that without any standard or universal rules or accepted allocation formulas among the states as to how exposures are to be allocated for surplus lines premium tax purposes, the reconciliation effort is the classic comparison of "apples and oranges" and is a useless exercise. Without an accepted and universal system of premium allocation and tax remittance there is no way to determine how much each state is truly owed in surplus lines tax on multi-state risks. If such a system were developed, brokers would be able to determine the proper amount of tax due and there would be no need to involve the non-admitted surplus lines companies in the process.

On occasion, states insist that the surplus lines companies make-up any shortfalls in tax monies the states believe were not remitted to them by the brokers. Out of fear of losing their surplus lines eligibility, these companies often comply with these requests.

Simply stated, the premium allocation and tax remittance system for surplus lines premium tax for multi-state risks is dysfunctional and chaotic. This chaos and the constant battles it creates produces inefficiencies which increase transactional costs and make the surplus lines market difficult to use, particularly for multi-state risks.

Over the last two decades numerous efforts to alleviate these problems and create a rational, transparent and auditable system for tax remittance to the states for surplus lines taxes have failed. The states are just not capable of coming together to create a universal system of tax allocation and remittance for surplus lines that they all can accept. NAPSLO has concluded that only solution is federal legislation that creates a rational system among the states for the proper and fair allocation of surplus lines tax revenues. NAPSLO believes that this system should allow the surplus lines brokers pay all premium tax due on a multi-state surplus lines transaction to one state and direct the states to allocate this tax revenue, among themselves, based upon an accepted formula.

In unanimously passing the Nonadmitted and Reinsurance Reform Act in 2006 and again by voice vote in 2007, the House agreed that federal legislation for reform is needed. NAPSLO hopes that the Senate will also take action and pass S.929.

Multi-State Compliance Problems

In 1999 Congress enacted the Gramm-Leach-Bliley Act.[4] This law dramatically changed the landscape for surplus lines in that it ultimately made non-resident surplus lines licenses available in all states. Prior to the passage of Gramm-Leach-Bliley only six states offered non-resident surplus lines licenses and in half of them, the availability of such licenses was limited to licensed resident surplus lines brokers in contiguous states.

One of the goals of Gramm-Leach-Bliley was to create, among the states, either a uniform or reciprocal system of non-resident licensing for virtually all classes of insurance producer licenses including surplus lines licenses.[5] If such a system was not

[4] Public Law 106-102
[5] Public Law 106-102, Subtitle C, Section 321

created within three years, Congress directed that a separate agency entitled the National Association of Registered Agents and Brokers (NARAB) would be established to facilitate the acquisition of such licenses for the insurance producer community.[6] The states elected, through the National Association of Insurance Commissioners (NAIC), to create a reciprocal system of non-resident licensing for insurance producer licenses including surplus lines licenses.

For a reciprocal system of non-resident licensing to meet Gramm-Leach-Bliley muster and prevent the creation of NARAB, Congress required that the NAIC certify that at least twenty-nine jurisdictions had established, within three years, reciprocal non-resident licensing laws meeting the Gramm-Leach-Bliley requirements. The NAIC made such a certification and in August 2002 announced that as many as thirty-five states had meet the Gramm-Leach-Bliley requirements for reciprocal non-resident producer licensing.[7]

Unfortunately, one of the unintended effects the enactment of non-resident surplus lines licensing laws in all the states, which Gramm-Leach-Bliley fostered, has been to exacerbate the problems surplus lines brokers have in placing multi-state surplus lines risks. Moreover, the promise that Gramm-Leach-Bliley held for surplus lines insurance producers to acquire non-resident surplus lines licenses on a simple and efficient reciprocal basis has not been realized.

[6] Ibid

[7] "Its Official: States Hit Reciprocity goal," *National Underwriter Online News Service*, Aug. 12, 2002

Prior to the advent of non-resident surplus lines licenses in every state, surplus lines brokers would place multi-state risks through their resident surplus lines license and comply with the surplus lines laws of their resident state. The insurance of exposures in the other states were seen as ancillary to the transaction in the resident state or viewed as an "independent procurement" transaction where the insured purchased the coverage independent of the laws of the state where the exposure or risk is located.

While this structure for surplus lines regulation has some difficulties for surplus lines brokers in making surplus lines placements with risk exposures in multiple states, surplus lines brokers only had to comply with the surplus lines laws of one state in procuring the insurance. However, with non-resident surplus lines licenses available in all states, the states now are requiring that the broker not only be licensed in each state where an exposure exists, but also comply fully with each state's surplus lines law. Thus, brokers procuring surplus lines insurance having multi-state exposures must comply with multiple and duplicative surplus lines placement requirements in all states in which an exposure exists.

To illustrate this point, consider a surplus lines broker whose insured is a contractor operating in five different states. Such a placement of surplus lines insurance requires the surplus lines broker to comply with all of the elements of five separate state surplus lines laws. This means that the broker must comply with five different "diligent search" requirements; five different affidavit or regulatory reporting requirements; five surplus lines informational consumer notice requirements, each with different statutory language saying essentially the same thing; five different sets of policy record storage requirements and five different tax filing reports and procedures. In addition, the surplus lines broker has to assure that the insurance company is an eligible surplus lines insurer in each of the five states under five different sets of eligibility standards as well as having to hold (and maintain) at least ten licenses (a general agents or brokers license and a surplus lines license in each state).

All of this is for a single surplus lines policy placement in five states. If the surplus lines broker has a national or nationwide account with exposure in all fifty states the problems, costs and inefficiencies of multiple state compliance must be multiplied five fold.

NAPSLO recognizes the need for oversight and regulatory compliance for surplus lines placements. It is the regulatory structure that defines surplus lines. But, the cost and inefficiency created by multiple compliance requirements when placing a multi-state surplus lines risk, we believe, is unnecessary and NAPSLO sees no consumer benefit by perpetuating such a costly, burdensome and overlapping system of multiple state compliance.

Unfortunately, history has shown that the states are unable to harmonize and create, among themselves, an efficient regulatory system for these multi-state surplus lines risks. Consequently, NAPSLO believes that the best answer to this problem lies in federal legislation. Such legislation would direct that on surplus lines risks, one state, the "home state" of the insured, be designated as the one state to control and regulate the placement surplus lines insurance. NAPSLO believes that regulation of surplus lines placements should be the responsibility of one state and that the "home state" of the insured would have the strongest nexus to assert regulatory authority on behalf of the insured. The NRRA as passed by the House and as introduced by introduced by Senators Mel Martinez and Bill Nelson of Florida in this chamber does just that, thereby creating a sensible, efficient regulatory system for multi-state surplus lines risks.

Surplus Lines Licensing Issues

In setting forth the standards for an acceptable reciprocal non-resident insurance producer licensing system for the states, Congress, in Gramm-Leach-Bliley, set forth four, and only four, requirements that a state could impose on a non-resident applicant. These requirements are that the non-resident license applicant submit: 1) a completed application for licensure with the state; 2) a copy of the applicant's original application for licensing filed in the producer's home State; 3) proof the producer is licensed in good standing in his or her home State, and 4) payment of any required fees.[8] The expectation was that once a licensee applicant submitted and fulfilled these requirements, the requested non-resident license would be expeditiously issued.

As the era of non-resident surplus lines broker licenses has progressed, NAPSLO broker members report that the non-resident licensing process between states the NAIC has certified as "reciprocal" is much more difficult than expected, often with lengthy licensure application forms and detailed "backup" material being required as well as long delays in the issuing of the non-resident license. However, what is more problematic for

[8] Public Law 106-102; Subtitle C- Subsections C (1) (A-D)

surplus lines brokers seeking non-resident licenses in reciprocal states is that each state requires the non-resident applicant to have (and maintain) a non-resident agent or broker license as a condition of issuing a non-resident surplus lines license.

The requirement that an applicant for a reciprocal non-resident surplus lines license must have a non-resident agent or broker license as pre-requisite for the issuance of the non-resident surplus lines license, NAPSLO believes violates the requirements in Gramm-Leach-Bliley for reciprocity. NAPSLO sees nothing in the four requirements for reciprocal licensing that gives a state authority to demand an applicant have a non-resident agent or brokers licensing as a pre-condition to securing a non-resident surplus lines license.

To our knowledge every state certified by the NAIC as reciprocal requires a non-resident agent or broker license as a precondition to issuing a non-resident surplus lines license. To the extent non-resident agent and broker licenses are required by a reciprocal state before a non-resident surplus lines license is issued, the NAIC's certification that the state is reciprocal is incorrect. We urge Congress to take action to assure that the promise in Gramm-Leach-Bliley of the establishment of an efficient reciprocal licensing system for insurance producers is truly fulfilled.

Better Access to the Surplus Lines Market for Large, "Sophisticated" Commercial Buyers

The surplus lines marketplace offers consumers a marketplace where their difficult insurance requirements can be addressed in a flexible and innovative manner.

However, before it can enter surplus lines market, the risk must pass over a regulatory hurdle of being rejected by the "admitted market." This process is known as a "diligent search" and this regulatory requirement is generally considered fulfilled if three admitted / licensed insurers reject the risk for coverage. The obvious purposes of this requirement is to not only protect the licensed market, but also assure that the buyer, even a large commercial buyer, is not insured by a surplus lines carrier unless there is failure of the licensed market to accept the risk for coverage.

Sixteen states have modified their "diligent search" requirement by creating an "export list" process whereby the state insurance commissioner places certain coverages or identifies certain risks for which there is no available admitted insurance company or admitted market in the state writing the coverage. These coverages or risks are placed on the "export list" and can be insured directly in the surplus lines market, by a licensed surplus lines broker, without a "diligent search."

While this is helpful for situations where the admitted market is demonstrably unable or unwilling to provide coverage, the "diligent search" requirement creates a significant impediment for the "sophisticated" commercial insurer and its broker representative, with knowledge and resources of insurance coverages and markets, to quickly and efficiently enter the surplus lines market and take advantage of the market's flexibility and innovation. In fact, it may eliminate that buyer's ability to enter the surplus lines market altogether.

NAPSLO believes that insurance marketplace and insurance availability would be enhanced if the "diligent search" requirement or barrier would be eliminated for the larger, "sophisticated" commercial buyers so that they or their broker representatives can access and use the surplus lines market on the same basis as the admitted market. Having immediate and unfettered access to both the admitted and surplus lines market would enhance these larger, "sophisticated" buyers' access to insurance markets and provide them with more options for their difficult to insure insurance risks. To note, NAPLSO supports revising the S.929 definition of "sophisticated commercial purchaser" to be consistent with the language passed by the House in 2007. Any federal reform of the insurance regulatory structure, NAPSLO believes should include the elimination of the "diligent search" requirement for large, "sophisticated," commercial insurance buyers.

Conclusion

Again, I want to thank the members of the Committee and Chairman Dodd and Ranking Member Shelby for holding this important hearing on the current structure of insurance regulation and oversight and for the opportunity to present NAPSLO's views on the subject.

Surplus lines market is an important and vital segment of the property / casualty insurance industry. It is the part of the industry to which consumers turn to find coverage when the standard markets or sources of insurance are unable to meet the insured's needs. Unfortunately, the current regulatory process for surplus lines, surplus lines brokers cannot easily and efficiently comply with the premium tax remittance obligations they have when insurance policies cover risks that are in multiple states, and such policies are a growing portion of the surplus lines market. Moreover, with the arrival, in the last decade, of non-resident surplus lines licenses in every state, surplus lines brokers are faced with costly, burdensome and duplicative multiple compliance requirements on multi-state risks. This makes placement of policies with multiple state exposures problematic and unnecessarily difficult and surplus lines placements for "national accounts" a nightmare of fifty state compliance.

There are those who might see some future federal action that creates a federal regulatory system as a reason for Congress to delay considering a federal solution to the problems I have presented. Surplus lines is part of the state system of regulation and to the extent that state regulated companies and the state regulatory systems exist, surplus lines will continue to be an important part of the state system. NAPSLO urges the Senate to consider these problems of surplus lines taxation, compliance and licensing and solve them by passing S.929. Given the marketplace need, the favorable political posture, and the industry-wide support for this legislation, NAPSLO believes this bill is ripe for Senate action. Most importantly, insurance consumers who need the surplus lines market and the professionals that work in the marketplace will all benefit from such action.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM GEORGE A. STEADMAN

Q.1. Does the Council favor Congress moving forward with the NARAB II legislation before it adopts more comprehensive reforms, such as the establishment of an optional federal charter?

A.1. Yes, the Council does support the immediate enactment of the proposed NARAB II legislation. The Council also supports the enactment of a comprehensive optional federal charter but we do not believe that the two efforts are duplicative or mutually exclusive in any way. The NARAB II legislation would establish a national licensure clearinghouse for the licensing of insurance agents and brokers by the states. Agents and brokers licensed through the NARAB II facility would still be required to obtain a license from each state in which they would like to engage in the business of insurance and they would still be required to comply with all of those states' post-licensure requirements.

In contrast, under the optional federal chartering proposals that have been introduced to date, a comprehensive federal regulator would be established and would function as the sole regulator for the carriers, agencies, agents and brokers that opt to be chartered at the federal level. Individuals and firms licensed by the federal regulator would be subject only to the rules and requirements established by the federal regulator and would be completely exempt from oversight by the state insurance regulators. This model is based closely on the national bank and federal thrift regulatory regimes.

The Council's expectation is that some of its members undoubtedly will opt for the federal regime and some will opt to remain state regulated. NARAB II is a broadly supported, simple piece of legislation that would resolve a current problem that would remain a problem even after the enactment of optional federal chartering legislation. All of the insurance producer trade associations as well as the National Association of Insurance Commissioners have voiced their support for NARAB II. In contrast, the optional federal chartering legislative debate is just getting started and there are numerous issues that must be resolved and overcome before that legislation will be enacted. The Council can identify no benefit of delaying action on NARAB II until the optional federal chartering issues can be resolved.

Q.2a. How would the Surplus Lines and Reinsurance legislation affect the amount of premium taxes States presently collect on surplus lines transactions?

Q.2b. Can you give assurances that no State would see a reduction in the amount of premium taxes they collect if the legislation is enacted?

A.2a. It is very difficult to determine with any specificity how the legislation ultimately would affect the premium taxes collected by any single State. The legislation would prohibit any State except the "home state" of the insured from requiring the payment of premium taxes on surplus lines products. The legislation also, however, is designed to encourage the States to enter into a premium tax sharing compact under which they each would share the premium taxes on a pro rata basis based on the premium exposure in each State. If all of the States participated in the sharing compact, it appears inevitable that surplus lines premium tax collection would rise in the aggregate.

Two factors explain this. First, it does not appear that States currently are collecting all of the surplus lines premium taxes to which they may be entitled. Many states impose the premium tax payment obligation directly on the insureds but the morass of complicated and overlapping tax payment obligations sometimes elude insureds and the insureds may then opt to not comply. We have attached a study conducted by Mackin & Company for the Excess Line Association of New York that purports to demonstrate that surplus lines premium taxes would likely rise overall under the proposed tax sharing system because of the current level of non-compliance.

Second, if the transactional costs of accessing the surplus lines markets are reduced, then insureds—and their insurance brokers—should be more likely to want to access those markets. Much of this expanded capacity most likely would be used to replace self-insurance and off-shore coverage mechanisms, neither of which generate any premium tax revenue at all for the States.

A.2b. If a State would opt to not participate in the premium tax sharing mechanism, it is difficult to estimate the effect that it would have on its premium tax collections. That State would be permitted to collect 100 percent of the surplus lines premium taxes for insureds that are based in that State but that State would not be able to collect any tax related to insured exposures from insureds located elsewhere. No one really knows how any individual state would be affected by the imposition of this rule both because it is difficult to determine—today—which insureds would be subject to the tax payment obligation and how that would compare to current collections and because of the non-compliance issue noted above. We also must note, as an aside, that a rule dictating that only the "home state" of the insured may impose a surplus lines premium tax actually is the constitutionally mandated rule announced by the Supreme Court over 40 years ago, and the primary function of the legislation at some level is to ensure that this constitutional mandate actually is followed. Several States also use this rule now, which leads to the conflicts and duplicative tax payment obligations for insureds that also have covered exposures in States that use a pro rata approach.

CONFIDENTIAL
DRAFT REPORT

DATE: FEBRUARY 27, 2007

TO: DAN MAHER
EXECUTIVE DIRECTOR
EXCESS LINE ASSOCIATION OF NEW YORK

FROM: MACKIN & COMPANY

RE: TAXATION OF MULTISTATE E&S PLACEMENTS: A QUANTITATIVE AND QUALITATIVE ANALYSIS

INTRODUCTION AND SUMMARY OF FINDINGS

In 1963, Julius S. Wikler said that surplus lines regulation "is the Achilles' heel of state regulation, and will constitute a wedge with which proponents of federal regulation may open up the entire field unless the states commence to evince a real interest in the matter."[1] In 2006, the U.S. House of Representatives unanimously passed H.R. 5637, "The Non-admitted and Reinsurance Reform Act of 2006," and more could happen in 2007.

It is in this public policy context that ELANY is working toward development of an interstate compact as a means of addressing the present untenable situation for brokers and other participants in the non-admitted market when it comes to taxation of multistate excess and surplus lines (E&S) placements. Such a compact could help preserve state-based regulation, and create a fair, efficient, cost-effective means of complying with appropriate rules and paying appropriate taxes on multistate placements in the non-admitted market. It would also provide brokers with needed confirmation that their multistate placements are in compliance with applicable tax and other rules. A contemplated compact could create a mechanism for defining which state would be the "home state" whose rules would prevail, or by creating a clearinghouse which could process all multistate placements. Either method would apply uniform allocation methods for taxing purposes.

The Gramm Leach Bliley Act (GLB) ushered in welcome reforms, specifically nonresident licensing for E&S brokers. At the same time, it compounded and expanded problems for brokers trying to comply with laws and a regulatory framework left over from the resident-only licensing days. That regulatory framework worked well in governing E&S placements on a single-state compliance basis. Under resident-only licensing, a broker would generally comply with rules and file and pay taxes in only one state – generally the state where the broker held a license. Since the enactment of GLB, brokers placing multistate risks have faced a formidable tangle of different and often conflicting state rules, and no guidance on which

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[1] Wikler, p. 539, cited in Weese, p. 192.

state's or states' rules apply to those placements. This is particularly problematic when it comes to paying premium taxes on such placements.

State officials have expressed concern about the revenue implications of a coordinated multistate tax and regulatory system like a compact, with many perceiving that it would lead some states to gain and others to lose revenues, the so-called "winners and losers" question.

Against this general background, you have asked that we undertake a study to find out whether the winners and losers question can be quantifiably answered. You have also asked that we review more qualitative elements of the present situation.

We have found -- as many surplus lines professionals but few others already know -- that today's system is uneven, incongruous, and confusing, and that it raises serious issues of fairness, cost-effectiveness, and compliance. We have gathered information that points to the need for reform of regulation and taxation of multistate E&S placements, and suggest that such reforms, possibly in the form of an interstate compact, could lead to increased tax revenues on those placements in most, if not all, states. Our research tells us that data is not available that can point with certainty to an answer to the winners and losers question. Most states do not collect data on the premium that they do not tax, and states vary widely in terms of the data they capture on premium they do tax. Those facts of life make it nearly impossible to determine accurately the amount of gross E&S premium written in the U.S., or even on a state-by-state basis, which would be key to determining whether states would gain or lose revenues under a coordinated regulatory and taxation system for multistate E&S placements. It is likely that establishment of a coordinated state system of tax collection and reporting would fill this gap in our present understanding of premium levels on a state-by-state and on a national basis.

Notwithstanding the above statement that the data does not exist to answer the winners and losers question, we think it's fair and appropriate to point out that, under a state-based system like a compact, if a state found that its revenue levels decreased, it would retain the ability to adjust its E&S tax rates to compensate for part or all of the loss.

Our research tells us that coordinated regulation of multistate E&S placements:

- is essential post-GLB,
- would lead to fair and equitable distribution of tax revenues, and
- could very well lead to increased tax revenue in most, if not all states.

This paper is in two parts. Part One covers the qualitative aspects of our study and our conclusions. Part Two reports on the methodology and data analysis that contributed to the conclusions presented in the Part One.

Part One of this paper will:

- describe the essential characteristics of the present situation regarding tax collections on multistate E&S placements, including two large brokers' estimates of costs that could be saved under a coordinated system;
- identify key historical developments that have led to the present situation; and
- discuss the qualitative results of our study, including our conclusions regarding specific ways that states could gain or lose revenues under a compact or a similar coordinated taxation system for multistate E&S placements.

Part Two of this paper will present the specific results of the quantitative aspects of our study. It will:

- describe our methodology;
- describe our data analysis, including validation of the data we received and calculations we performed on that data; and
- present selected tax and premium data that we collected and the results of our calculations.

Also, attached as an appendix, is a glossary of certain terms used in the paper that may not be familiar to public policy makers and those outside the E&S industry.

PART ONE: <u>QUALITATIVE ANALYSIS</u>

THE PRESENT SITUATION

E&S brokers presently face an untenable situation in which there is no guidance as to which states' laws apply to multistate placements. In an effort to comply with multiple states' rules, even when it's not clear that they must do so, brokers are incurring enormous costs which are shifted back to insureds, and ultimately to the consumers of those insureds' goods and services. This is in contrast to state laws governing admitted insurance business, which "typically do specify which laws apply to in-state activities involving multistate risks."[2] Challenges relating to determining which states' laws might govern multistate E&S placements apply to premium tax payments, as well as to related E&S filings and other aspects of regulation.

To illustrate the issue, we will briefly discuss the straightforward tax and regulatory compliance obligations that come with a simple single-state placement. In such a placement, the insured and the risk are in the same state, the broker is licensed and based in that state, and the policy is negotiated and delivered there. It is clear in such a situation that the broker must

[2] National Association of Professional Surplus Lines Offices (NAPSLO): *Multistate Compliance Problems in the Surplus Lines Industry*, p. 2.

comply with the state's laws and regulations. The broker would file all the appropriate documentation and pay tax on the premium to that state. There is no question as to what is the "home state" of the placement.

But when it comes to E&S placements involving multiple states, questions regarding tax and regulatory compliance for brokers and other market participants are innumerable.

Let's start with a few examples of the myriad possible configurations of multistate placements. A placement could feature a broker that is licensed and located in the state where the insured has its headquarters but with insured risks located in several other states. Or, a placement could have a broker with a nonresident license in the state where the insured has its headquarters, and insured risks located elsewhere. In such multistate placements there is virtually no guidance as to which state's or states' rules apply.

E&S insurers are, by definition, non-admitted, and therefore, by and large, beyond the reach of state insurance regulators.[3] This leaves state licensed E&S brokers, who do answer to state regulators and taxing authorities, responsible for paying premium taxes, filing appropriate documentation with regulators, and generally ensuring compliance with the laws of the states where they are licensed.

However, in multistate placements, brokers have no guidance regarding which state laws apply. The unhappy result is duplicate regulation and compliance efforts. Also, state laws often conflict, which is particularly problematic where states have taken the position that multistate transactions must comply with the rules of each state with any stake in the transaction.[4]

Three main differences among states' tax rules relate to:

- whether states tax multistate placements on a gross basis, i.e., they tax all of the premium on a transaction regardless of how much risk is located in that state, or whether they tax-allocate, i.e., they tax multistate transactions based on a proportion of premium that derives from risk located in the state;

- the methods for allocating premium on multistate risks, which vary widely among states; and

- the existence and interpretation of direct or independent procurement taxes.

Taxes on multistate placements are generally paid in two ways. A broker usually pays E&S premium tax in the state of their license, and the insured could pay direct procurement or

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[3] E&S insurers operate outside the "normal" regulatory framework, which enhances their flexibility to handle extraordinary risks. The E&S market serves as a supplemental, rather than an alternative market. This does not mean that E&S insurers are unregulated. State rules generally require that non-admitted insurers be recognized as eligible to provide coverages not available in the admitted market. Eligibility requirements vary by state but generally are aimed at ensuring that non-admitted insurers are financially secure, and adhere to certain underwriting disciplines. (Westphalen, Weese)

[4] NAPSLO: *Multistate Compliance Problems of the Surplus Lines Industry*, p. 2.

independent procurement taxes that may be due to other states. Direct or independent procurement taxes serve, in many states, as a way to collect tax on a placement in which a portion of the risk is located in the state, but the placement's broker is not licensed there, and the broker has complied with E&S laws in a different state.

Although states generally first adopted direct or independent procurement taxes as a way to tax E&S placements that an insured procured directly from a carrier without the assistance of a broker, E&S market participants have used those tax laws to pay taxes on multistate placements. In such placements, a broker generally informs the insured that it may have a direct or independent procurement tax liability in states where the broker is not licensed. It would then be up to the insured to pay the direct or independent procurement taxes.[5] This process is, in itself, problematic, because it depends on insureds' risk management staff conveying the appropriate tax liability information to colleagues who may be completely unfamiliar with the concept, or even the terms, "unauthorized" or "non-admitted" insurance.

Since GLB, these problems are exacerbated because a broker may be licensed in several or even all states involved in a multistate placement. That compounds confusion regarding whether taxes are due and to what states, and whether such taxes should be in the form of E&S premium tax or direct or independent procurement tax. Also, brokers may be exposed on the compliance side if they hold a license in a state, but are making and filing a placement under the laws of another state, where they also hold a license, and which has a stronger relationship with the placement, e.g. because most of the insured risk is located there. It is unclear whether the laws of the state with the smaller portion of the risk apply.

As referenced above, the lack of clarity in the present system exacts a significant toll on E&S brokers and their clients. Two large E&S brokers have provided estimates of the amount they could save on an annual basis if a coordinated multistate regulatory system, such as the one envisioned under the Smart Act, were enacted. Each broker's estimate follows.

Broker One estimates that it would realize savings of $10,075,000 per year as follows:

- $1,275,000 in processing of broker/client affidavits,
- $3,000,000 in E&S tax filings,
- $4,800,000 in simplified marketing, and
- $1,000,000 in licensing costs.

[5] It should be noted that there is a body of case law challenging the validity of direct or independent procurement taxes.

Broker Two estimates that it would realize savings of $13,712,004 per year as follows:

- $7,778,265 in administrate costs including, for example, affidavit preparation, signature follow-up, exposure allocations, and state filings, payments, and reporting;

- $3,600,000 in diligent search/declination costs; and

- $2,333,739 in compliance costs, including audits and fines and interest.

The last bullet above, which projects savings of over $2.33 million in compliance costs under a coordinated system, underscores the risk that brokers now bear. It is virtually if not absolutely impossible to comply with all states' rules when those rules conflict, and those compliance challenges ultimately cost consumers money.

HOW WE GOT HERE

It is helpful to know key regulatory developments in the history of the E&S market. The following will show how we got to the present regulatory mismatch between laws that, on the one hand, facilitate nonresident broker licensing but, on the other hand, still don't adequately address compliance and tax issues relative to multistate transactions.

Most recently, enactment of GLB established full nonresident licensing for E&S brokers. This brought many benefits to brokers, but it also brought a major problem because it only changed licensing rules, leaving in place a legal and regulatory framework that reflected the old reality of resident-only licensing.[6]

In the preceding period of strictly resident E&S broker licensing, brokers typically complied with the laws of, and paid premium taxes to, only their home state, where they held their resident license. As referenced above, when it came to multistate transactions, brokers would typically inform insureds of those insureds' potential liabilities under other states' direct or independent procurement taxes, and the insureds would pay those taxes. During this time period, brokers tried to pay taxes on multistate risks in several ways. Following are examples of those efforts and how they have fared.

- Some brokers have attempted to file documents and pay premium taxes in states where they were not licensed and received letters from regulators informing them that they had illegally transacted insurance without a license.[7]

- Some brokers have paid surplus lines premium taxes to their own state on the full premium amount of a multistate placement. If another state contacted the broker regarding its share of the tax, the broker would direct that state to the broker's

[6] NAPSLO: *Multistate Compliance Problems of the Surplus Lines Industry*, p. 1.
[7] Bouhan 1994.

home state which had collected the tax.[8] This method was not especially efficient for those other states, though it would have benefited the brokers' home states.

- Some brokers made payments to other states by engaging the services of locally licensed brokers, who would make "accommodation filings" or "courtesy filings" on their behalf. This was deemed illegal in several states, on the grounds that an insurance transaction is generally only considered an E&S placement in a single state, and using brokers to file E&S placements in other states effectively made them E&S transactions strictly for tax purposes.[9] Also, the brokers making such courtesy filings may have had no genuine involvement in the placement.

Prior to GLB, the most significant industry-wide legislative overhaul was the shift to tax allocation in most states in the 1980s. Before that, states taxed multistate insurance transactions based on the policy's gross premium, regardless of how much risk was located in each state. In other words, if five percent of a placement's premium derived from risk located in a state, the state would still tax 100 percent of the premium on the whole placement. This led to multiple taxation of the same premium dollars and, in some cases, to premium taxes that equaled or even exceeded the premium amount in a placement.[10]

Even now, beyond tax-allocation as referenced above, most state laws governing E&S insurance largely contemplate insurance policies covering risks in only one state. In fact, most laws are based on New York's original statute, enacted in 1890.[11]

THE WINNERS AND LOSERS QUESTION

As referenced above, we are unable to determine conclusively whether or not a coordinated system would create winners and losers when it comes to state tax revenue. We do know that brokers need a new way to file and comply with state tax laws when it comes to multistate placements. The present system is fractured and was not designed to regulate and tax multistate placements. On the tax side, this is particularly important because, relative to their number, multistate placements generate a large amount of premium. We believe that most states will be "winners" under a coordinated system of regulation and taxation. In fact, we can only identify two ways that states could possibly lose revenue under such a system.

This section will discuss

- public policies and methods of implementing those policies, which, if replaced under a coordinated system like a compact, would likely lead to more revenues for states; and

- two ways some states could possibly lose revenue under a coordinated system like a compact.

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[8] ibid.
[9] Bouhan 1994, 1999.
[10] NAPSLO 2006, p. 3.
[11] NAPSLO: *Multistate Compliance Problems of the Surplus Lines Industry*, p 1; Brockett, p. 236.

WAYS STATES COULD WIN

Here are examples of state public policies whose repeal, through a compact, would likely result in increased state revenue.

- Taxation of multistate transactions on a gross basis provides a disincentive for brokers to file there, particularly if a small portion of a transaction's premium derives from risk in that state. A compact could address this by ensuring fair and complete tax collection.[12]

- States that do not have direct or independent procurement tax, or that have the tax but do not use it to tax multistate placements where a broker is involved, would stand to gain under a compact that allocated tax payments in accordance with risk locations.[13]

On the implementation side, a compact could provide a simple, accurate way to tax premium that is currently taxed under direct or independent procurement laws. These premiums are difficult to track. Insureds generally remit direct and independent procurement taxes to states' revenue divisions, rather than insurance regulators, who generally (though not always) collect E&S premium taxes. We have found that states do not always track their direct or independent procurement tax collections. Specifically,

- three states do not track their direct and independent procurement tax collections separately from their E&S premium tax collections - they reported to us a single figure covering both categories of tax collection[14]; and

- five states say they collect direct or independent procurement tax, but they don't track the collections at all.[15]

WAYS STATES COULD LOSE

As referenced above, our analysis identified only two ways in which states, either individually or together, could lose revenues under a coordinated multistate taxation system. They follow.

[12] Our research only concretely identifies two states that tax this way, Virginia and Texas. Texas employs a variation known as the "orphan tax," under which it taxes premium allocable to other states only if those other states are not collecting tax on the same premium.

[13] Our research shows that the following ten states do not have a direct or independent procurement tax: Delaware, Illinois, Massachusetts, Montana, Nebraska, North Dakota, Oregon, Washington, West Virginia, and Wyoming. South Carolina reported to us that, although they do not have a specific direct procurement tax, they track E&S premium tax paid on brokerless placements.

[14] States that reported to us that they do not track direct or independent procurement tax separately from E&S premium tax collections are Alabama, Delaware (which has no statutory provision for direct procurement, so when insureds pay such tax, it's recorded as E&S premium tax), and Georgia.

[15] The states that reported to us that they collect direct or independent procurement taxes but do not track those collections at all are Connecticut, Iowa, Kentucky, Oklahoma, and Virginia.

- First, as indicated above, a tax-allocating state could lose revenue if a large number of its brokers have been inappropriately paying premium tax on gross premium on multistate placements. Under a multistate agreement, the brokers would likely allocate such revenues, as appropriate, to other states, which would reduce revenue to the brokers' home states. The data we have gathered does not show -- and cannot show -- the amount of tax that may be inappropriately paid in this way to brokers' home states.

- Second, if a gross-taxing state is presently getting all of the premium tax it deserves and shifts to a tax-allocation method under a multistate agreement, it would obviously lose revenue. It is impossible to tell whether such states are collecting all the premium tax they are due. And our research only firmly identifies Virginia and Texas[16] as gross-taxing states.[17] And mitigating the possibility that those states could lose tax revenue is the idea referenced in the previous section, i.e., gross-taxing states could gain revenue by collecting tax on multistate transactions that may not presently be filed there.

CONCLUSION

A coordinated tax system for multistate E&S placements would not only enhance consumer value by providing clear guidance regarding compliance issues on those placements, it would also ensure fair and equitable distribution of tax revenues among the states. A clear and simple means of compliance with tax rules and other regulations are also likely to increase compliance, boosting overall tax collections. At the same time, under such a collection system, any state would retain its inherent ability to adjust its E&S tax rates and make up for any shortfall.

As Congress and the states contemplate regulatory modernization and more coordinated regulation of insurance, through optional federal chartering, the Smart Act, and state by state initiatives, a compact for E&S regulation and taxation merits consideration by federal and state policymakers.

[16] As referenced in a previous footnote, Texas' variant on gross-taxation has it collect tax on premium derived from risk in other states only if those states are not collecting tax on the same premium.
[17] Hawaii, New Mexico, Rhode Island, and Vermont did not respond to either of our surveys, so we could not determine whether or not they are gross-taxing states.

PART TWO: METHODOLOGY AND QUANTITATIVE ANALYSIS

As referenced above, Part Two of this paper will address the quantitative portion of our research. It will:

- describe our survey-based methodology;
- describe our data analysis, including validation of the data we received and calculations we performed on that data; and
- present selected tax data that we collected and the results of our calculations.

METHODOLOGY

Our methodology included a review of existing literature, two 50-state surveys of regulators, and one survey of E&S stamping offices. We designed the surveys to collect premium and tax revenue data for 2004 and 2005, and to confirm information we had regarding tax rates in the states. We also compared the data we collected from regulators and stamping offices with information reported in other published and unpublished sources.

Specifically, we surveyed

- stamping offices of the 15 states that have such offices, seeking the gross policy premiums written in those states each year; and
- insurance regulatory professionals in charge of surplus lines in State Insurance Departments, regarding
  - how much E&S lines premium tax each state collected in 2004 and 2005;
  - how much direct/independent procurement tax each state collected on E&S lines business in 2004 and 2005;
  - whether the tax rates applied to an allocated portion or risks located in the state, or to 100 percent of policy premium;
  - whether each state's E&S lines premium tax rate had changed since the beginning of 2004;[18] and
  - whether each state's direct/independent procurement tax rate on E&S lines business had changed since the beginning of 2004.[19]

[18] The purpose of this question was to verify tax rates reported in the A.M. Best/NAPSLO 2005 special report.
[19] The purpose of this question was to verify tax rates supplied by LeBoeuf Lamb Greene & MacRae.

Other data sources we reviewed included

- a *Business Insurance* special report plus unpublished data collected in conjunction with that report,
- A.M. Best/NAPSLO special reports on the industry for 2004 and 2005, and
- Schedule T data from 25 of the top 26 E&S insurers (excluding Lloyd's, which does not file a Schedule T).

Following our review of all of the above information, we decided to conduct a follow-up survey of Insurance Department personnel because we determined that

- several Insurance Department respondents had not interpreted correctly our question regarding whether they tax-allocate, and
- responses relative to "gross premiums" did not necessarily include premiums on multistate transactions.

Our follow-up survey addressed the two issues identified immediately above, and attempted to clarify other questions that arose in our data analysis. The follow-up survey

- asked more clearly whether states tax-allocate on multistate transactions or tax the full premium amount,
- asked whether tax allocating states collect data on portions of multistate transactions they don't tax, i.e. gross premium on multistate placements including the out-of-state portion,
- asked how much taxable premium was written in each state in 2004 and 2005,
- sought information regarding dates of tax years, and
- sought information regarding applicability of different tax rates to different categories of risk and premium amounts taxed at those rates.

DATA REVIEW AND ANALYSIS

VALIDATION

We began our data analysis with an effort to validate data we collected in our surveys by comparing it with published data. We found that, in most cases, the data we collected was broadly similar to data published. However, the comparison helped us identify certain errors in our data that resulted from respondents' incorrect answers, which we were able to correct. We also identified several inconsistencies in published data, which illustrate the potential for confusion when discussing E&S premium and tax amounts. It is not the purpose of this paper to analyze or critique survey data published elsewhere, but we discovered, for example, that several states reported E&S premium tax numbers to *Business Insurance* that included direct or independent procurement tax, with no notation to that effect.

CALCULATIONS

As referenced above, this study was aimed at providing a quantitative response to the argument that a coordinated system of taxation and regulation like a compact would produce state revenue winners and losers. The hypothesis underlying our calculations was that many states were collecting less than they could have been entitled to collect.

In our effort to determine whether states were definitively under-collecting taxes on E&S transactions, we performed three sets of calculations, which we have identified below. None of the calculations proved that states were, or were not, under-collecting taxes.

Specifically, the three sets of calculations

- compared NAIC Schedule T data for 25 of the top 26 non-admitted insurers[20] in the U.S. market with premium tax collections in the states,
- compared premium tax data that we collected in our surveys with published premium numbers, and
- attempted to determine how much revenue states "lost" by tax-allocating that they did not "make back" in the form of direct or independent procurement taxes.

The calculations are presented in more detail below, along with tables showing selected data.

SCHEDULE T CALCULATION AND ANALYSIS

The hypothesis we tested with the Schedule T analysis was that most states did not collect as much premium tax as "should have" been generated by the amounts of premium reported on the largest insurers' Schedule T filings with the NAIC. According to its instruction document, the Schedule T "is intended to exhibit the amount of premiums allocated to each state and it should be the basis of premium tax calculations."

Our analysis did not show any broad or significant under-collection of premium taxes based on Schedule Ts.

More important, closer examination of the issue, including conversations with industry representatives, has convinced us that non-admitted carriers' Schedule T filings are not a reliable means of determining whether specific states have collected all the premium taxes to which they are entitled. The biggest reason for the unsuitability of Schedule T data for use in collecting E&S premium tax is that E&S brokers file and pay premium tax and carriers file Schedule Ts for other purposes.

[20] As referenced above, Lloyd's, the second largest E&S insurer in the U.S. market, could not provide state by state premium data.

Brokers' and carriers' filings will always vary for a variety of reasons, including the following.

- Brokers and carriers have different filing schedules.

- Brokers and carriers must treat direct and independent procurement taxes differently. While carriers would report premium generated without a broker, no broker can report this premium.[21]

Finally, allocation methods vary widely between brokers and carriers, as they must under the present system. For example, if a multistate placement involves a gross-taxing state and an allocating state

- the premium derived from risk located in the allocating state would be taxed twice,

- the broker would file documents showing that tax was paid on more than 100 percent of the premium on the placement, and

- the carrier would allocate the amount of the actual premium, because its Schedule T filings must tie to its financial statements.

In other words, the broker's filings are tied to premium taxes paid, while the carrier's Schedule T filings only show premium written. In the case described above, the carrier would report a lower premium amount than the broker would report.

Additionally, even if this fundamental difference between the two reporting systems did not exist, carriers would face the same challenges that brokers now face regarding the vagaries of allocating risk in multistate policies under the present uncoordinated system of different, and often conflicting, state laws.[22]

This issue is particularly important in light of recent efforts by several states, and now the NAIC, to use Schedule T filings to confirm that they have collected all the E&S premium taxes they are due. We have identified just a few of many reasons that such efforts will not garner the desired result.

CALCULATIONS BASED ON PREMIUM AND TAX DATA

The second theory we tested was that, on a national and on a state by state basis, states were not collecting tax on all taxable premium. To check this theory, we calculated the amount of premium that was taxed in each state and compared it to unpublished data on taxable premium that *Business Insurance* collected and supplied to us. We did this by

[21] Bouhan 1994.
[22] Undated NAPSLO Manuscript

- dividing the surplus lines premium tax collected in each state by the tax rate to calculate how much premium was taxed this way,

- dividing the direct or independent procurement tax collected in each state by that tax rate to calculate how much premium was taxed this way,

- adding the two calculated premium figures to determine how much premium was taxed in each state for each of the years in question, and

- comparing this number with the premium written figures reported in *Business Insurance's* "Spotlight Report: Surplus Lines Premiums and Taxes by State," published September 11, 2006.

We found that the amount of premium taxed broadly matched the amount of premium reported to *Business Insurance*, and did not indicate any widespread or significant under-collection of taxes. In fact, when we compared the amount of premium taxed on a nationwide basis, and compared it with published figures reporting total E&S premium written on a national basis, our figures showed that in 2004, 95 percent of premium written was taxed, and in 2005, 94 to 99 percent was taxed (there is a range for 2005 due to the different premium figures reported by A.M. Best and *Business Insurance*, as discussed below). Table One below shows the state by state analysis, and Table Two shows the aggregated national figures.

It is appropriate here to note that accurate premium numbers are very difficult to ascertain, both on a state by state and on a national basis.[23] Table Two below shows significant differences between gross premium written figures reported by *Business Insurance* and by A.M. Best. Specifically, A.M. Best's figures for 2005 are 4.44 percent lower than *Business Insurance*.

CALCULATIONS BASED ON MULTISTATE GROSS PREMIUM DATA

The third theory we tested was that, for tax-allocating states, the amount they collect in direct and independent procurement taxes did not "make up for" tax "lost" on multistate premium they did not tax.

We were unable to perform this calculation in a meaningful way because, of the 38 states that responded to our second survey, which was aimed at gathering data on premiums on multistate transactions, we found that only one, New York, was a tax-allocating state that collected data on premium it does not tax because of its multistate nature. Several states reported premium that was not taxed because the type of risk or the type of insured are exempt from such taxes.

The lack of data at the state level on premium derived from risks located in other states points out the difficulty in ascertaining how much premium is actually written in the U.S. E&S market. Establishment of clear and uniform tax payment and premium allocation through a coordinated state system like a compact could fill this void in our present knowledge of E&S premium amounts on a state and national basis.

[23] Brockett p. 244.

TABLE ONE – PREMIUM AND TAX CALCULATIONS

Note that, in the last column, positive values for several states, which could, at first glance, suggest over-collection of taxes, are explained largely, if not completely, by direct or independent procurement taxes in the same amounts.

2004					
States	**Calculated Premium on which Procurement Taxes were paid**	**Calculated Premium on which Premium Taxes were paid**	**Total Calculated Premium**	**Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)**	**Difference Between Calculated Premium and BI Taxable Premium**
	Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate	*E&S Premium Tax Collected divided by E&S Tax Rate*[24]	*Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid*	*Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.*	*Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)*
Alabama	0	407,736,700	407,736,700	406,991,433	745,267
Alaska	14,533,333	81,370,370	95,903,704	64,685,222	31,218,482
Arizona	18,859,400	528,067,100	546,926,500	**528,067,100**	18,859,400
Arkansas	18,825,500	184,392,325	203,217,825	184,392,693	18,825,132
California	620,586,733	5,572,769,167	6,193,355,900	5,572,768,644	620,587,256
Colorado	364,756	461,452,700	461,817,456	**461,452,700**	364,756
Connecticut	0	300,753,350	300,753,350	300,753,350	0
Delaware	0	73,810,000	73,810,000	73,810,093	(93)
Florida	417,564,180	2,232,627,720	2,650,191,900	2,508,508,400	141,683,500
Georgia	0	852,746,750	852,746,750	852,746,750	0
Hawaii[25]	0	197,744,851	197,744,851	198,509,751	(764,900)
Idaho	94,982	66,246,655	66,341,636	66,245,757	95,879
Illinois	0	818,937,057	818,937,057	1,012,483,750	(193,546,693)
Indiana	5,819,926	375,323,160	381,143,086	375,323,146	5,819,940
Iowa	0	131,528,629	131,528,629	131,528,643	(14)
Kansas	10,844,139	148,701,300	159,545,439	152,743,375	6,802,064
Kentucky	0	151,349,200	151,349,200	152,515,154	(1,165,954)
Louisiana	10,757,780	829,719,940	840,477,720	837,300,751	3,176,969
Maine	5,117,667	67,448,833	72,566,500	62,986,560	9,579,940

[24] In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.
[25] Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2004					
States	**Calculated Premium on which Procurement Taxes were paid**	**Calculated Premium on which Premium Taxes were paid**	**Total Calculated Premium**	**Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)**	**Difference Between Calculated Premium and BI Taxable Premium**
	Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate	*E&S Premium Tax Collected divided by E&S Tax Rate*[26]	*Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid*	*Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.*	*Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)*
Maryland	16,191,000	395,932,833	412,123,833	395,781,933	16,341,900
Massachusetts	0	629,166,875	629,166,875	708,640,237	(79,473,362)
Michigan	145,505,720	725,763,840	871,269,560	**725,763,840**	145,505,720
Minnesota	13,672,750	376,346,833	390,019,583	377,566,333	12,453,250
Mississippi	7,558,833	264,172,200	271,731,033	264,177,156	7,553,877
Missouri	44,907,340	444,408,560	489,315,900	489,315,902	(2)
Montana	0	45,425,018	45,425,018	**45,425,018**	0
Nebraska	0	92,163,633	92,163,633	92,163,633	0
Nevada	20,943,343	278,287,857	299,231,200	336,217,740	(36,986,540)
New Hampshire	10,485,900	80,254,900	90,740,800	80,254,867	10,485,933
New Jersey	112,038,467	1,055,349,500	1,167,387,967	**1,055,349,500**	112,038,467
New Mexico[27]	0	63,126,474	63,126,474	**63,126,474**	0
New York	339,444,444	2,609,827,000	2,949,271,444	2,609,826,997	339,444,447
North Carolina	3,393,640	493,665,120	497,058,760	496,474,709	584,051
North Dakota	0	30,846,400	30,846,400	30,843,557	2,843
Ohio	1,362,220	246,000,000	247,362,220	157,234,516	90,127,704
Oklahoma	0	304,276,600	304,276,600	**304,276,600**	0
Oregon	0	282,675,850	282,675,850	257,090,552	25,585,298
Pennsylvania	193,500,000	770,100,000	963,600,000	865,603,000	97,997,000
Rhode Island[27]	0	76,957,533	76,957,533	2,308,726	74,648,807
South Carolina	69,450	389,463,625	389,533,075	389,533,050	25
South Dakota	967,480	45,127,680	46,095,160	45,127,696	967,464

[26] In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.
[27] Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2004					
States	**Calculated Premium on which Procurement Taxes were paid**	**Calculated Premium on which Premium Taxes were paid**	**Total Calculated Premium**	**Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)**	**Difference Between Calculated Premium and BI Taxable Premium**
	Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate	*E&S Premium Tax Collected divided by E&S Tax Rate*[28]	*Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid*	*Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.*	*Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)*
Tennessee	7,596,440	473,107,960	480,704,400	**473,107,960**	7,596,440
Texas	253,010,206	3,221,598,598	3,474,608,804	3,321,116,492	153,492,312
Utah	20,625,200	143,018,565	163,643,765	146,245,111	17,398,654
Vermont[29]	0	38,173,700	38,173,700	**38,173,700**	0
Virginia	0	633,603,289	633,603,289	679,051,028	(45,447,739)
Washington	0	712,362,250	712,362,250	712,362,142	108
West Virginia	0	128,384,375	128,384,375	128,061,144	323,231
Wisconsin	66,983,133	328,196,367	395,179,500	328,196,368	66,983,132
Wyoming	0	33,122,600	33,122,600	33,122,878	(278)
Totals:	*2,381,623,962*	*28,893,631,842*	*31,275,255,804*	*29,595,352,131*	*1,679,903,673*

[28] In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.
[29] Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

TABLE ONE CONTINUED – PREMIUM AND TAX CALCULATIONS

Note that, in the last column, positive values for several states, which could, at first glance, suggest over-collection of taxes, are explained largely, if not completely, by direct or independent procurement taxes in the same amounts.

2005					
States	**Calculated Premium on which Procurement Taxes were paid**	**Calculated Premium on which Premium Taxes were paid**	**Total Calculated Premium**	**Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)**	**Difference Between Calculated Premium and BI Taxable Premium**
	Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate	*E&S Premium Tax Collected divided by E&S Tax Rate*[30]	*Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid*	*Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.*	*Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)*
Alabama	0	445,746,000	445,746,000	445,746,000	0
Alaska	16,825,033	89,453,519	106,278,552	89,377,259	16,901,293
Arizona	19,708,233	663,703,267	683,411,500	**663,703,267**	19,708,233
Arkansas	17,037,200	201,859,750	218,896,950	201,859,745	17,037,205
California	442,349,233	5,622,450,467	6,064,799,700	5,622,450,389	442,349,311
Colorado	2,860,889	543,781,333	546,642,222	503,030,140	43,612,082
Connecticut	0	329,358,800	329,358,800	329,358,800	0
Delaware	0	92,835,950	92,835,950	92,689,683	146,267
Florida	551,294,600	2,660,908,760	3,212,203,360	3,221,704,536	(9,501,176)
Georgia	0	895,643,150	895,643,150	895,643,175	(25)
Hawaii[31]	0	232,951,489	232,951,489	233,981,170	(1,029,681)
Idaho	7,491	74,202,255	74,209,745	74,201,272	8,473
Illinois	0	1,016,504,629	1,016,504,629	1,016,395,632	108,997
Indiana	8,481,865	412,265,320	420,747,185	409,581,452	11,165,733
Iowa	0	135,130,933	135,130,933	134,327,940	802,993
Kansas	7,209,230	160,279,300	167,488,530	170,585,763	(3,097,234)
Kentucky	0	167,996,133	167,996,133	165,200,696	2,795,437
Louisiana	29,017,240	853,173,280	882,190,520	**853,173,280**	29,017,240
Maine	2,454,000	60,111,200	62,565,200	66,766,454	(4,201,254)

[30] In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.

[31] Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2005					
States	**Calculated Premium on which Procurement Taxes were paid**	**Calculated Premium on which Premium Taxes were paid**	**Total Calculated Premium**	**Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)**	**Difference Between Calculated Premium and BI Taxable Premium**
	Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate	*E&S Premium Tax Collected divided by E&S Tax Rate*[32]	*Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid*	*Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.*	*Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)*
Maryland	20,321,933	434,887,600	455,209,533	434,889,000	20,320,533
Massachusetts	0	708,640,225	708,640,225	702,878,772	5,761,453
Michigan	109,586,640	703,357,040	812,943,680	**703,357,040**	109,586,640
Minnesota	32,890,050	393,128,400	426,018,450	392,730,267	33,288,183
Mississippi	8,040,533	263,313,175	271,353,708	263,329,614	8,024,094
Missouri	32,249,760	404,489,860	436,739,620	436,739,610	10
Montana	0	64,692,873	64,692,873	**64,692,873**	0
Nebraska	0	92,141,167	92,141,167	92,141,171	(4)
Nevada	24,099,514	354,271,514	378,371,029	370,018,174	8,352,855
New Hampshire	13,524,475	102,946,250	116,470,725	102,917,482	13,553,243
New Jersey	82,831,967	1,087,994,033	1,170,826,000	**1,087,994,033**	82,831,967
New Mexico[33]	0	67,608,458	67,608,458	**67,608,458**	0
New York	427,777,778	2,768,618,083	3,196,395,861	2,768,618,072	427,777,789
North Carolina	1,888,660	514,965,060	516,853,720	516,807,631	46,089
North Dakota	0	36,223,943	36,223,943	36,222,949	994
Ohio	3,420,240	342,000,000	345,420,240	241,263,107	104,157,133
Oklahoma	0	319,526,400	319,526,400	**319,526,400**	0
Oregon	0	312,702,150	312,702,150	**312,702,150**	0
Pennsylvania	236,900,000	780,666,667	1,017,566,667	780,666,667	236,900,000
Rhode Island[33]	0	71,794,067	71,794,067	2,153,822	69,640,245
South Carolina	191,025	412,489,825	412,680,850	412,680,977	(127)
South Dakota	1,862,240	38,702,120	40,564,360	38,702,132	1,862,228
Tennessee	7,960,040	451,775,240	459,735,280	**451,775,240**	7,960,040

[32] In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.
[33] Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

2005					
States	**Calculated Premium on which Procurement Taxes were paid**	**Calculated Premium on which Premium Taxes were paid**	**Total Calculated Premium**	**Taxable Premium as Reported to Business Insurance (supplemented by our calculations - see note below)**	**Difference Between Calculated Premium and BI Taxable Premium**
	Direct/Independent Procurement Tax Collected divided by Direct/Independent Procurement Tax Rate	*E&S Premium Tax Collected divided by E&S Tax Rate*[34]	*Calculated Premium on which Premium Tax was paid Plus Calculated Premium on which Procurement Tax was Paid*	*Where BI had no data, we have entered our calculated premium on which PT was paid. Noted with bold numbers.*	*Calculated Premium minus BI-reported Taxable Premium (negative suggests premium amounts possibly untaxed)*
Texas	239,839,938	3,059,170,454	3,299,010,392	3,046,363,903	252,646,489
Utah	14,043,506	142,593,412	156,636,918	147,809,055	8,827,863
Vermont[35]	0	41,919,433	41,919,433	41,919,438	(5)
Virginia	0	611,530,667	611,530,667	642,889,272	(31,358,605)
Washington	0	739,932,050	739,932,050	739,930,065	1,985
West Virginia	0	130,476,250	130,476,250	128,356,483	2,119,767
Wisconsin	31,605,533	248,758,333	280,363,867	248,758,333	31,605,534
Wyoming	0	40,526,967	40,526,967	40,526,980	(13)
Totals:	*2,386,278,847*	*30,400,197,249*	*32,786,476,096*	*30,826,745,823*	*1,959,730,273*

[34] In some cases, states have different rates for different categories of risk including, for example, marine or fire risk. In these cases we used the "Surplus Lines" rate.
[35] Data for this state is from September 11, 2006, Business Insurance Spotlight Report because the state did not respond to our survey.

TABLE 2 - NATIONAL DATA

	2004	2005
AS REPORTED TO BUSINESS INSURANCE:		
GROSS PREMIUM WRITTEN US[36]	32,983,618,705	34,749,265,476
TAX COLLECTED NATIONWIDE (INCLUDES SOME DIRECT AND INDEPENDENT PROCUREMENT TAX)[36]	1,094,850,585	1,145,836,004
AS REPORTED IN AM BEST: GROSS PREMIUM WRITTEN US[37]	33,011,955,000	33,280,702,000
AS REPORTED TO US:		
TOTAL E&S PREMIUM TAX COLLECTED	1,064,052,918	1,122,309,379
TOTAL DIRECT/INDEPENDENT PROCUREMENT TAX COLLECTED	87,321,944	90,336,970
TOTAL TAX COLLECTED ON E&S BUSINESS	1,151,374,862	1,212,646,349
CALCULATIONS BASED ON OUR DATA:		
CALCULATED PREMIUM ON WHICH PREMIUM TAX WAS PAID	28,893,631,842	30,400,197,249
CALCULATED PREMIUM ON WHICH D/I PROCUREMENT TAX WAS PAID	2,381,623,962	2,386,278,847
TOTAL CALCULATED PREMIUM ON WHICH TAX WAS PAID	31,275,255,804	32,786,476,096
OUR CALCULATED TAXED PREMIUM AS A PERCENTAGE OF GROSS PREMIUM WRITTEN AS REPORTED TO BUSINESS INSURANCE	94.82%	94.35%
OUR CALCULATED PREMIUM AS PERCENTAGE OF GROSS PREMIUM WRITTEN AS REPORTED BY AM BEST	94.74%	98.51%

[36] We have excluded the District of Columbia from the *Business Insurance* Gross Premium Written and Tax Collected figures because our survey did not include the District.
[37] AM Best data includes the District of Columbia because AM Best did not provide premium numbers on a jurisdiction by jurisdiction basis.

APPENDIX A: DEFINITION OF TERMS

Following are several terms used in this report and the meanings with which they are used.

- allocated premium: The portion of a premium in a multistate transaction that is allocated to risk(s) in a particular state for tax and regulatory purposes. Brokers generally make these allocations.

- broker: An intermediary between a customer and an insurance company. Brokers typically search the market for coverage appropriate to their clients. They work on commission and usually sell commercial, not personal, insurance.[38]

- direct procurement: Procurement of an insurance policy from a non-admitted insurance carrier without use of a broker licensed in a particular state. A broker licensed in another state or states might be involved.

- direct procurement tax: Premium tax charged by several states on insureds that have directly procured an insurance policy from a non-admitted insurance carrier.

- excess lines insurers: Non-admitted insurer.

- gross premium: Total premium amount on a multistate transaction.

- gross-basis taxation: A premium taxation method under which a state taxes 100 percent of the policy premium on a multistate transaction, regardless of how much premium derives from risk(s) located in the state.

- independent procurement: Same as Direct Procurement, defined above.

- independent procurement tax: Same as Direct Procurement Tax, defined above.

- multistate placement: A transaction relating to the purchase of insurance covering risks located in more than one state.

- non-admitted insurer: Insurer licensed in its domiciliary state, which is not licensed, but is eligible to sell E&S insurance in other states. They sell coverage that is unavailable from licensed insurers within the state.

- premium tax: Tax paid on insurance premiums. In non-admitted markets, such taxes are generally paid by brokers.

- single state transaction: A transaction relating to the purchase of insurance covering risks located within a single state.

[38] Insurance Information Institute Glossary of Insurance Terms (www.iii.org)

- surplus lines insurer: Non-admitted insurer.
- tax allocation: A premium taxation method under which a state taxes only the portion of a multistate policy premium that derives from risk(s) located in the state.
- taxable premium: Premium that is taxable under a state's laws.
- tax-exempt premium: Premium that is exempt from tax under a state's laws, often because of the nature of the risk (e.g. several states exempt aviation risks from premium tax), or the nature of the insured (e.g. a government or other tax-exempt entity).

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM THOMAS MINKLER

Q.1. Mr. Minkler, in your testimony you discussed at length the benefits of state regulation and your opposition to an optional federal charter. Yet, you support the enactment of Federal legislation to establish a national system for agent licensing.

Since you support state regulation, why not have the States, rather than the Federal government, address the problems you identified with agent licensing?

A.1. IIABA supports federal legislation, the NARAB Reform Act, to provide for national licensing reciprocity and not a national licensing system. As I mentioned in my testimony, while IIABA continues to support the state system, we do not believe that the states will be able to resolve all of their problems on their own. Therefore, we believe that focused congressional action is necessary to help reform the state regulatory system, but only on an as-needed basis to overcome the structural impediments to reform at the state level. The NARAB Reform Act is such legislation, because it improves the state-based system of insurance regulation by providing licensing reciprocity through a board of state commissioners and industry representatives instead of creating a massive new federal bureaucracy.

Q.2. Do you believe that the NAIC provides an effective mechanism for streamlining and harmonizing state regulation?

A.2. We believe that the NAIC is effective in moving the states towards reform and helping to streamline the system. However, while the NAIC can help encourage harmonization of state laws, it cannot compel all states to adopt such laws. We therefore believe that there are areas where the state-based system needs to be streamlined and modernized through the use of targeted federal legislation such as the NARAB Reform Act and the Nonadmitted and Reinsurance Reform Act.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM RICHARD BOUHAN

Q.1. Will you please explain why you believe Federal legislation is needed to streamline the regulation of surplus lines insurance?

A.1. Federal legislation is the only way to ensure that uniform rules and procedures are created and implemented among all the states to overcome and rationalize the current inconsistencies and conflicts in state regulatory requirements in the placement and taxation of surplus lines business, particularly when the surplus lines transaction involves multi-state exposures. The inconsistencies and conflicts in state laws and regulations governing surplus lines transactions are a result of these laws being "state-centric" (unique to each state) and are state specific to a much greater extent than the rules governing the admitted or standard market transactions.

While an interstate compact (or some type of interstate agreement) has been offered as a vehicle to solve these inefficiencies and conflicts in order to streamline surplus lines regulation, these proposed solutions require that each state, individually, agree and join the accord. Such a "patchwork" solution would still require the surplus lines industry to maintain an infrastructure to operate under the current system of inconsistent, conflicting and inefficient rules and regulations, as well as those under the new agreement. Federal legislation is the only method by which these problems can be solved immediately and universally among the states.

NAPSLO is aware that the Committee is considering legislation to broadly or "globally" reform the current insurance regulatory system. But such legislation, if enacted, would not eliminate the state based system of insurers and insurance regulation. Surplus lines is part of the state based system. The reform enacted through S. 929 would continue and benefit the surplus lines market and those buyers that use the surplus lines market even after a broad insurance regulatory reform is enacted.

Q.2. Why should we not leave it to the NAIC to accomplish this task?

A.2. The simple answer is that the NAIC cannot solve the problem. It neither has the history nor is it, as a trade association representing state insurance regulators, structured to do so. Moreover, the NAIC has no regulatory or enforcement authority that would allow it to accomplish this task.

The NAIC has been aware of the premium tax allocation and remittance problems regarding surplus lines for decades and various NAIC committees, sub-groups and task forces have addressed these problems over time. Yet, none of this effort has resulted in any solution to the problem.

Even if a solution had been forthcoming from the NAIC, it is doubtful that one would have been enacted in the states. The history of the enactment of NAIC model laws in the states, much less enacted by all states, is dismal. Few of the over 260 NAIC model bills have been adopted in all fifty states. In fact, the track record of the enactment of NAIC model laws has been so poor that the last year the NAIC announced a moratorium on working on model bills and compacts since so few were actually passed.

As was noted at the July 29, 2009 hearing, the NAIC is generally supportive of S. 929/H.R. 1065 and has indicated that the surplus lines tax question, in particular, is an area where Federal legislation could be helpful. In their August 2007 issue paper on this legislation, the NAIC stated: *Conflicting state oversight and licensing rules governing surplus lines insurance and surplus lines brokers, particularly for premium tax collection and allocation, should be resolved through a state compact or through federal legislation.* Subsequently, the NAIC abandoned work on developing model state compacts.

Q.3. Mr. Bouhan, how do you respond to the concerns Mr. Plunkett raised in his testimony about the Surplus Lines and Reinsurance bill? Please specifically address Mr. Plunket's concern that the bill would exempt certain personal lines of insurance from state consumer protection laws.

A.3. S. 929 does not impact any consumer protections laws or regulations. The legislation only affects the surplus lines placement and tax payment requirements on multi-state risks by directing the placing broker to comply with the placement and tax remittance laws of only the insured's "Home State." This eliminates duplicative, overlapping and costly multiple compliance and remittance procedures on multi-state surplus lines transactions. No other laws, in any state including the "Home State" of the insured, are affected by the legislation. Each state's consumer protection laws remain in effect.

While the above addresses the impact S. 929 would have on consumer protections related to surplus lines insurance purchases, including personal lines transactions, the relationship between personal lines—personal auto and homeowners—and the surplus lines market that Mr. Plunkett's question raises needs to be addressed.

To the extent that homeowners coverage and dwelling policies are found in the surplus lines market, they are written on structures located in earthquake and hurricane areas that the standard companies don't want to write. In recent years that segment of the surplus lines market, particularly in states with coastal exposures, has increased as the incidence of natural disasters has grown.

Based upon recent surplus lines stamping office statistics, NASPLO estimates that somewhere between 2.5 and 3.0 percent of the almost $40 billion dollars in annual surplus lines premium comes from personal lines products. However, personal lines transactions are overwhelmingly "single state" in nature and since S. 929 is directed at multi-state surplus lines transactions, the legislation would have minimal impact on the limited number of personal lines transactions written in the surplus lines market.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

AMERICAN ACADEMY *of* ACTUARIES

Testimony Concerning State of the Insurance Industry:
Examining the Current Regulatory and Oversight Structure

By James Rech, Chair, Financial Regulation Reform Task Force
of the American Academy of Actuaries

U.S. Senate Committee on Banking, Housing and Urban Affairs
July 28, 2008

Chairman Dodd, Senator Shelby, and Members of the Committee:

The Financial Regulatory Reform Task Force of the American Academy of Actuaries would like to ensure that the actuary maintains a key role in any potential federal regulatory structure for insurance. Accomplishing this goal is fundamental to the objective of protecting insurance consumers and preserving the financial integrity of the industry.

The American Academy of Actuaries is a 16,000-member professional association whose mission is to assist public policymakers by providing objective expertise and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The primary purpose of government regulation is to protect consumers, particularly to protect the solvency of companies so they can fulfill their promises to policyholders. The Academy of Actuaries' mission is to serve the public on behalf of the United States actuarial profession. Actuaries analyze and shape insurance regulations that preserve the financial integrity of the insurance system. Membership in the Academy is the primary credential qualifying actuaries to make this contribution.

Actuaries have historically played an essential role in the regulation of insurance. That role has included, among other functions, the review of reserve adequacy reports by companies, reviewing insurance product designs for all products and also the prices for non-life insurance products, reviewing contracts for risk transfer consideration, assisting in the design and operation of capital adequacy and risk management standards, and advising insurance commissioners in the event of mergers, acquisitions or insolvencies. Actuaries also serve as regulators, and have played a vital part in assuring the financial well-being of the industry.

The current state-based structure of insurance regulation has been in place since 1869.Many actuaries play a vital role in the design and operation of this structure as employees of insurance regulators. Many more serve as advisors to the regulators —either individually as interested persons or as members of the Academy committees that make recommendations to the regulatory authority.

The primary responsibilities of the regulatory actuary are:

- Monitoring the solvency and financial condition of domestic insurers by reviewing companies' reserves and risk-based capital calculations, and the Statements of Actuarial Opinion provided by each company's Appointed Actuary

- Reviewing product-related Actuarial Certifications for compliance with prescribed laws and regulations
- Evaluating the reasonableness of premiums for certain insurance plans
- Advising the Commissioner on the impact to the public and others of acquisitions, demutualizations, and mergers
- Assisting the Commissioner in managing the rehabilitation or liquidation process for troubled insurance companies
- Developing and implementing changes to insurance laws and regulations concerning proper reserve levels, premium rates, accounting and solvency requirements

A financially sound insurance industry could not exist without actuaries. The actuarial profession is essential to the sound operation and structure of insurance regulation in two crucial ways. First, as experts in assessing and managing the financial security risks that Americans face, actuaries have vital knowledge and experience in how to assess and manage these risks. By working collaboratively with industry trade groups, regulators, and public policy-makers, actuaries have helped to shape the modern regulatory system. The American Academy of Actuaries has been the principal professional organization through which the actuarial profession has educated public policy-makers in insurance and financial security risk. Our goal has been to produce reasonable and fair regulations that protect the solvency of financial security systems and the interests of all policyholders.

Second, many regulatory agencies employ actuaries. The fundamental role of state insurance regulation has been solvency protection and the actuarial profession has been very involved in this process. Regulatory actuaries ensure that companies within their jurisdiction have complied with the specific actuarial requirements included in the insurance regulations. Most important, the regulatory actuary protects insurance consumers by analyzing and monitoring insurance companies to help prevent insolvencies. To ensure that the regulatory system protects stakeholders, such as the individual insured, it is essential that the actuarial role and related reporting requirements continue under any federal insurance regulatory structure. However, based upon our analysis of the various proposals for a federal insurance option, the role of the actuary is not apparent. We therefore recommend that the actuarial role and requirements be clearly defined in any laws that implement a federal insurance regulatory system.

The American Academy of Actuaries has worked for many years to assure that sound actuarial principles are reflected in the current state-based regulatory system. Should a federal system evolve, we feel that it too should directly incorporate the actuarial role.

The Academy maintains an objective perspective, and as such, does not take a position on whether or not a federal regulatory system for insurance is appropriate. However, as this and other proposals look to reconfigure insurance regulation, it feels that the role of actuaries in any such system should be explicitly addressed. If you have any questions concerning this letter or the attached please direct them to Craig Hanna, Director of Public Policy, at (202)-223-8196 or hanna@actuary.org or Tina Getachew, Risk Management and Financial Reporting Policy Analyst at (202)-223-8196 or getachew@actuary.org.

American Association of Independent Claims Professionals

The Honorable Christopher J. Dodd
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Richard C. Shelby
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

August 6, 2008

Re: Statement for Committee Hearing on the "State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure"

Dear Chairman Dodd and Ranking Member Shelby:

The American Association of Independent Claims Professionals (AAICP), a nationwide network of independent adjusting companies, commends you for holding a hearing to examine the state of the insurance industry's regulatory and oversight structure. The independent adjusters represented by AAICP are often among the first to respond when policyholders experience loss, so our members have firsthand experience in dealing with those regulatory structures on a regular basis.

Today's complex array of state approaches on adjuster licensing and other regulatory matters has a direct impact on the day-to-day lives of consumers, insurers, and adjusters alike. Responding promptly to consumers' needs requires flexibility and mobility to apply the right expertise to adjusting losses from natural disasters or individual accidents.

Unfortunately, a patchwork of often conflicting state laws prevents adjusters from providing the most efficient, timely, and cost-effective customer service across state lines, whether for workers' compensation, disability, residential, automobile, crop, or other claims. These laws hinder adjusters' ability to work across state borders to assess and pay claims quickly.

As a result, the AAICP recommends that to speed claims adjustments and boost consumer protections, Congress enact legislation to bring about uniform and reciprocal adjuster licensing across state lines, similar to what it provided agents in the Financial Modernization Act of 1999, also known as the "Gramm-Leach-Bliley Act." This legislative change could be part of a comprehensive Congressional insurance reform package, or through more targeted legislation specifically addressing this issue, similar to the Gramm-Leach-Bliley provisions for agents.

American Association of Independent Claims Professionals
150 South Warner Road, Suite 156
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We look forward to working with you on that legislation, which could be designed to improve the cross-state licensing and regulatory structures of producers as well as adjusters. In the case of adjusters, the AAICP believes that such legislation should emphasize the following priorities:

- Congress needs to take legislative action to bolster consumer protections and improve cross-state uniformity and reciprocity in adjuster licensing, in order for policyholders to have their claims adjusted as expeditiously as possible.

- The AAICP would be comfortable with legislation that ensures a continued, active role for the National Association of Insurance Commissioners (NAIC) in the oversight of adjuster licensing and other insurance policy matters.

- Congressional legislation should bolster consumer protections by encouraging the licensing of adjusters, by spurring states to adopt uniform adjuster licensing criteria, and by authorizing a multi-state exam to ensure adjusters' knowledge of such criteria.

- Finally, the AAICP believes that such legislation should facilitate accelerated adjusting of claims for victims of natural or other disasters.

The AAICP appreciates the opportunity to set out our priorities for Congressional insurance reform. We stand ready to answer any questions, and we look forward to continuing to work with you as we move forward to improve the regulatory and oversight structure of the insurance industry.

Respectfully yours,

Bernd G. Heinze
Executive Director

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Executive Director
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July 29, 2008

The Honorable Chris Dodd
Chairman, Senate Banking Committee
United States Senate
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member, Senate Banking Committee
United States Senate
Washington, DC 20510

Dear Chairman Dodd and Ranking Member Shelby:

Thank you for holding today's hearing. As strong supporters of establishing an optional federal insurance charter, the members of the American Bankers Insurance Association (ABIA) appreciate your willingness to debate reform of the current state-based insurance regulatory system.

Reform of the system should be a high priority of the American government. Due to problems in other sectors of the American financial industry, attracting capital is the single largest challenge facing all American financial institutions. American insurers, however, have an additional challenge; they must compete in the capital markets while being regulated by an antiquated system of fifty-one separate state regulatory regimes. Absent modernization of this system, we are literally driving investment dollars away from our shores.

The current insurance regulatory system suffers from inconsistent and inefficient regulation, disparate enforcement across state lines, statutory barriers to product introduction and innovation, inconsistent and duplicative market conduct regulation, and a patchwork of other state laws that have remained unchanged for decades. In addition, the current regulatory system greatly impedes our ability to negotiate in the international regulatory arena. Whereas most countries are represented by a single federal regulator, like in Great Britain, the United States is represented by a variety of state insurance regulators who, by definition, do not and cannot speak for the United States.

Secondly, the difficulty of entering the U.S. market under the current state regulatory system dissuades foreign capital from investing in the U.S. market, restricting overall insurance capacity, and reducing the number of insurance products available to U.S. consumers. It is simply the case that there are relatively few foreign companies willing to expend the time and resources necessary to navigate our confusing state regulatory system.

By that measure, it is also the case that there are many American companies that do not have the resources to enter every state's market. In that regard, foreign insurers and small domestic insurers share the same problem: the benefit of entering every state's market does not equal its cost. The effect is fewer products available to consumers and higher prices for the products that are available.

The stewards of the state system – state legislators and state regulators working through their trade associations – have tried and failed to correct the disparities and inequities of the system. Clearly, federal action is required.

An optional federal charter proposal would embrace the best of state insurance regulation and allow insurers, insurance agencies and insurance producers to take advantage of the regulatory flexibility banks have long enjoyed – the option of doing business under one set of national rules.

By establishing an optional federal charter, Congress would allow the U.S. insurance industry to compete more equitably on a global basis and insurance industry regulation would catch up to banks and securities firms, whose regulation has been reformed and modernized. Last year, studies such as the Schumer/Bloomberg report urged that an optional federal charter should be given serious consideration in order to improve the competitiveness of the U.S. financial services industry.

As you are aware, Senator Tim Johnson and Senator John Sununu introduced S. 40, the National Insurance Act, which proposes an optional federal charter for insurers and insurance producers. S. 40 creates a federal insurance regulatory regime as an alternative to the current state system. Instead of replacing the state system through incremental federal reforms that supplant state regulation, we urge consideration of the kind of comprehensive reform the Sununu/Johnson bill represents.

We look forward to debating the provisions of S. 40 and look forward to working with you on this important issue.

Sincerely,

JVA McVedie

Executive Director

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American Association of
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SUBMISSION OF
BERND G. HEINZE, ESQ.
EXECUTIVE DIRECTOR OF THE
AMERICAN ASSOCIATION OF MANAGING GENERAL AGENTS

BEFORE THE

U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

ON

STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

Introduction

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Bernd G. Heinze, Esq., and I am the Executive Director of the American Association of Managing General Agents (AAMGA), headquartered in King of Prussia, Pennsylvania, just west of Philadelphia, Pennsylvania. We are pleased to submit these remarks as an extension to those submitted during the Hearing held before the Committee on July 29, 2008.

The AAMGA is an international trade association comprised of 503 member agents, brokers, insurance, captive and reinsurance companies, Lloyd's of London syndicates and underwriters, state stamping and surplus line offices and related professional entities all engaged in the wholesale insurance marketplace in the United States and the United Kingdom. Since 1926 AAMGA members have been committed to serving the non-admitted or excess and surplus lines and admitted markets, with reliable integrity, and in offering creative, sound, dependable insurance security, products, services and solutions to specialty and unique risk exposures. Collectively, these efforts identify the Association as the professional standard to the wholesale insurance market, and as a credible authority on matters of importance to the global insurance community.

The AAMGA's 262 member managing general agents are located in all 50 states and are called upon to work with retail agents and their policyholder customers in all lines of insurance business. In 2007, they wrote in excess of $22.9 billion in annual written premium, or approximately 72% of the gross excess and surplus lines premium written in the non-admitted market. Our member agents employ over 10,000 employees in over 350 storefronts across America.

Thus, we see each day the challenges and opportunities that exist in this market, and are honored to have the privilege to share our views in support of the Committee's on-going efforts. We have reviewed the "Non-admitted and Reinsurance Reform Act (S. 929)" and wish to provide this Committee with our unwavering support of the legislation.

Prior to its introduction in the Senate, the AAMGA was privileged to have the opportunity to work with Representative Richard Baker (LA), Representative Dennis Moore, (KS), Representative Ginny Brown-Waite (FL) and the staff of the US House of Representatives Subcommittee on Capitol Markets, Insurance and Government Sponsored Enterprises in 2006, in drafting, facilitating and testifying on the need for reform and modernization of the excess and surplus lines insurance industry through the provisions of the companion Bills to S. 929, HR 1065 and, in 2007, HR 5637.

We were pleased to work in conjunction with our industry colleagues at the Independent Insurance Agents and Brokers of America; Council of Insurance Agents and Brokers, National Association of Professional and Surplus Lines Organizations; Reinsurance Association of America; Risk Insurance Management Society; the AAMGA member state stamping and surplus lines offices and other state-based and national trade associations in galvanizing a grassroots movement among members and the general public, resulting in unanimous passage of the respective Bills. S.929 is legislation on which there is consensus within the insurance industry and profession, and we respectfully urge this Committee to take action and secure its passage during this Congressional Session.

The AAMGA commends you Mr. Chairman, and this Committee, on the continuing focus to modernize commercial insurance markets and, thereby, implement procedures and regulations that will enhance uniformity and increase competition, while maintaining the surplus lines market's fundamental precept of freedom of rate and form to benefit and provide access for the private and commercial consumer to the secure protection of its risk exposures within the surplus lines and wholesale insurance marketplace.

The History of the Excess and Surplus Lines Insurance Market are Rooted in the Record and Success of an Emerging Democracy

The E&S insurance market traces its origins to the period following the war between the states after which insurers sought local and regional expertise of insurance agents and professionals to develop, market and provide access to secure capital and coverage to help rebuild the Nation's infrastructure. In essence, they became the *de facto* branch offices of the insurance companies.

Now, as then, the specialty needs of insurance consumers are best addressed by agents who are aligned with their customers by living and working in the same neighborhood, town, city, state or region as the policyholder, thereby understanding the customer's unique risk exposures. They share common experiences, priorities and motivations to jointly foster the success of an enterprise, the protection of and making whole the person or enterprise that has sustained a loss, and they are familiar with the distinctive issues impacting their customers and community.

During the country's industrial revolution, excess and surplus lines wholesale agents, and the insurance companies who have entrusted their underwriting pen to their agents in the field, continued working together to protect existing difficult, unique and high-risk entities. In addition, many new manufacturing, textile, iron-making, construction and public service companies began to emerge with new, untested technologies, production methods and inventions that, through development, provided positive social and institutional changes and access to new and innovative products and services unavailable from any other resource.

Again, then – as now – new enterprises offering these innovative solutions, products and services were hampered in securing insurance coverage due to the non-existence of a loss history and risk experience for conventional insurers to use in evaluating and calculating an appropriate premium based on prior losses and their own risk appetite.

The admitted insurance market has not been able to address all of the insurance needs of US consumers and industry. In many cases, the unusual exposure presented is beyond the scope of the admitted market underwriters' experience, in others the magnitude of the potential loss exceeds their capacity. As industry has grown, so to has the need for greater capacity and the ability of insurers to cover the new risks which are evolving.

Recognizing that excess and surplus/non-admitted domestic insurers and international ones, such as Lloyd's of London, are necessary when admitted insurers are unable to fill industry's insurance needs, state regulators have established special rules to permit the writing of insurance with non-admitted carriers under certain circumstances. The famed San Francisco earthquake in 1906, is an example of the surplus lines market again helping to rebuild a city following the impact of a catastrophic loss. Following that disaster, Lloyd's Underwriters cabled word to their US binding authority/coverholder agents to pay all valid claims.

Thus, throughout history, the excess and surplus lines marketplace has existed as a secure source of entrepreneurial capital – as well as a safety net or backstop to secure those risks which would otherwise run the added risk of not being insured at all – or to being inadequately secured given the unique indices of the risk and capital necessary to provide appropriate coverage.

Today, the expansion of commerce, the development of international trade, and need for consumer protection serve as the driving force to provide creative products and services to consumers and industry. They serve as another important factor underscoring the essential and important need to provide reform and modernization to the excess and surplus lines marketplace.

The Benefits Afforded by the Excess & Surplus Lines Insurance Market

As noted, into addition to providing a secure market for unique risks, the E&S market also often acts as a "safety valve" by providing coverage for hard to place risks, as well as those that would otherwise be unprotected, or where the amount of premium required to protect those risks would be unaffordable. In part, the benefits of this innovative market are that it:

- Accepts unfamiliar business risks
- Accepts coverage when the standard market declines the risk
- Develops and provides a stable market with new products and services to secure special/individual and program risk exposures
- Develops premium for risks without much historical data
- Provides the consumer with a competitive choice as compared to the involuntary, inflexible residual market
- Provides additional capacity
- Affords flexibility to tailor coverages to meet the needs of policyholders
- Quickly responds to needs of the market (e.g., as the standard insurance market companies exit a line of business or higher risk prone areas, excess and surplus line insurers and agents often are able to provide the coverage required. This includes instances where hurricanes or other natural or man-made occurrences make areas of our country, and the people who live and work in them, more prone to a higher frequency and/or severity of risk).

As the most recent study: 2007 Special Report: U.S. Surplus Lines – Market Review[1] conducted by A.M. Best on behalf of the NAPSLO Derek Hughes Foundation notes from its perspective of a trusted ratings agency:

[1] The AAMGA will be pleased to provide the Committee Members and staff with a complete copy of the 2007 edition of A.M. Best's Annual Report upon request.

- No financial impairments were reported in 2006 among surplus lines companies, which have outperformed the total property/casualty industry in this regard in recent years
- Surplus lines grew 173% among domestic professional carriers over the past five years, far faster than the total US Property/casualty market
- A.M. Best expects continued positive underwriting returns for surplus lines, driven by adequate and appropriate rates, disciplined underwriting and favorable prior-year loss-reserve development
- The Nonadmitted and Reinsurance Reform Act, pending in Congress remains a top legislative priority as the surplus lines industry seeks uniformity in the now fragmented system of regulation and taxation applied to the industry
- A.M. Best believes many of the loss ratio advantages of surplus lines insurers are achieved through their ability to set pricing and coverage terms [best suited to the needs of the consumer]; a high level of underwriting discipline and expertise; and increasingly effective risk management techniques
- Among other attributes, the most successful, well established surplus lines carriers have underwriting staffs with extensive experience writing these unique, distressed and high-capacity risks throughout different stages of the market cycle

All states and jurisdictions have promulgated surplus lines laws to protect the insurance consumer by controlling eligibility standards of surplus lines insurers and requiring specialty licensed brokers and agents to assist the consumer. These standards facilitate the open market, enhance competition, allow agents, brokers and insurers to be more responsive to consumer needs and provide the flexibility in the buying decisions being made.

The surplus lines market is essential to our nation's economic infrastructure. It provides protection and security to national industrial and local commercial businesses, those associated with operation of major public facilities like airports, schools, municipal utilities, and some of the largest port facilities in the country.

In the private sector, key commercial enterprises and consumers similarly rely on the surplus lines marketplace. These risks include, for example, those associated with electrical generation, oil production and refining, heavy construction, private aviation, ski resorts, trucking companies, restaurants and small businesses, aerospace manufacturing, mining, and agriculture, nursing homes and day care centers, large and small commercial and residential construction projects; maritime risks from jet skis to tanker vessels and every day risks from Main Street to Wall Street.

AAMGA managing general agent members include professional insurance facilities of varying size and multi-state operations to small and family businesses vital to maintaining the spirit of entrepreneurial growth in the insurance industry and our economy. Further, the AAMGA University is fully accredited by all 50 state insurance departments as a provider of insurance education and professional development to thousands of insurance professionals each year. This knowledge exchange and access to industry leaders is essential in complementing and fostering the ability of surplus lines professionals to stay ahead of the developments impacting the market, and to afford their customers the most innovative products and services available and, when they are not available, to design and implement a solution to best serve the needs of the consumer.

Perhaps one of the most immediate benefits of the surplus lines market, separate and apart from the trusted security provided, are the taxes paid on surplus lines transactions to the states. Over $38.7 billion in gross premium was written in 2006, with a resultant $1.3 billion in taxes paid to the states; an increase in over 11.5% in taxes paid compared to 2005.[2] Were these taxes not paid and collected, consumers would wind up paying more in property and other taxes for infrastructure, capital development and services by local and municipal governments.

A selection of surplus lines taxes collected in 2005 and 2006 shows the incremental benefit these transactions provide to state governments:

Surplus Lines Taxes Collected in Selected States[3]

State	Taxes Collected 2005	Taxes Collected 2006
CT	$13,174,352	$13,202,676
SD	$967,553	$877,189
RI	$2,153,822	$2,114,415
NY	$99,670,251	$94,396,410
IN	$10,239,536	$9,299,903
DE	$1,856,719	$1,391,112
NJ	$35,526,829	$36,871,781
HI	$10,948,720	$15,126,468
OH	$12,076,886	$27,419,179
PA	$23,420,000	$26,402,000
MT	$1,997,423	$1,604,037
AL	$26,744,760	$27,091,840
UT	$6,281,324	$6,901,722
CO	$15,340,834	1`5525724
WY	$1,215,809	$1,557,061
NE	$2,764,235	$2,892,931
KY	$5,144,899	$5,251,389
ID	$2,040,562	$2,097,486
NC	$25,842,686	$25,389,360
FL	$160,641,155	$205,739,594
TN	$11,314,281	$12,612,474
Total:	**$469,362,636**	**$518,239,027**

[2] Business Insurance, December 2007; Insurance Information Institute; A.M. Best Company, Inc., 2007 Special Report: U.S. Surplus Lines-Market Review.
[3] Business Insurance, December 2007

Current Issues Impacting the Non-admitted Market Provide a Disincentive <u>to Stimulate Creative Risk Products and Services</u>

While the premium growth of the surplus lines market now comprises 14.4%[4] of the gross written property and casualty premium in the United States, managing general agent, broker and company members of the AAMGA, as well as their customers and consumers, face increasing processing and compliance costs due to inefficiencies and inconsistent standards now existing in the various states. Agent members of the AAMGA report these overhead costs often cost into the hundreds of thousands of dollars depending upon the size of the agency.

For example, depending on rules of a home state and the nature of a multi-state risk, volumes of affidavits confirming the completion of a diligent search, the completion and filing of state tax payment forms and related materials are necessary to adhere to individual state requirements. A 50 state summary of the surplus lines taxes imposed on transactions is attached hereto as Exhibit A. In and of itself, this chart is additional credible evidence of the need for uniformity in the surplus lines market.

As S. 929 denotes, multi-state commercial risks written in the surplus lines market will no longer require agents to pay the state surplus lines taxes to the each state in which the proportionate share of the premium for that risk resides. Rather, the surplus liens tax will be paid in the Home State of the insured.

Further, for multi-state managing general agents, brokers and insurance companies, the various state licensing, continuing education requirements and non-reciprocal state regulations place added burdens and unnecessary costs on to the insurance transaction, without a commensurate increase in value to the consumer.

<u>Benefits of the Non-admitted and Reinsurance Reform Act</u>

Insurance is the DNA of capitalism and free market entrepreneurship. Providing the availability of varying levels of security from risk stimulates the growth of business and opportunities, provides incentives for research and development that help to create jobs and positive returns on investment and equity; and, for the public and private consumer, affords continuity and recovery from fortuitous events based on the terms and conditions of coverage.

Continued growth in per capita incomes, generated through on-going improvements in productivity is what drives improvements in living standards and the security of our homes and families. Faster growth will also provide additional resources to address domestic and foreign challenges. But all these can only be generated and succeed through the private sector. Thus, the pace at which the economy, private enterprise and consumers advance, depends heavily on the clarity, consistency, uniformity and application of rules and more incentives to stimulate competition, ideas, growth and service to the consumer and our infrastructure.

[4] <u>Id.</u>

As foreign competition and domestic requirements increase, radical innovation must be allowed to flourish, and not repressed by over-burdensome regulations. Opportunities in the advancement of unique insurance products and services will motivate faster growth, the development of new technologies and ways of doing things.

For all these reasons, the AAMGA greatly appreciates the efforts of Senators Martinez and Nelson in introducing the Non-admitted and Reinsurance Reform Act, and the efforts of this Committee in advancing its progress and prospective passage. Specifically, we believe the Bill and this Committee's other efforts on commercial insurance modernization will:

- enhance the speed to market of new and needed insurance products and services;
- stimulate open competition and the creation of innovative risk products specifically addressing or manuscripted to the needs of the consumer;
- establish and mandate a uniform, simple tax allocation formula and system for multi-state risks, making the payment of proportionate tax more equitable and efficient;
- allow for automatic export for exempt commercial purchasers – the sophisticated insurance buyers as defined in the Act – without the burdensome diligent search requirements, thus allowing the surplus lines marketplace to work more efficiently and specifically to the needs of the consumer, insurance companies, wholesale and retail agents and brokers;
- facilitate uniform and consistent compliance requirements for the surplus lines agents and brokers now that the insured's home state will have authority and regulatory primacy;
- encourage individual initiatives toward sustained growth to protect increased risk exposures;
- reducing regulatory burdens
- enhance operational efficiencies and certainty; and
- establish a uniform and consistent licensing system created by the national insurance producer database

Passage of S. 929 Will Also Benefit Consumers

This Committee has heard from several industry experts on the benefits the Non-admitted and Reinsurance Reform Act will provide to the industry. We must also examine the benefits it will afford to consumers and commercial buyers of surplus lines insurance. These include:

- allowing for further expansion of specialty market products and services to provide secure coverage in lines of business being demanded
- quicker access to security for all citizens as well as those who would otherwise be uninsured, or only partially protected in the event of a loss to their property and possessions

- increase the speed to market of new insurance products and services to keep pace with emerging risk exposures not adequately addressed by the standard insurance market
- eliminate the productivity pressures and overhead costs of compliance with outdated state regulations for insurance agents and brokers
- allow for a more equitable and efficient framework within which an insurance purchaser can work with their agent or broker of choice, without being forced to engage in time consuming and wasteful transactions in an inefficient network borne solely by the perceived need of multi-state compliance
- The Nonadmitted Insurance and Reinsurance Reform Act will also alleviate the burdens of duplicative licensing requirements by relying on the insured's Home State for licensing and encouraging states to participate in a national insurance producer database without diminishing the quality and expertise of the surplus lines insurance distribution channel.

Conclusion

Mr. Chairman, this Act is an important step in sustaining the non-admitted insurance market's effective, efficient and economical services to the public and private sector, while streamlining the processing, licensing and compliance components of insurance transactions. Most importantly, it will develop and create a uniform and consistent foundation on which essential state based regulation can continue without restraining the creativity, investment and security provided by the surplus lines market.

The AAMGA looks forward to working with you Mr. Chairman, Ranking Member Shelby, co-sponsoring Senators Martinez and Nelson, and our Pennsylvania representative on the Committee, Senator Casey and the other Members of the Committee to secure passage by Committee, adoption by the full Senate and approval by the President of the Non-admitted and Reinsurance Reform Act, to produce immediate commercial insurance reform, uniformity and modernization.

Thank you for the opportunity to provide the views of the American Association of Managing General Agents. We look forward to responding to any questions you or the Committee may have, and to providing additional information as may be desired.

Respectfully submitted,

Bernd G. Heinze
Executive Director

EXHIBIT A

Surplus Lines Premium Tax Allocation by State

State	Statute	Provision
Alabama	AL ST §27-10-31	(b) If a surplus lines policy covers risks or exposures only partially in this state, the tax so payable shall be computed on the portion of premium which is property allocable to the risks or exposures located in this state.
Alaska	AK ST §21.34.180	(c) If a surplus lines policy procured through a surplus lines broker covers risks or exposures only partially located or to be performed in this state, the tax payable shall be computed on the portions of the premium properly attributable to the risks or exposures located or to be performed in this state as follows: (1) if the risk insured is real or personal property, the percentage of the entire tax that is due to this state is the same as the percentage of the entire risk that is located in this state, computed on the same basis as was employed to calculate the insurable value of the risk; (2) if the risk insured is business operations, general liability, or employee benefits, the percentage of the entire tax that is due to this state is the same as the percentage of the insured business operations or employees that are located in this state.
Arizona	AZ ST §20-416	C. Except as provided in subsection D of this section, for the purpose of determining the surplus lines tax, the total premium charged for surplus lines insurance placed in a single transaction with one underwriter or group of underwriters, whether in one or more policies, shall be allocated to this state in the proportion as the total premium on the insured properties or operations in this state, computed on the exposure in this state on the basis of any single standard rating method in use in all states or countries where the insurance applies, bears to the total premium so computed in all the states or countries. D. The surplus lines tax on insurance on motor transit operations conducted between this and other states is payable on the total premium charged on all surplus lines insurance less the portion of the premium determined as provided in subsection C of this section charged for operations in other states taxing the premium of an insured maintaining its headquarters office in this state or the premium from operations outside of this state of an insured maintaining its headquarters office outside of this state and a branch office in this state.

Arkansas	AR ST §23-65-315	(b) If a surplus lines policy covers risks or exposures only partially in this state, the tax so payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
California	CA INS §1775.5	For the purpose of determining such tax, the total premium charged shall be allocated to this state in such proportion as the total premium on the insured properties or operations in this state, as computed on the exposure in this state on the basis of any single standard rating method in use in all states or countries where such insurance applies, bears to the total premium so computed in all states or countries in which such nonadmitted insurance may apply.
Colorado	CO ST§10-5-111	(2) If a surplus lines policy covers risks or exposures only partially in this state, the tax so payable shall be computed upon the proportion of the premium which is properly allocable to the risks or exposures located in this state.
Connecticut	CT ST §38a-277	(d) If a policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portions of the premium which are properly allocable to the risks or exposures located in this state.
Delaware	DE ST TI 18 §1917	(b) If a surplus lines policy covers risks or exposures only partially in this State, the tax so payable shall be computed upon the proportion of the premium which is properly allocable to the risks or exposures located in this State.
District of Columbia	DC ST §31-2502.40	(a) Each agent or broker so licensed shall pay to the Collector of Taxes, through the commissioner, on February 1st and August 1st of each year, a sum equal to 2 per centum of the amount of the gross premiums upon all kinds of policies procured by him during the immediately preceding 6 months' period ending December 31st and June 30th, respectively.
Florida	FL ST §626.932	If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
Georgia	GA ST 33-5-31	(b) If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state

Hawaii	HI ST §431:8-315	If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state
Idaho	ID ST 41-1229	If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state
Illinois	215 IL CS 5/445	A surplus line producer shall file with the Director on or before February 1 and August 1 of each year a report in the form prescribed by the Director on all surplus line insurance procured from unauthorized insurers during the preceding 6 month period ending December 31 or June 30 respectively, and on the filing of such report shall pay to the Director for the use and benefit of the State a sum equal to 3.5% of the gross premiums less returned premiums upon all surplus lines insurance procured or cancelled during the preceding 6 months.
Indiana	IN ST 27-1-15.8-4	Every surplus lines insurance agent so licensed under this section shall, on or before February 1 and August 1 of each year, collect from the insured and remit to the department for the use and benefit of the State of Indiana an amount equal to two and on-half percent (2 ½%) of all gross premiums upon all policies and contracts of any kind or kinds procured by such agent or broker under the provisions of this section during the preceding six (6) months period pending December 31 and June 30, respectively.
Iowa	IA ST §507A.9	2. If the policy covers risks or exposures only partly in the state, the tax payable shall be computed on the portions of the premium which are properly allocable to the risks or exposures located in the state. In determining the amount of premiums taxable in this state, all premiums written, procured, or received in this state and all premiums on policies negotiated in this state shall be deemed written on property or risks located or resident in this state, except such premiums as are properly allocated or appointed and reported as taxable premiums of any other state or states.

Kansas	KS ST §40-246c	Any individual placing a policy with an insurer not authorized to do business in this state on a risk domiciled in a state other than this state, but also covering a risk or location in Kansas, shall file with the commissioner a statement in the form prescribed by the commissioner, describing the risk and shall pay to the commissioner a sum equal to 6% of the portion of the premium applicable to the risk located in Kansas within 120 days after writing the risk.
Kentucky	KY ST§304.10-180	If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state
Louisiana	LA R.S. 22:1265	If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state. *(To be renumbered as LA ST §22: 438 effective 1/1/09)*
Maine	ME ST T. 24-A § 2016	If a surplus lines policy covers risks and exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
Maryland	MD INSURANCE §3-324	If a surplus lines policy covers risksonly partially in this state, the tax payable shall be computed on the part of the premium that is properly allocable to the risks located in this state.
Massachusetts	MA ST 175 §168	The Broker must, in January, file with the state treasurer a sworn statement of the gross premiums charged for insurance procured or placed and the gross return premiums on such insurance cancelled under such license during the year ending on December thirty-first last preceding, and at the time of filing such statement will pay to the commonwealth an amount equal to four percent of such gross premiums, less such return premiums so reported.
Michigan	MI ST 500.451	Any unauthorized insurer transacting insurance in this state shall be subject to a tax of 2% of premiums written in this state and to an additional regulatory fee of 0.5% on premiums written in this state. The tax requires by this section shall be considered delinquent if not paid within 30 days after a copy of the computation of the tax by the commissioner is delivered to the insurer in the manner prescribed by law for the service or process.

Minnesota	MN ST §2971.05	Subd. 7 (b) If the insurance covers a subject of insurance residing, located, or to be performed outside this state, for the purposes of this section, a proper pro rata portion of the entire premium payable for all of that insurance shall be allocated according to the subjects of insurance residing, located or to be performed in this state.
Mississippi	MS ST §83-5-61	Corporations not authorized to transact business in this state, shall file with the insurance commissioner of the state sworn statement or declaration, setting forth the name of the company, number of policy, amount of insurance rate, premium, and description, shall be required to pay to the insurance commissioner a tax thereon of three percent (3%) of the premiums paid on said policies, and shall further pay to said commissioner a fee of $1.00 on each policy for filing a record of the said statement or declaration, which record shall be kept for the private information of the insurance department and shall be kept for the private information of the insurance department and shall not be public record.
Missouri	MO ST 384.059	There is hereby imposed on surplus brokers for the privilege of doing the business of a surplus lines broker in this state a tax of five percent of the net premium received with respect to surplus lines insurance on risks located in this state.
Montana	MT ST §33-2-311	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
Nebraska	NE ST §44-5506	Every surplus lines licensee transacting business under the Surplus Lines Insurance Act shall annually, on or before February 15 in each year, make and file with the department a verified statement upon a form prescribed by the department which shall exhibit the true amount of all such business transacted during the year ending on December 31 next preceding the file thereof. The licensee shall, at the time such statement is filed, pay to the department a tax of three percent on the total gross amount of direct writing premiums received by the licensee on such business and the fire insurance tax prescribed in section 81-523.
Nevada	NV ST 685A.180	If a surplus lines policy covers risks or exposures only partially in this state, the tax so payable must be computed on the portion of the premium properly allocable to the risks or exposures located in this state.

New Hampshire	NH ST §406-B:11	II. If a policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portions of the premium which are properly allocable to the risks or exposures located in this state. In determining the amount of premiums taxable in this state, all premiums written, procured, or received in this state and all premiums on policies negotiated in this state shall be deemed written on property or risks located or resident in this state, except such premiums as are properly allocated or apportioned and reported as taxable premiums of any other state or states.
New Jersey	NJ ST §17:22-6.59	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
New Mexico	NM ST §59A-14-12	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
New York	NY INS §9102	In determining the amount of direct premiums taxable in this state, all such premiums written, procured, or received in this state shall be deemed written on property or risks located or resident in this state except such premiums properly allocated and reported as taxable premiums of any other state or states.
North Carolina	NC ST §58-21-85	Gross premiums charged, less any return premiums, for surplus lines insurance are subject to a premium receipts tax of five percent (5%), which shall be collected by the surplus lines licensee as specified by the Commissioner, in addition to the full amount of the gross premium charged by the insurer for the insurance.
North Dakota	ND ST 26. 1-44-06	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.

Ohio	OH ST §3905.36	Surplus lines insurer shall annually, on or before the thirty-first day of January, pay to the treasurer of the state a tax of five per cent of such premium, fee, assessment, dues, or other consideration, as calculated on a form prescribed by the treasurer of the state. This section does not apply to: Transactions in this state involving a policy solicited, written, and delivered outside this state covering only subjects of insurance not resident, located, or to be performed in this state at the time if issuance, provided such transactions are subsequent to the issuance of the policy.
Oklahoma	OK ST T. 36 §1115	The total premium charged for surplus lines insurance placed in a single transaction with one underwriter or group of underwriters, whether in one or more policies, shall be allocated to this state in such proportion as the total premium on the insured properties or operations in this state, computed on the exposure in this state on the basis of any single standard rating method in use in all states or countries where such insurance applies, bears to the total premium so computed in all such states or countries.
Oregon	OR ST §735.470	(1) The surplus lines licensee shall pay the Director of the Department of Consumer and Business Services an amount equal to the tax which would have been imposed under RS 731.816(1993 Edition) if that section were in effect and operative and the tax which is imposed by ORS 731.820, on authorized insurers for the premiums shown in the report required by ORS 735.465. The tax shall be collected by the surplus lines licensee as specified by the director, in addition to the full amount of the gross premium charged by the insurer for the insurance. The tax on any portion of the premium unearned at termination of insurance having been credited by the state to the licensee shall be returned to the policyholder directly by the surplus lines licensee or through the producing insurance producer, if any. The surplus lines licensee is prohibited from absorbing such tax and from rebating for any reason, any part of such tax. (2) The surplus lines tax is due quarterly on the 45th day following the calendar quarter in which the premium is collected. The tax shall be paid to and reported on forms prescribed by the director or upon the director's order paid to and reported on forms prescribed by the surplus lines association...(4) In applying ORS 731.816 (1993

		Edition) for purposes of this section, the rate shall be two percent rather than two and one-quarter percent.
Pennsylvania	PA ST Ti. 40 P.S. §991. 1621	In the event that a placement of insurance involves subjects of insurance resident, located or to be performed in one or more states other than this Commonwealth, than the premium taxes provided for in this section shall be levied only on that portion of the premium reasonably ascribable to that portion of the risk situated in this Commonwealth.
Puerto Rico	PRS ST T. 26 §1013	There is hereby imposed upon each surplus line coverage granted in Puerto Rico, or which covers risks, or residents, located or to be performed in Puerto Rico wherever it was negotiated, a tax equal to nine (9) percent of the total premium collected on account thereof, exclusive of tax. The broker shall be responsible for the collection and payment of the tax.
Rhode Island	RI ST §27-3-38.1	(a)(2) For the purposes of this subsection, properties, risks or exposures only partially located or to be performed in this state, which are covered under a multi-state policy placed by a surplus lines licensee in another state, shall be deemed to be insurance independently procured unless the insurer is licensed to do business in this state. (c) If an independently procured policy covers properties, risks or exposures only partially located or to be performed in this state, the tax payable by the insured shall be computed on the portion of the premium properly attributable to the properties, risks or exposures located or to be performed in this state.
South Carolina	SC ST §38-45-30	A non resident may be licensed as an insurance broker by the director or his designee if the following requirement, among others, is met: he must pay to the department, within thirty days after March thirty-first, June thirtieth, September thirtieth, and December thirty-first each year, a broker's premium tax of four percent upon the premiums approved for policies or insurers not licensed in this state.
South Dakota	SD ST 58-32-45	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.

Tennessee	TN ST §56-14-113	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state. In determining the amount of premiums taxable in this state, all premiums written, procured or received in this state and all premiums on policies negotiated in this state, except such premiums as are properly allocated or apportioned and reported as taxable premiums of any other state or states.
Texas	TX INS §225.004	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
Utah	UT ST §31A-3-303	If a policy covers risks that are only partially located in this state, for computation of tax under this part of the premium shall be reasonably allocated among the states on the basis of risk locations. However, all premiums with respect to surplus lines insurance received in this state are taxable in full under this part, subject to a credit for any tax actually paid in another state to the extent of a reasonable allocation on the basis of risk location.
Vermont	VT ST T. 8 §5036	If any such insurance also covers a subject located or to be performed outside this state, a proper pro rata portion of the entire premium shall be allocated to the subjects of insurance located or to be performed in this state.
Virginia	VA ST §38.2-4809	Each person licensed or required to be licensed under this chapter whose annual premium tax liability can reasonably be expected to exceed $1,500 shall file a quarterly tax report with the Commission. Such report shall be on a form prescribed by the Commission. This report shall be filed no later than thirty days after the end of each calendar quarter. Notwithstanding any provision to the contrary, each such person shall pay the premium tax owed for the direct gross premiums adjusted for the additional and returned premiums shown by each quarterly tax report when such report is filed with the Commission.
Virgin Islands	VI ST T. 22 §662	If a surplus lines policy covers risks or exposures only partially in this territory, the tax payable shall be computed on the pro portion of the premium which is properly allocable to the risks or exposures located in this territory.

Washington	WA ST §48.15.120	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the portion of the premium which is properly allocable to the risks or exposures located in this state.
West Virginia	WV ST §33-12C-7	(a) Where the insurance covers properties, risks or exposures located or to be performed both in and out of this state, the sum payable shall be computed on that portion of the gross premiums allocated to this state pursuant to subsection (g) of this section less the amount of gross premiums allocated to this state and return to the insured due to cancellation of the policy.
Wisconsin	WI ST 618.43	If a policy covers risks that are only partially located in this state, the premium shall be reasonably allocated among the states on the basis of risk locations in computing the tax, except that all premiums received in this state or charged on policies written or negotiated in this state shall be taxable in full under this section, with a credit for any tax actually paid in another state to the extent of a reasonable allocation on the basis of risk locations.
Wyoming	WY ST §26-11-118	If a surplus lines policy covers risks or exposures only partially in this state, the tax payable shall be computed on the proportion of the premium which is properly allocable to the risks or exposures located in this state.

SEAN MCGOVERN
Director & General Counsel [redacted]

The Honourable Christopher J. Dodd
Chairman
U.S. Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510
USA

6 August 2008

Dear Senator Dodd

On behalf of Lloyd's, I would like to thank you for the opportunity to submit the enclosed comments on the *State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure* for the Committee's July 29, 2008 hearing record.

We commend you for examining the current U.S. insurance regulatory structure and look forward to working with the Committee as you consider how the regulatory structure can best promote global competitiveness.

Yours sincerely

Sean McGovern

cc: Senator Richard C. Shelby, Ranking Member

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STATEMENT OF LLOYD'S OF LONDON

HEARING ON
"STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE"

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

JULY 29, 2008

We thank Chairman Dodd and Ranking Member Shelby for holding the Committee's July 29 hearing on the *State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure* and recognizing how that regulatory structure impacts global competitiveness. Given the regulatory cooperation that has been recently achieved among banking and securities regulators in Europe, the United States and the other more developed economies, it would be a pity if the United States failed to participate in similar efforts in the insurance and reinsurance sector which can only be strengthened domestically and globally by regulatory cooperation. In particular, we believe it is time for Congress to help move the United States—particularly in the business-to-business transactions of reinsurance and sophisticated "non-admitted transactions"—promptly toward a system of reciprocal or mutual supervisory recognition both among the States and with the well-regulated supervisory systems of major trading partners such as the United Kingdom.

Lloyd's is the world's leading specialist insurance and reinsurance market, with business coming from 200 countries and territories through 167 accredited brokers. As such, Lloyd's exemplifies the international nature of reinsurance business as the consummate global industry. It is currently the fifth largest provider of reinsurance capacity in the world and wrote $32 billion of insurance and reinsurance business globally in 2007. The United States remains Lloyd's largest market, accounting for $12.5 billion insurance and reinsurance premiums in 2007. Lloyd's reinsurance support has played a vital role in helping the United States recover from catastrophic events. The Lloyd's market paid $7.8 billion in claims following the September 11 attacks and $10.1 billion following the 2005 hurricanes. Lloyd's support of the U.S. goes back well over a century as evidenced by the role played by Lloyd's in helping San Francisco recover from the 1906 earthquake. In addition, eleven percent of Lloyd's outward reinsurance is purchased on a cross-border basis from U.S.-domiciled reinsurers. By comparison, the U.K.'s total share (including Lloyd's and other reinsurers) of reinsurance ceded from the U.S. market is only nine percent.

Lloyd's is also a strong supporter of the U.S. direct insurance market and is among the country's leading providers of surplus lines insurance. Lloyd's is also a licensed insurer in three U.S. jurisdictions (Illinois, Kentucky and the U.S. Virgin Islands).

We welcome the opportunity to provide further insight for the hearing record on the problems with the current regulatory system and how that system can be improved to interface more effectively with the global reinsurance marketplace.

Introduction

We focus our attention on the international aspects of reinsurance business as they impact the U.S. industry and those international reinsurers seeking to provide reinsurance capacity to the U.S. market. As such, there is no need for us to comment on the issue of whether the Federal Government should directly assume regulatory responsibility from the States for insurance generally. This raises complex questions particularly in relation to issues of consumer protection. It is, however, our position that for certain areas—reinsurance, surplus lines (and other sophisticated commercial lines)—a Federal mandate for uniformity and elimination of duplication is overdue. The current U.S. regulatory regime is out of line with international developments. This damages the ability of U.S. reinsurers to compete in the global market and limits the ability of the U.S. market to attract international reinsurance capacity.

Reinsurance is a business-to-business transaction which, like the capital markets, is global in nature. In order to best perform its function of spreading and absorbing risk, reinsurance business must operate on a cross-border basis with a minimum of barriers and a maximum reliance on supervisory cooperation. However, the United States' current multi-state regulatory system does not recognise the domiciliary financial regulation of even the most financially secure non-U.S. reinsurers. This approach to regulation results in duplicative and discriminatory regulation of non-U.S. reinsurers. It not only adds unnecessarily to the insurance costs of business and individual consumers alike, but also acts to restrict potential capacity at a time when U.S. policymakers are seeking better answers for the U.S. coastal windstorm market.

The discriminatory nature of the current U.S. credit-for-reinsurance system has also caused increasing regulatory tensions with the European Union (EU) and other major trading parties; in no small part because over the past eight years, many State insurance regulators, the National Association of Insurance Commissioners (NAIC) and various Federal officials have repeatedly acknowledged the need to reform this practice, but have made very little progress. (*See* EC/CEIOPS Letter to NAIC at Appendix A.) The absence of a Federal representative with the authority to negotiate on behalf of and bind the United States with respect to international agreements for insurance services has only compounded the problem. There is little doubt that being out of step on reinsurance supervisory best practices has contributed to the recent decline in the competitive position of the U.S. insurance and reinsurance sectors.

In view of these issues, the Federal Government has a strong and immediate interest in dealing with the current situation. This can be accomplished with a minimum disturbance of the federalism balance in the American system by use of a Federal mandate along the lines of the proposed the Insurance Information Act (H.R. 5840), the Reinsurance International Solvency Standards Evaluation Board Act of 2008 (H.R. 6213) and the Nonadmitted and Reinsurance Reform Act (S. 929/H.R. 1065). As explained in greater detail below, these proposals incorporate the principles of consumer protection, regulatory efficiency and competitiveness advanced by Chairman Dodd during the hearing.

Modernization of U.S. Reinsurance Regulation Is Overdue

The current regime in the U.S. is significantly out of line with international trends, as evidenced through the work of the International Association of Insurance Supervisors (IAIS), and the regulatory regimes of key jurisdictions around the world.

At present, non-U.S. reinsurers, often referred to in State insurance laws and regulations as "alien reinsurers," must post 100 percent collateral in the U.S. in respect of the reinsurance they provide to U.S. insurers in order for these U.S. cedents to receive balance sheet credit for the reinsurance. This is the case even if the non-U.S. reinsurer has a top credit rating, is financially strong, has a long track record of performance and is subject to robust regulation in its country of domicile. U.S.-based reinsurers, even if they are financially weaker, are subject to no such requirement.[1] The vast majority of U.S. reinsurance premiums that are ceded into the

[1] Put another way, State laws provide that U.S.-ceding insurers can take no credit whatsoever in solvency statements for reinsurance purchased from "alien" reinsurers, regardless of the reinsurers' financial strength, rating, claims payment record or the quality of their home-country regulatory regimes, unless the alien reinsurers provide acceptable collateral in an amount equal to 100 percent of their outstanding gross liabilities. By contrast, full credit

international market are to reinsurers domiciled in Germany, Switzerland, UK, France and Bermuda. These are the world's leading reinsurance markets and are well-regulated, with legal systems that protect the rights of contracting parties. State regulators in the United States, however, have been unwilling, to date, to give any recognition to the equivalent, or better, supervision which exists in these jurisdictions and instead require reinsurers domiciled in these jurisdictions to post 100 percent collateral.

The current U.S. reinsurance collateral requirements treat all U.S. licensed reinsurers as a safe haven. Moreover, they regard all non-U.S. reinsurers as absolute credit risks, i.e., they treat an AAA reinsurer the same as a B-rated reinsurer—by requiring 100 percent collateral. They treat a non-U.S. reinsurer which has operated in a major financial centre for decades the same as one established for one year in a lightly regulated offshore jurisdiction. The lack of prudential basis for this imbalanced system is demonstrated by the charts we submit in the attached PowerPoint document (Appendix B).[2]

The contrast between the U.S. system and regulation by trading partners is stark. No other major insurance jurisdiction (UK, Germany, Switzerland, Japan, or Bermuda) requires collateral from those providing reinsurance capacity to cedents in those jurisdictions. Put simply, if a U.K.-domiciled insurer buys reinsurance from a U.S.-domiciled reinsurer on a cross-border basis, that U.S. reinsurer faces no collateral or other duplicative regulatory requirements

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can be taken by U.S. cedents for their reinsurance transactions with U.S.-based reinsurers, whatever their rating and financial strength, merely on the basis of holding one or more State licenses.

[2] The major rating agencies have all noted that the current collateral system is inefficient. Fitch issued a report in February 2007 concluding that the proposed minimum collateral requirements under the draft NAIC Reinsurance Evaluation Office (REO) proposal adopted in December 2006 would "provide more than adequate default protection." In fact, Fitch estimated that under that REO proposal, there would still be excess collateral supporting non-life retrocessions of USD 62 billion.

in the UK. As mentioned above, U.S. reinsurers provide a greater percentage of Lloyd's outward reinsurance—free of mandated collateral requirements—than the U.K. provides to the U.S. market. The Financial Services Authority (FSA), the U.K. regulator, places the responsibility on the ceding insurer to assess and manage the counterparty credit risk arising from the reinsurance transaction and relies on the quality of the home state supervision of the U.S. reinsurer. It is important to note that the introduction of the EU Reinsurance Directive does not affect the ability of third country reinsurers and mixed insurers to do reinsurance business on this cross-border basis in the UK. As FSA Director & Sector Leader for Insurance, Sarah Wilson, recently clarified:

> Acceptability of cross-border reinsurance is a matter for individual member states' discretion. In the UK, there are no regulatory restrictions (except for prudent provisions in relation to concentration on individual reinsurers) on the provision of reinsurance cover to domestic insurers by reinsurers from the US, or indeed anywhere else. Overseas reinsurers are not required to be authorised here in order to provide reinsurance coverage to UK cedants. The implementation of the Reinsurance Directive has had no effect on our stance in this area, and we have no intention of changing our policy.

(*See* Letter from Sarah Wilson to John Oxendine, Georgia Insurance & Fire Safety Commissioner (Nov. 30, 2007), attached at Appendix C.)

For business–to-business transactions, such an approach is the appropriate model and both of these principles—cedent responsibility and reliance on home state supervision—are gaining increased recognition throughout the world through the work of the IAIS and the European Commission. The IAIS Reinsurance sub-Committee, chaired by Commissioner Stephen Goldman of New Jersey, has recently completed a draft of its 'Guidance Paper on the Mutual Recognition of Reinsurance Supervision'. The paper is a clear analysis of the forms supervisory recognition may take, and that these may recognise equivalence between regulators with acceptable allowances for local law and market custom. It studies the benefit this development brings to open markets in avoiding duplication of regulation. Above all, it notes that stand-alone regulation simply 'does not reflect the economic realities of the way in which many reinsurance businesses operate in practice'. The distribution of risks on the widest possible basis means that open access to global markets, freedom of contract and the ability to resource appropriately are all crucial to the strength of the global reinsurance industry.

With negotiations underway in the EU Parliament and Council of a new Solvency II regime, this issue of U.S. discriminatory collateral requirements is likely to receive a great deal of attention in Europe over the coming months. In addition, the EU and the U.S. have accepted the GATS Understanding in Financial Services. This Understanding includes a requirement that each signatory must permit non-resident suppliers of reinsurance and retrocession services to supply such services under national treatment terms and conditions. It is questionable how the discriminatory collateral requirements are compatible with the General Agreement on Trade in Services (GATS) Understanding.

It is in the interests of the U.S. and the EU (and other trading partners) that this issue is resolved. Notwithstanding the optional federal charter (OFC) debate underway in Washington D.C., the reinsurance collateral problem needs to be addressed in a shorter time-frame and can be addressed with modest federal involvement.

Need to Balance Prudential and Business Regulation in a Global Market

U.S. industry needs a more efficient regulatory structure in order to compete globally. It is the EU's experience that a streamlined supervisory system, based on convergence of regulatory rules, respect for home state supervision and a passport system, has served to avoid unnecessary prudential and financial duplication and to reduce trade barriers. This has enhanced competition in the internal market to the ultimate benefit of policyholders. We consider that a balance of prudential safety and soundness regulation and conduct of business regulation is essential in the smooth functioning of markets in financial services.

For all insurance firms operating across national borders within the EU, there is already a significant distinction drawn between prudential supervision and conduct of business regulation. For business across borders, dual responsibility exists—within agreed limits—between the "home state" (country of domicile) or "host state" (situs of insured or risk). In such instances, the insurer's country of domicile remains responsible for the prudential supervision of the insurer, taking into account the risks to a firm at a 'whole balance sheet' level.[3] The insurer is required to maintain assets in its home state only, avoiding the obligation to split its financial resources between many different countries.

Host states may require an insurer to comply with local conduct of business rules, although these must pass a requirement that they be "for the general good"; in other words, for the protection of consumers. Implementation of the regime in Europe has taken a proportionate approach to conduct of business regulation, working on the basis that commercial and reinsurance business does not need the same protection as consumer lines. Given the more equal bargaining relationship that exists between reinsurers/insurers and their commercial customers, legislators internationally have almost universally taken the view that there is no need for legislation to regulate their commercial relationships either through prescriptive conduct of business rules or through additional prudential requirements such as collateral requirements.

[3] EU legislation reserves certain items of legislation to the regulator in the firm's country of domicile. A list of these items as expressed by the FSA Handbook is attached at Appendix D.

This proportionate approach to business-to-business transactions has created a more competitive environment in the commercial and reinsurance markets. Backed by prudential home state regulation, commercial clients are freed from burdensome requirements, acting as a further encouragement to the development of a single market.

The EU Reinsurance Directive, implemented by Member States last year, follows a similar model. The advantage of this approach is that it streamlines regulation by avoiding competing regulatory oversight by different jurisdictions, focuses legislative attention and obligations on capital adequacy and solvency of the supervised insurer and reinsurer, and promotes competition throughout the EU, thereby giving customers greater choice of suppliers.

The NAIC Reinsurance Task Force (RTF) is currently working on a framework proposal to modernize the regulation of reinsurance. The RTF proposes establishing "single state" U.S. regulation of (1) "national reinsurers", who would be licensed in their home (U.S.) States, and (2) "port of entry" (POE) reinsurers certified by a POE State. Non-U.S. reinsurers would be eligible to become POE reinsurers only if they are domiciled in recognised non-U.S. jurisdictions. In other words, non-U.S. reinsurers would remain subject to duplicative supervision since they would be subject to the supervision of their domiciliary jurisdictions as well as the oversight of a U.S. POE State.

Under the proposed framework, a newly created Reinsurance Supervision Review Department (RSRD) within the NAIC would establish principles for recognizing the supervision of non-U.S. jurisdictions and eligibility criteria and uniform standards for home States and POE States.[4] The RSRD would also maintain a list of non-U.S. jurisdictions eligible for recognition

[4] *See* NAIC, *NAIC Reinsurance Supervision Review Department: Draft proposal to Grant Recognition of Regulatory Equivalence to Non-U.S. Insurance Supervisors* 3 (Sept. 7, 2007). *See also* Memorandum from Bryan

by POE States and develop sample agreements and protocols for supervisory recognition. However, the NAIC and the States lack constitutional authority to negotiate international agreements for such recognition.

Although the RTF's proposal would attempt to distinguish between financially strong and weak reinsurers, it would not eliminate collateral requirements for strong, well-regulated non-U.S reinsurers. POE regulators would evaluate financial strength and operating integrity and assign ratings to reinsurers—based on recognised statistical rating organisation ratings and NAIC expertise—that would be reviewed periodically by the POE State. Applicable collateral requirements would vary based on a reinsurer's rating.

While we certainly recognise the strength of the U.S. insurance regulatory system, we also recognise that regulatory systems in certain other jurisdictions are equally strong. It is not justified to impose collateral requirements that differ from those for U.S. reinsurers on strong reinsurers domiciled in those jurisdictions. This is particularly true where the RSRD has judged those jurisdictions to impose effectively equivalent regulation to that in the U.S. We continue to believe that the framework should treat a strong well-regulated non-U.S. reinsurer the same as its equivalent in the U.S. Whilst the approach taken is aligned with some aspects of the regime used in Europe, it falls short in making best use of passporting across borders or in recognizing equivalent regulators in non-U.S. jurisdictions. Both of these elements are necessary to the ultimate goal for the regulation of the global reinsurance industry: full multi-national recognition of qualified reinsurers regardless of their domicile.

Fuller, NAIC Senior Reinsurance Manager, to Reinsurance (E) Task Force Members, Interested Regulators and Interested Parties (July 3, 2008).

It is clear that some of the most significant challenges to the NAIC's proposal come in the field of implementation. Unless the Federal Government mandates a consistent approach throughout the country's credit for reinsurance system, the proposal will have little practical value to reinsurers, cedents or policyholders. Under current State-based regulation and even if certain State-based initiatives are adopted, each State applies its credit for reinsurance rules to all ceding insurers domiciled in that State. A number of States also assert a prerogative to impose their own credit for reinsurance rules on the financial solvency statements of any ceding insurer licensed to do business in the State, not just domestic insurers. Although the RTF proposes that host States be required to grant credit for reinsurance ceded by their domiciliary insurers to national or POE reinsurers, the NAIC has no authority to require that all States participate in the proposed regulatory scheme or to preempt the credit for reinsurance laws of States with differing requirements.

Near-Term Solution Needed

Redress of the challenges presented by the United States' current multi-state regulatory system almost certainly requires some immediate action by the Federal Government. It is not for Lloyd's to suggest a Federalisation of insurance or even reinsurance regulation. We are mindful of the debate that is underway over various OFC proposals. Certainly, each of the two OFC bills that have been introduced in the current Congress contain subtitles which appear to provide for the accreditation of reinsurers based outside of the United States on a cross-border basis and on relatively fair, non-discriminatory terms.

However, given the years that most informed commentators estimate will be required before any OFC proposals come to fruition in the United States, Lloyd's believes that Congress should focus on a nearer-term solution to the reinsurance problem.

The NAIC is currently working on proposals to modernize the regulation of reinsurance regulation. The proposed RTF approach does not follow international trends but, if adopted, would be a significant improvement on the status quo. Implementation of any NAIC agreed proposal remains a significant stumbling block to near-term action. Based on experience, it would almost certainly be many years before any final RTF recommendation for improvement of credit for reinsurance was adopted by a majority of State legislatures; and history suggests that even then uniformity among the States could still prove elusive. Given the extraterritorial application that States currently assert in this field, there could be no practical improvement to reinsurance supervision or accreditation until all or nearly all of the States adopt the same reform.

Necessary reforms should not and need not be postponed until the broader OFC debate is resolved. States have an important role to play especially in respect of business close to consumers, such as personal lines. State regulators might also continue to function as appropriate financial supervisors of insurers, so long as duplication and lack of uniformity are eliminated from the system. Where it seems most appropriate for the Federal Government to prioritise mandating uniformity and the elimination of duplication is in the field of business-to-business risk transfer, such as reinsurance and surplus lines transactions for sophisticated customers.

The proposed Reinsurance International Solvency Standards Evaluation Board Act of 2008 (H.R. 6213) and the Nonadmitted and Reinsurance Reform Act (S. 929/H.R. 1065) are consistent with this approach toward uniformity. Both are useful models of how a fair, geographically agnostic, and uniform system of reinsurance regulation could be achieved by State regulators through the use of a Congressional mandate.[5] Both of those issue-specific proposals would, however, be immeasurably aided by creation of a Federal Office of Insurance Information (OII), such as that proposed by the Insurance Information Act of 2008, H.R. 5840. Such an office would not become a regulator, and would not displace the States' regulators, but could help to resolve issues of consistency and, equally important, provide an authoritative U.S. counterparty for international supervisory negotiations.

These proposals appropriately incorporate the reform principles advanced by Chairman Dodd during the Committee's hearing: (i) consumer protection, (ii) regulatory efficiency and (iii) competitiveness. The OII, RISSEB and NRRA proposals would establish a more streamlined reinsurance regulatory structure based on recognition of equivalent prudential supervision of global reinsurers and preservation of host state conduct of business regulation and strengthened by the establishment of federal insurance expertise in the OII. This structure would not compromise the United States' history of strong, State-based consumer protection. Moreover, eliminating duplicative and discriminatory regulation of non-US reinsurers and extra-territorial regulation of reinsurance would not only result in regulatory efficiencies in the U.S., but would also enhance U.S. insurers' and reinsurers' ability to compete in the global insurance marketplace.

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[5] These proposals are also consistent with the approaches proposed under the National Association of Registered Agents and Brokers Act (H.R. 5611) and the Increasing Insurance Coverage Options for Consumers Act of 2008 (H.R. 5792) which have attracted widespread support in the House.

Insurance Information Act

Ensuring that American markets and their regulation interface smoothly with the increasingly globalised reinsurance market is a key Federal interest. Certainly facilitating appropriate regulatory cooperation with supervisors in other countries, especially major trading partners in the EU and Asia, is of great importance if U.S. markets are to remain competitive. The proposed Insurance Information Act would facilitate such cooperation and help strengthen the global competitiveness of the U.S. insurance industry.

The Bill would provide for the development of insurance expertise within a newly created Office of Insurance Information (OII). The OII's expertise would inform the negotiation of international agreements for insurance services. The advisory role of the OII with respect to the negotiation of such agreements, combined with a preemption mechanism for State insurance laws that are inconsistent with such agreements, would enable the U.S. regulatory system to interface more effectively with the global reinsurance marketplace.

However, the proposal pending in the House should be amended to define clearly the scope of the agreements that would give rise to preemption, including the entities with authority to negotiate such agreements. Clarifying the scope of the agreements would ensure clear delineation of domiciliary regulation (i.e., prudential regulation) and host State regulation (i.e., conduct of business regulation).

Current provisions that would allow the Treasury Secretary to stay preemption should also be modified as they ignore the distinction between prudential supervision and conduct of business regulation. This threatens to undermine the effectiveness of the bill with respect to promoting competition in the global market. Preserving the stay mechanism would effectively give the United States an escape clause with respect to international insurance agreements and diminish its bargaining power with foreign governments, authorities or regulators.

Reinsurance International Solvency Standards Evaluation Board Act

We also view the proposed Reinsurance International Solvency Standards Evaluation Board (RISSEB) Act as an effective complement to the OII bill. The RISSEB would consist of individuals with "demonstrated expertise in reinsurance matters", including members with regulatory backgrounds. The RISSEB would be responsible for evaluating the reinsurance supervisory systems of both U.S. States and non-U.S. jurisdictions to determine which jurisdictions provide an acceptable level of prudential supervision for their domiciled reinsurers. The measure would preempt State credit for reinsurance requirements that treat reinsurers in good standing that are supervised by certified jurisdictions differently from domestic reinsurers. The RISSEB would also propose uniform standards to appropriate state and federal entities to improve reinsurance regulation where new standards or conflicts of law have emerged. This proposal could be appropriately incorporated into the OII bill as either additional OII functions or a separate Advisory Board or entity within the Treasury.

This structure would provide a vehicle for U.S. regulatory dialogue and cooperation with, e.g., the EU and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) under the forthcoming Solvency II regime.

Nonadmitted and Reinsurance Reform Act (NRRA)

The broader cost/benefit analysis of U.S. State-based regulation as a whole is beyond our capacity. As explained above, we do not address whether reinsurance supervision should be performed primarily at the State or Federal level. What is clear, however, is that the inconsistency and duplication of effort that arises in the current State regulatory approach to reinsurance supervision—and surplus lines regulation—imposes significant costs on both reinsurers and cedents with no ultimate compensating benefits. The NRRA represents the "minimum" path forward in addressing these problems.

Two examples illustrate the point:

- First, the costs of maintaining collateral, either through letters of credit or deposit of cash or securities, runs at least 100 basis points per year of the face amount of the obligations collateralized. Given the evidence from the ratings agencies (*see* Attachment B, Slide 10) that the collateral amounts from non-U.S. reinsurers will, even under NAIC "reform" proposals, exceed the reasonably estimated default risk by at least USD 50-60 billion, the costs are at least USD 500-600 million annually. No doubt this raises the cost of insurance in the United States without conferring any security improvement.

- Second, significant costs are incurred in complying with preparing and filing quarterly reports and other accreditation materials which must be filed with all or most of the 50-plus jurisdictions in order to maintain accredited status for the benefit of ceding insurers with national or multi-state operations. There are also additional costs in complying with other state-by-state variations found in the credit for reinsurance laws. For example, mandatory contract terms such as offset clauses, termination provisions and dispute resolution clauses become particularly problematic when applied extra-territorially to cedent-reinsurer contract relationships that involve risks in many states. A single State of domiciliary supervision (for domestic reinsurers) and a single port of entry (for non-U.S. based reinsurers) could be such for prudential financial regulation of reinsurers.

Congressional action is necessary to establish this principle and to ensure that no jurisdiction other than the domiciliary State (or port of entry) may interfere with that financial supervision. Greater consistency (or better yet, deference to home States) would certainly reduce friction costs on the economy. The NRRA, which has already been passed by the House, would establish such deference for both surplus lines and reinsurance regulation.

With respect to surplus lines regulation, the NRRA would streamline regulation of the surplus lines market by establishing the home State of the insured as the sole point of regulation for multi-state surplus lines transactions. The Bill would similarly eliminate duplicative and extra-territorial regulation in the reinsurance field. However, as the Reinsurance Association of America's testimony suggested, the Bill's reforms in the reinsurance area are incomplete and would benefit from the concurrent enactment of the OII proposal.

Conclusion

Lloyd's urges the Committee to put its support behind immediate action on reinsurance regulatory reform, whatever position it may ultimately take with respect to the longer term scheme of insurance regulation. The proposed Insurance Information Act, the Reinsurance International Solvency Standards Evaluation Board Act and the Nonadmitted and Reinsurance Reform Act represent appropriate near-term measures for the Committee's consideration and action. As explained above, these proposals are consistent with the principles of consumer protection, regulatory efficiency and competitiveness articulated by Chairman Dodd during the hearing.

Again, we commend the Committee on its attention to and leadership on this issue and thank you for the opportunity to submit comments for the hearing record. We stand ready to assist the Committee in its ongoing efforts.

APPENDICES

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Appendix A

European Commission
Committee of European Insurance and Occupational
Pensions Supervisors (CEIOPS)
Letter to NAIC

EUROPEAN COMMISSION
Internal Market and Services DG

Director-General

Brussels, 21.09.07 3716
MARKT/H2/BC/cl D(2007)13305
ED/10.020/0007.01

Mr John W. Oxendine
NAIC Reinsurance Task Force
Chairman
Office of Commissioner of Insurance
2 Martin Luther King, Jr. Drive
Suite 704, West Tower
USA-Atlanta, Georgia 30334
United States of America

Subject: NAIC Draft Reinsurance Collateral Proposals – 7 September 2007

Dear Commissioner Oxendine,

The European Commission and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) have engaged seriously with the Reinsurance Task Force and with the NAIC more broadly over the last few years in order to try to find a mutually acceptable solution to the reinsurance collateral issue.

Under the Reinsurance Task Force's latest proposals, which were published on the 7th September, a US Reinsurer rated BBB- would be required to post no collateral under the new proposals, whereas an EU Reinsurer rated AAA, and subject to regulation in its home jurisdiction judged to be equivalent to that applied in the US, would be required to post 60% collateral. This is surprising, as it is not in line with the original charge given to the Reinsurance Task Force, which requires "approaches that account for a reinsurer's financial strength regardless of domicile – i.e. state or country" to be considered.

The European Commission and CEIOPS are extremely disappointed that the Reinsurance Task Force appears to have back-tracked on this issue over the last few months. As you well know, the treatment of credit for reinsurance in the US is a matter of great importance to the European Commission, European insurance supervisors and the European insurance industry and with the introduction of the EU Reinsurance Directive looming and Solvency II negotiations in Parliament and Council underway this issue is likely to receive a lot of attention over the coming months.

Given the international nature of reinsurance business and the importance that geographical spread and diversification of risks play in sound reinsurance risk management, the European Commission and CEIOPS strongly believe a system based on mutual recognition and equivalence is more appropriate for today's international reinsurance markets than a system based on requirements to post collateral. Article 50 of the EU Reinsurance Directive 2005/68/EC provides for the conclusion of such mutual recognition agreements with third countries. The proposal put forward by the Reinsurance Task Force is currently incompatible with such an approach as it not only tests for equivalence, but also involves the imposition of collateral requirements, which differ depending on the domicile of the reinsurer. We would therefore strongly urge the Task Force to revise this draft proposal, and in particular to remove the discriminatory elements contained within it.

If the NAIC's review of its credit for reinsurance rules does not result in the introduction of a non-discriminatory system, the European Commission will be forced to explore other routes to ensure that EU reinsurers receive a fair treatment.

Yours sincerely,

Jörgen HOLMQUIST

Director-General
Internal Market and Services DG

Thomas STEFFEN

Chairman
CEIOPS

Contact:
Ben Carr, Telephone: +32 (02) 295 97 60, Benedict.Carr@ec.europa.eu

cc: Mr Bryan Fuller

Appendix B

Financial Data

DEWEY & LEBOEUF

Submitted to United States Department of the Treasury
November 21, 2007

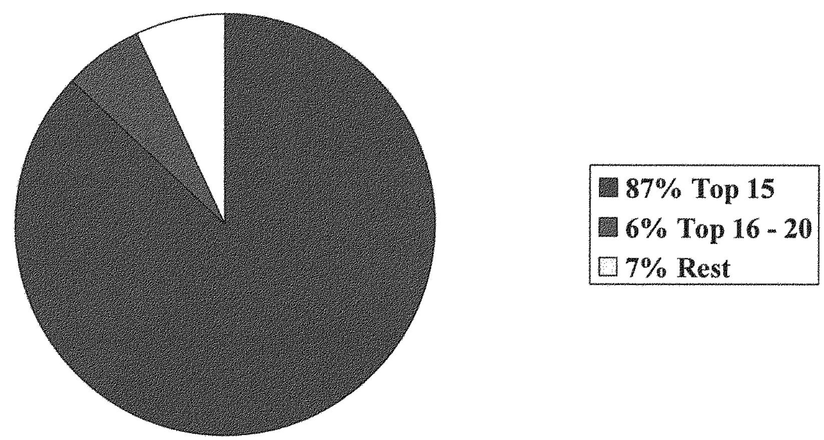
Financial Data Concerning States' Requirement of Reinsurance Collateral for Non-U.S.Based Reinsurers

On behalf of :

Lloyd's of London and Hannover Re

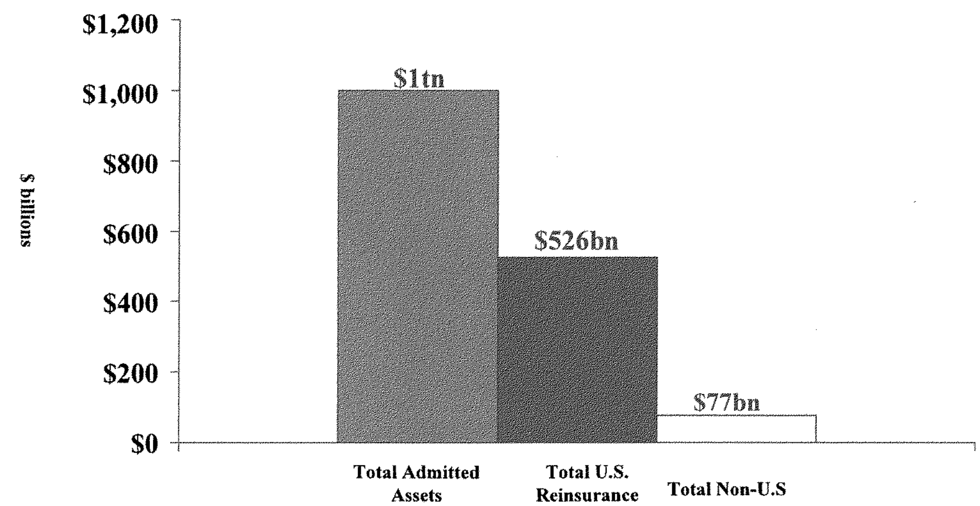
L. Charles Landgraf
Tel. 202-986-8067
Email: landgraf@dl.com

Reinsurance Recoverables Concentrated in High Quality Reinsurers



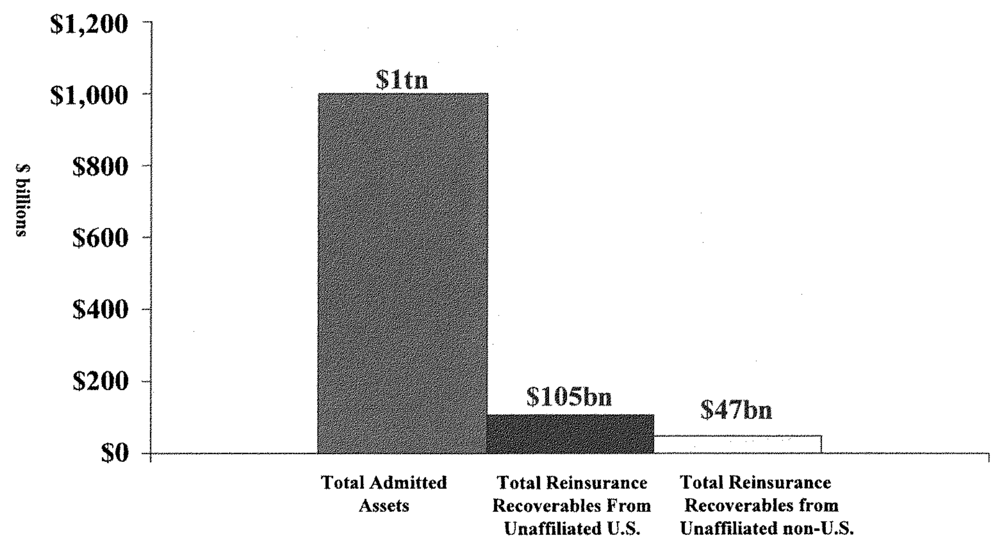
Dewey & LeBoeuf   Source: Swiss Re, sigma No. 5/2003

Total Reinsurance Credit Exposure for U.S. P/C Industry



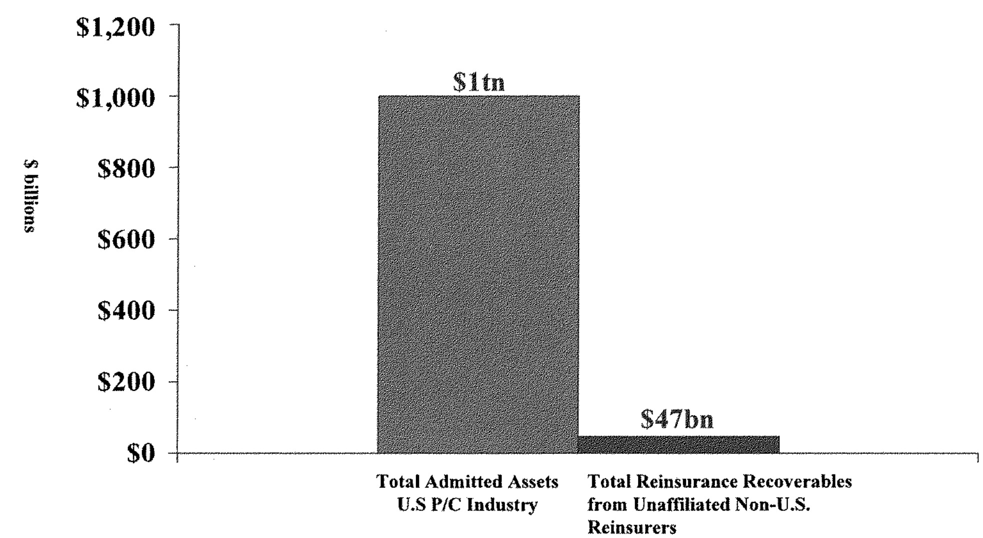
Source: Best's Aggregate & Averages – Property/Casualty, United States and Canada 2003 Edition and 2003 Supplement

Non-affiliated Reinsurance Credit Exposure of U.S. P/C Industry



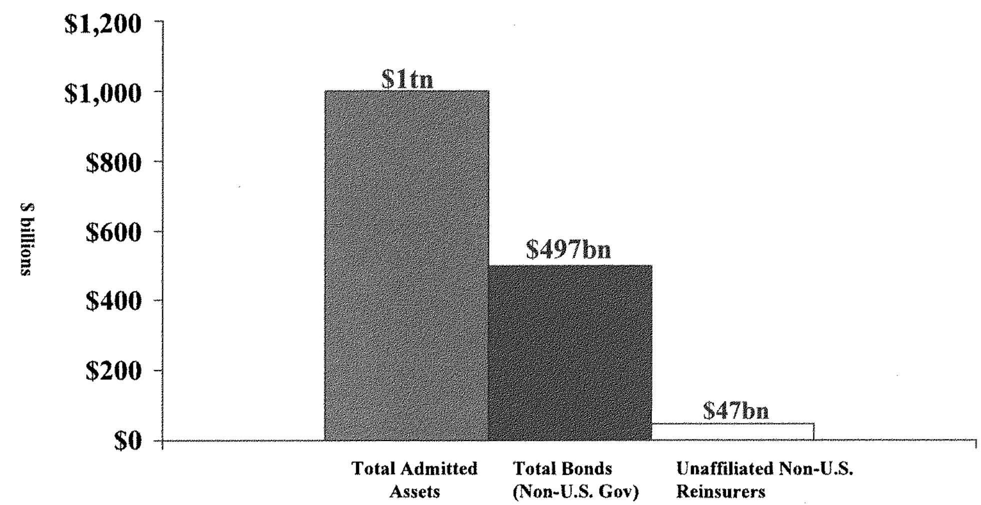
Source: Best's Aggregate & Averages – Property/Casualty, United States and Canada 2003 Edition and 2003 Supplement

Non-affiliated alien reinsurance = 4.7% of Total Admitted Assets



Source: Best's Aggregate & Averages – Property/Casualty, United States and Canada 2003 Edition and 2003 Supplement

Relative Credit Exposure to non-U.S. Reinsurers



Source: Best's Aggregate & Averages – Property/Casualty, United States and Canada 2003 Edition and 2003 Supplement

Current U.S. Credit for Reinsurance Rules

- If it is U.S., it is 100% safe
- If it is non-U.S., it is 100% unsafe
- Neither statement is correct
  - Many of the oldest, largest, strongest reinsurers are non-U.S.
  - U.S. P/C insolvencies: 2001 = 24, 2002 = 28, 2003 = 20

It is time to Modernize

- The current system is out of date and out of step with all major insurance markets.
  - The reinsurance markets of London, Germany, Bermuda, Japan, to name a few, have operated **WITHOUT ANY COLLATERAL**. They have not had collection problems.
  - U.S. insurers are not particularly vulnerable.
- The current rules ignore the actual reinsurance credit risk of U.S. insurers.
  - AAA reinsurers treated the same as B reinsurers.

continued →

It is time to Modernize

  - A reinsurer in existence for 150 years, domiciled in a major financial capital (London, Zurich, Tokyo, Paris) treated the same at a reinsurer formed last December and domiciled in a sunny offshore island.
- Reinsurance collateral imposes substantial costs on the industry. Where not needed, it should be eliminated.
- Reinsurance collateral promotes "unsafe reinsurance practices".
  - False sense of security.
  - Failure to assess real market risks.

continued →

It is time to Modernize

- "In an open market that values financial strength, the least reliable reinsurers would be shunned by security-minded ceding companies and eventually driven out of business.

  ....

  In the long term however, the outcome [if the collateral rules were changed] would be better risk-based reinsurance placement, a stronger global reinsurance market, and reduced insolvency risk."

"Collateralization: Curse or Cure?" Standard & Poors Research Note August 10, 2003.

Impact of NAIC Collateral Requirements

"Fitch estimates that in the life and non-life sectors, the [recent NAIC] proposal's minimum collateral requirements **exceed anticipated defaults by roughly USD 52 billion and USD 62 billion respectively**."

(See "Impact of Proposed Changes in Collateral Requirements", Fitch Ratings February 27, 2007.)

Appendix C

Financial Services Authority (FSA) Letter to Georgia Insurance & Fire Safety Commissioner

Financial Services Authority

From Sarah Wilson
Director / Sector Leader for Insurance

Direct line: 020 7066 9342
Local fax: 020 7066 9343
Email: sarah.wilson@fsa.gov.uk

The Hon John Oxendine, Esq
Georgia Insurance & Fire Safety Commissioner
Two Martin Luther King, Jr Drive
West Tower, Suite 704
ATLANTA GA 30334
UNITED STATES OF AMERICA

30 November 2007

Our Ref: SAW0120/DJ

Your Ref:

Dear Commissioner Oxendine

NAIC Reinsurance Task Force

I am writing to respond formally to the Framework Memorandum developed by the Reinsurance Task Force following its meeting in Atlanta earlier this month. This letter is intended to complement the communication dated 21 September 2007 from the European Commission and CEIOPS.

As you know, we have been engaged in a dialogue with you for a number of years now on this topic, and any progress in this area is a welcome development. We are, however, conscious that the proposal as it stands does not address a number of areas of significant detail, many of which are crucial to a satisfactory resolution of the issue.

We remain of the view that, as a matter of principle, no regulatory purpose is served by the blanket application of collateral requirements to reinsurers, irrespective of their country of domicile. The collateral rules as presently applied militate against the efficient allocation of capital by the reinsurance industry. Reinsurance contracts are by definition business-to-business transactions, in which there can be no justification for regulatory intervention favouring one group of cedants over another. As we have said repeatedly, we believe that the best regulatory approach is to place the onus on senior managers of insurers to manage their credit risk properly, an approach which aligns commercial and regulatory objectives.

When the Reinsurance Supervisory Review Department (RSRD) proposals were presented in September, we were disappointed to see that the underlying discrimination between domestic and 'alien' reinsurers was to remain, and we urge the Task Force to reconsider this position during its deliberations in 2008.

We do, however, welcome the 'port of entry' concept as a useful simplification of the current regime, and look forward to further discussions with you to establish how the details of this concept will work in practice, with particular interest in the interface between the port of entry supervisor and the reinsurer's home state regulator. We regard this as an ideal opportunity to put into place a genuine system of mutual recognition, as envisaged in the ongoing discussions within the IAIS, although we do not see a port of entry supervisor as a necessary pre-requisite for the provision of services on a cross-border basis.

Whilst writing, I thought it would be useful to reiterate the comments made by my colleague David Johnston at the Task Force's recent meeting in Atlanta, particularly those in relation to the provision of cross-border services by non-EEA reinsurers. In your recent letter to the *Financial Times* you pointed out that there is no Europe-wide framework in the Directives in relation to the provision of cross border services by non-EEA reinsurers, and then drew inference that this was not possible at all. This is not in fact true. Acceptability of cross-border reinsurance is a matter for individual member states' discretion. In the UK, there are no regulatory restrictions (except for prudent provisions in relation to concentration on individual reinsurers) on the provision of reinsurance cover to domestic insurers by reinsurers from the US, or indeed anywhere else. Overseas reinsurers are not required to be authorised here in order to provide reinsurance coverage to UK cedants. The implementation of the Reinsurance Directive has had no effect on our stance in this area, and we have no intention of changing our policy.

I hope that this clarifies our position in this area. If you have any further questions about this or any other aspect of our supervision of reinsurance, please feel free to contact me.

Yours sincerely

P.P. **Sarah Wilson**
Director & Sector Leader for Insurance

cc: The Hon Steven M Goldman, Esq
New Jersey Commissioner of Banking & Insurance
20 West State Street
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TRENTON NJ 08625
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National Association of Insurance Commissioners
2301 McGee Street
Suite 800
KANSAS CITY MO 64108-2662
UNITED STATES OF AMERICA

Appendix D

FSA Handbook: Matters Reserved for Home State Regulator

Chapter 13A

Qualifying for authorisation under the Act

FSA

Matters reserved to a Home State regulator

Introduction

1. The application of certain provisions in the *Handbook* to an *incoming EEA firm* or *incoming Treaty firm* depends on whether responsibility for the matter in question is reserved to the *firm's Home State regulator*. This annex contains *guidance* designed to assist such *firms* in understanding the application of those provisions. This annex is not concerned with the *FSA's* rights to take enforcement action against an *incoming EEA firm* or an *incoming Treaty firm*, which are covered in the Enforcement Guide (*EG*), or with the position of a *firm* with a *top-up permission*.

Requirements in the interest of the general good

2. The *Single Market Directives*, and the *Treaty* (as interpreted by the European Court of Justice) adopt broadly similar approaches to reserving responsibility to the *Home State regulator*. To summarise, the *FSA*, as *Host State regulator*, is entitled to impose requirements with respect to activities carried on within the *United Kingdom* if these can be justified in the interests of the "general good" and are imposed in a non-discriminatory way. This general proposition is subject to the following in relation to activities passported under the *Single Market Directives*:

    (1) the *Single Market Directives* expressly reserve responsibility for the prudential supervision of a *MiFID investment firm*, *BCD credit institution*, *UCITS management company* or passporting *insurance undertaking* to the *Firm's Home State regulator*. The *Insurance Mediation Directive* reaches the same position without expressly referring to the concept of prudential supervision. Accordingly, the *FSA*, as *Host State regulator*, is entitled to regulate only the conduct of the firm's business within the *United Kingdom*;

    (2) there is no "general good" provision in *MiFID*. Rather, *MiFID* states exactly what the *Host State regulator* regulates (see paragraphs 8 - 10);

    (3) for a *BCD credit institution*, the *FSA*, as *Host State regulator*, is jointly responsible with the *Home State regulator* under article 41 of the *Banking Consolidation Directive* for supervision of the liquidity of a *branch* in the *United Kingdom*;

    (4) for a *MiFID investment firm* including a *BCD credit institution* which is a *MiFID investment firm*), the protection of *clients'* money and *clients'* assets is reserved to the *Home State regulator* under *MiFID*; and

    (5) responsibility for participation in compensation schemes for *BCD credit institutions* and *MiFID investment firm* is reserved in most cases to the *Home State regulator* under the *Deposit Guarantee Directive* and the *Investor Compensation Directive*.

3. It is necessary to refer to the case law of the European Court of Justice to interpret the concept of the "general good". To summarise, to satisfy the general good test, *Host State* rules must come within a field which has not been harmonised at a Community level, satisfy the general requirements that they pursue an objective of the general good, be non-discriminatory, be objectively necessary, be proportionate to the objective pursued and not already be safeguarded by rules to which the *firm* is subject in its *Home State*.

Application of SYSC 2 and SYSC 3

4. SYSC 2 and SYSC 3 do not apply to a *UK MiFID investment firm*. They only apply to an *EEA MiFID investment firm* on a limited basis. This is explained more fully in PERG 13.7 Q. 70 (systems and controls). See paragraph 8 below for a discussion of how the *common platform requirements* apply to an *EEA MiFID investment firm*. The *FSA* considers that it is entitled, in the interests of the general good, to impose the requirements in SYSC 2.1.3 R to SYSC 2.2.3 G (in relation to the allocation of the function in SYSC 2.1.3 R (2)) and SYSC 3 on an *incoming*

EEA firm and an *incoming Treaty firm*; but only in so far as they relate to those categories of matter responsibility for which is not reserved to the *firm's Home State regulator*.

5. Should the *FSA* become aware of anything relating to an *incoming EEA firm* or *incoming Treaty firm* (whether or not relevant to a matter for which responsibility is reserved to the *Home State regulator*), the *FSA* may disclose it to the *Home State regulator* in accordance with any applicable directive and the applicable restrictions in Part XXIII of the Act (Public Record, Disclosure of Information and Co-operation).

6. This Annex represents the *FSA's* views, but a *firm* is also advised to consult the relevant European Community instrument and, where necessary, seek legal advice. The views of the European Commission in the banking and insurance sectors are contained in two Commission Interpretative Communications (Nos. 97/C209/04 and C(1999)5046).

7. Examples of how the *FSA* considers that SYSC 3 will apply in practice to an *incoming EEA firm* are as follows:

(1) The Prudential Standards part of the *Handbook* (with the exception of INSPRU 1.5.33R on the payment of financial penalties and the Interim Prudential sourcebook (insurers) (IPRU (INS)) (rules 3.6 and 3.7) do not apply to an *insurer* which is an *incoming EEA firm*. Similarly, SYSC 3 does not require such a *firm*:

(a) to establish systems and controls in relation to financial resources (SYSC 3.1.1 R); or

(b) to establish systems and controls for compliance with that Prudential Standards part of the *Handbook* (SYSC 3.2.6 R); or

(c) to make and retain records in relation to financial resources (SYSC 3.2.20 R).

(2) The Conduct of Business sourcebook (*COBS*) applies to an *incoming EEA firm*. Similarly, SYSC 3does require such a *firm*:

(a) to establish systems and controls in relation to those aspects of the conduct of its business covered by applicable sections of *COBS* (SYSC 3.1.1 R);

(b) to establish systems and controls for compliance with the applicable sections of *COBS* (SYSC 3.2.6 R); and

(c) to make and retain records in relation to those aspects of the conduct of its business (SYSC 3.2.20 R).

See also Question 12 in SYSC 2.1.6 Gfor guidance on the application of SYSC 2.1.3 R (2)

Application of the common platform requirements in SYSC

8. Whilst the *common platform requirements* (located in SYSC 4- SYSC 10) do not generally apply to *incoming EEA firms*, *EEA MiFID investment firms* must comply with the *common platform record-keeping requirements* in relation to a *branch* in the *United Kingdom*.

Requirements under MiFID

9. Article 31(1) of *MiFID* prohibits *Member States* from imposing additional requirements on a *MiFID investment firm* in relation to matters covered by *MiFID* if the *firm* is providing services on a cross-border basis. Such firms will be supervised by their Home State regulator.

10. Article 32 of *MiFID* requires the *FSA* as the *Host State regulator* to apply certain obligations to an *incoming EEA firm* with an establishment in the *UK*. In summary, these are Articles:

(1) 19 (conduct of business obligations);

(2) 21 (execution of orders on terms most favourable to the client);

(3) 22 (client order handling);

(4) 25 (upholding the integrity of markets, reporting transactions and maintaining records);

(5) 27 (making public firm quotes); and

(6) 28 (post-trade disclosure).

The remaining obligations under *MiFID* are reserved to the Home State regulator.

11. *MiFID* is more highly harmonising than other *Single Market Directives*. Article 4 of the *MiFID implementing Directive* permits Member States to impose additional requirements only where certain tests are met. The *FSA* has made certain requirements that fall within the scope of Article 4. These requirements apply to an *EEA MiFID investment firm* with an establishment in the *United Kingdom* as they apply to a *UK MiFID investment firm*.

12. Further *guidance* on the territorial application of the *Handbook* can be found at PERG 13.6 and 13.7.

Statement of

The National Association of Insurance and
Financial Advisors

in connection with a hearing of

The Senate Committee on Banking, Housing and Urban Affairs

regarding

The State of the Insurance Industry:
Examining the Current Regulatory and Oversight Structure

July 29, 2008

The National Association of Insurance and Financial Advisors (NAIFA) appreciates the opportunity to share with the members of the Senate Committee on Banking, Housing and Urban Affairs our views regarding the need for insurance regulatory reform. We welcome the Committee's 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 nearly 800 state and local associations representing the business interests of 60,000 members 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.

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 to ensure a strong and healthy insurance marketplace. We believe, as others do, that fixing the problems with the insurance regulatory system ultimately will enable the insurance industry to provide better and greater choices for consumers, without sacrificing consumer protection.

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 33 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 critically 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). Despite being sent nearly a year ago, the letter remains accurate in its detailing of the shortcomings of the state insurance producer licensing system. The letter is addressed to Roger Sevigny, the New Hampshire insurance commissioner and current President-Elect of the NAIC. Commissioner Sevigny chairs a coalition sponsored by the NAIC to address producer licensing issues. NAIFA is a member of the coalition.

We are hopeful that the activity arising out of the coalition's work signals willingness on the part of the regulators to take real action to fulfill the spirit as well as the words of the Gramm-Leach-Bliley Act's NARAB provisions (and their own promises, as well). We welcome the regulators' current initiative and hope that it improves the situation for producers, but we are skeptical that even a concerted effort like this will be enough to bring recalcitrant states like Florida and California into the reciprocity/uniformity fold. 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. We are realistic in our expectations, and for that reason, we believe congressional action is necessary to achieve the reforms that are needed.

NAIFA supports congressional legislation that aims to modernize the current system of insurance agent licensing as it applies to those who are registered in multiple states. H.R. 5611, the National Association of Registered Agents & Brokers Reform Act ("NARAB II"), sponsored by Reps. David Scott (D-GA) and Geoff Davis (R-KY), has passed the House Financial Services Committee and is likely to come before the full House very soon.

NAIFA supports the enactment of NARAB II because it would allow insurance producers who are licensed to operate in multiple states to comply with a single set of non resident licensing and continuing education rules. The need to streamline the non resident licensing process is important for NAIFA members who frequently relinquish clients when they move to another state because of the burdens imposed by multistate licensing. NAIFA members are in the business of helping individuals and families address their basic financial security needs and prepare for retirement by helping them secure risk transfer based products such as life insurance, annuities, long term care, disability income coverage, medical and hospital insurance. The relationships our members have with their clients are based on a trust developed through years of providing important guidance and assistance in preparing for life's inevitable risks of dying too soon, living too long, becoming sick or disabled and/or needing long term care. For many of NAIFA members, however, the varying licensing compliance requirements from state-to-state make it unnecessarily burdensome to follow a client to another state when he or she moves. As a result, NAIFA members frequently have to refer their clients to another agent. Enactment of NARAB II is necessary because, in today's increasingly mobile world, it is a disservice to insurance consumers to have a regulatory system in place that makes it difficult for a consumer to retain their agent when they move to another state.

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, NAIFA has had a policy in place since 2002 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. (Addendum B.) The policy highlights NAIFA's support for the NAIC's regulatory modernization efforts and identifies certain federal proposals that could, if properly crafted, improve the regulation of our industry.

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.

In accordance with this policy, NAIFA's Board of Trustees recently voted to recommend to the full membership that the organization support the concept of the optional federal charter (OFC) for insurance, while continuing to support state-based regulation. Under the Board's recommendation, NAIFA support for OFC would be contingent upon OFC legislation meeting three general themes. The first theme is that an agent must have a true choice between federal or state licensure and that no company can discriminate against an agent based on their choice point of licensure. The second theme is that an OFC must include enhanced consumer protections so that insurance consumers are not negatively impacted by a new federal insurance regulator. Finally, an OFC must preserve the state system of insurance regulation for those agents and companies that choose to remain state regulated; but must also create a body of expertise on insurance to weigh in with Congress and the Administration on insurance policy matters that are national in scope.

The Board recommendation now goes to NAIFA's National Council for its consideration and approval during the upcoming NAIFA Annual Convention in September. In the meantime, given the complexity of the issue, there is a great deal of discussion and education about regulatory reform issues among the NAIFA membership.

In addition to comprehensive regulatory reform such as OFC, NAIFA is open to considering other federal efforts to improve the insurance regulatory system; provided any proposal is introduced in Congress is consistent with NAIFA's goals and concerns, while continuing to work through the NAIC and at the state level to achieve the necessary regulatory improvements. For example, NAIFA supports Rep. Paul Kanjorski's legislation creating an Office of Insurance Information with the Department of Treasury, H.R. 5840. The need for this legislation is clear to NAIFA members based on our own experience. Earlier this year, NAIFA leaders undertook an exhaustive study of the various proposals to reform the regulation of insurance. During that review, it became clear that there is a fundamental lack of understanding at the federal level regarding issues that impact professional agents and the industry on a national and international scale. Currently there are 14 federal agencies that have a role in regulating insurance, and yet there is no central body of expertise at the federal level to provide advice and council to the Administration and Congress on policy matters impacting the insurance industry. As provided for in Rep. Kanjorski's legislation, the OII would ably fill that role, while at the same time not impinging on state regulatory prerogatives. Like the NARAB II legislation, H.R. 5840 has passed the House Financial Services Committee and is likely to be considered by the full House soon.

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

NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

STATEMENT FOR THE RECORD OF

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

AT THE HEARING ON

"STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE"

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

JULY 29, 2008

Founded in 1895, the National Association of Mutual Insurance Companies ("NAMIC") is the nation's largest property and casualty insurance company trade association, with more than 1,400 members underwriting all lines of property and casualty insurance. NAMIC members range from large international writers to single-state niche writers.

NAMIC supports a *reformed* system of state regulation. The state-based insurance regulatory structure serves the dynamic and diverse needs of the national property and casualty marketplace.

NAMIC and the Role of Mutual Insurers

Most NAMIC members are mutual insurers that are owned by and operated for the benefit of their policyholders. The first successful insurance company in America was formed in 1752 by Benjamin Franklin and some of his Philadelphia neighbors to help insure their properties against fire loss. The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire is still in business today and is a NAMIC member.

In those early days, most insurance companies followed the contributionship model of neighbors forming entities to help each other avoid certain financial ruin if their properties were destroyed by fire. The other predominate type of insurance company is the stock company, which is owned by its shareholders. Today, NAMIC members account for 47 percent of the homeowners market, 39 percent of the automobile market, 34 percent of the workers' compensation market, and 32 percent of the commercial property and liability market.

The History of Insurance Regulation

States regulated the property-casualty insurance business until 1944, when the U.S. Supreme Court in *United States v. Southeast Underwriters Association* (322 U.S. 533 (1944)) declared that insurance was a form of interstate commerce and could be regulated by the federal government. Instead of creating a federal insurance bureaucracy, the Congress responded the next year by enacting the McCarran-Ferguson Act which declared that "[T]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States." The only exception would occur where the Congress enacted legislation that "specifically relates to the business of insurance." Since 1945, few exceptions have occurred with the result that insurance has been regulated at the state level.

NAMIC believes state regulation has generally served both consumers and insurers well over the years, particularly as it relates to the property-casualty business. Unlike the life insurance business, property-casualty insurance is primarily a state-based business. While some of our products cover interstate activities, most auto, farm, and homeowners policies are single state products tailored to local risks. As such, the states have the best understanding of the products and the people for whom the products provide protection.

The Current Insurance Regulatory System

By all economic measures, the U.S. property and casualty insurance industry is healthy, vibrant and highly competitive. There are more than 7,600 domestic insurers operating in the United States, of which more than 2,600 are property and casualty carriers, the majority of which are relatively small. Over 2,000 of these insurers were formed since 1995. A number of studies over the years, including those done by the U.S. Department of Justice, state insurance departments and respected economists and academics, have consistently concluded that the insurance industry is very competitive under classic economic tests.

The competitiveness and diversity in the insurance market is evidenced by NAMIC's membership in terms of size, geographic dispersion, lines of business and corporate structure. The scope of insurance products is likewise diverse ranging from traditional coverage for automobile and home, to commercial liability, to business and event interruption, to pet liability and identity theft coverage, to name but a few. Total premiums for insurance coverage topped $1.4 trillion in 2006, with premiums for property and casualty coverage accounting for fully one-third of that amount.

Insurance is a highly complex, unique, and personal product that fundamentally differs from other financial services, such as banking and securities. The 54 U.S. insurance jurisdictions employ more than 13,000 individuals regulating insurers, agents, brokers, and reinsurers, overseeing a myriad of products and responding to more than three million consumer inquiries annually.

Property and casualty insurance is inherently local in nature and thus corresponding insurance regulation differs. The United States has 54 well-defined jurisdictions, each with its own set of laws and courts. The U.S. system of contract law is well developed, and with respect to insurance policies is based on more than a century of policy interpretations by state courts. The tort system, which governs many of the types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also deeply based in state law including, for example, the law of defamation, professional malpractice, premises liability, state corporation law and products liability. State and local laws determine coverage and other policy terms. Reparation laws affect claims. Local traffic density, accident and theft rates impact pricing. Geographical and demographic differences among states also have a significant impact on property-casualty coverages. Types of risk – hurricanes, earthquakes, etc. – differ significantly from state to state.

With the ability to respond to unique local issues, the individual states serve as a laboratory for experimentation and a launch pad for reform. State-based regulators develop expertise on issues particularly relevant to their state. Insurance consumers directly benefit from state regulators' familiarity with the unique circumstances of their state and the development of consumer assistance programs tailored to local needs and concerns. State regulators, whether directly elected or appointed by elected officials, have a strong incentive to fairly and responsibly address the needs of consumers.

Despite state differences there are significant areas of uniformity. For example, solvency regulation is basically uniform among the states. Financial reporting standards and financial examination standards do not suffer from inconsistencies and vagaries among the states. In more recent years, insurers, regulators and legislators have turned their attention to promoting greater coordination and uniformity in other aspects of insurance regulation beyond financial reporting and solvency.

Inefficiencies in the insurance marketplace are less the result of the current functional regulatory framework, than the philosophy and execution of the regulatory objectives. Current inefficiencies in the insurance marketplace are driven by excessive rate and form regulation, which hamper competitive pricing, inhibit product and service innovation, and delay product delivery. Given that property-casualty insurance markets exhibit high levels of competition, the persistence of price and form regulation in insurance regulation cannot be justified as a response to market failure; it is rather a product of interest group pressure in the political process. Free market, competition-based economic structures coupled with a regulatory structure that emphasizes safety and soundness and prompt corrective action should be standard for a modern, vibrant, competitive regulatory structure capable of governing in the modern marketplace.

In the property and casualty arena, the state-based insurance regulatory system has over the years proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts. States have adopted specific programs and policies tailored to the unique needs of consumers within their state. State regulators and legislators consider and respond to marketplace concerns ranging from risks related to weather, specific economic conditions, medical costs, building codes, and consumer preferences. In addition, state regulation is able to respond and adapt to inconsistencies created by various state contract, tort and reparation laws.

States have not turned a deaf ear to the criticisms and have taken a number of steps to streamline and coordinate insurance regulation in a 21st century marketplace. A number of states have progressed in addressing antiquated rules such as those involving price controls and company licensing restrictions. On the matter of price regulation, specifically:

- Eleven states have adopted flex-band rating systems for property-casualty products to replace the rigid system of price controls.
- Fifteen states have adopted the more flexible use and file system.
- Twenty-six states have established no filing requirements, mostly for large commercial risks.
- Only 16 states still require statutory prior approval. Several of these states, however, are among the largest in the country, accounting for 40.8 percent of the total auto insurance market and 41.4 percent of the total homeowners insurance market nationwide.
- With respect to insurer licensing, the Uniform Certificate of Authority Application (UCAA) is now used in all insurance jurisdictions.
- A system of electronic filing has been implemented by most states and has streamlined the process by which rates and forms are filed by companies.
- Thirty-three states, representing over half of all premium volume, participate in the Interstate Insurance Product Regulation Commission and as of the start of this year the IIPRC has in effect 38 uniform standards for four product lines: life insurance, annuities, disability income, and long-term care insurance and serves as a single point of filing.
- The National Conference of Insurance Legislators (NCOIL), the National Conference of State Legislatures (NCSL) and the American Legislative Exchange Council (ALEC) have all endorsed competition as the best regulator of rates. NCOIL has adopted a significant model law that would create a use and file system for personal lines and an informational filing system for commercial lines.

Weaknesses of Current Regulation

NAMIC believes the state regulation must adapt to keep pace with today's global insurance market. Large and small insurers alike need to see changes in the state regulatory structure if they are to continue to provide customers with the products they need at the lowest possible prices.

From a property and casualty insurance industry perspective, the key regulatory problem continues to be an over reliance on outdated and inefficient price and form regulation. To achieve the paramount objective of preventing market failure and encouraging competition, it is imperative that price regulation for all property-casualty insurance lines end. Regulators should facilitate a vibrant marketplace that relies upon competitive forces to set prices. Consistency, while desirable and cost effective, will not in and of itself lessen the marketplace inefficiencies resulting from regulatory models that do not uphold competitive economic principles. Similarly, a shift from state-based regulation to federal regulation does not ensure consistent application of competitive regulatory principals.

While some states allow pricing freedom for commercial insurance products, the fact remains that personal insurance lines are the only products in America with multiple sellers whose price is regulated by the government rather than by the marketplace.

A brief review of different state approaches to pricing may be instructive here. Since 1969, Illinois has had purely competition-based pricing for both personal and commercial lines. As a result, Illinois has experienced stable rates and few entrants in its residual market because it has attracted the largest share of private passenger auto and homeowner insurers in the nation. A few years ago, South Carolina and Louisiana adopted a flex-rating system for personal lines and the states have seen their auto prices fall and new insurers enter the market. In both instances, the markets improved as a result of adopting more market-based rating.

At the other end of the spectrum, almost every state that has availability or affordability problems suffers from overregulation and price controls. For years, Massachusetts set uniform rates for auto insurance to be charged by all insurers doing business in the commonwealth, which discouraged all but 18 insurers from selling private passenger auto insurance there. Earlier this year, though, Massachusetts adopted some steps towards a managed-competition system, and as result, new insurers are showing interest in entering the Massachusetts market. Far too often, however, policymakers in these troubled jurisdictions react by placing a tighter regulatory grip on the market, which usually leads more insurers to leave the state, thus exacerbating availability and affordability problems.

While insurance price controls are the most troublesome feature of state insurance regulation, other examples also deserve attention. These include a lack of uniformity among states with respect to producer licensing laws, form filing procedures, underwriting restrictions preventing insurers from accurately assessing risk, expensive and otherwise unwanted coverage mandates, and arbitrary and redundant "market conduct examinations" that cost insurers enormous resources that could otherwise be used to pay claims

The Strengths of State-Based Regulation

Notwithstanding the need to improve state-based regulation, NAMIC believes the decentralized system of state-based insurance regulation has inherent virtues that would be lacking in a national insurance regulatory system. State insurance regulation has the capacity to adapt to local market conditions, to the benefit of consumers and companies, and affords states the opportunity to experiment and learn from each other.

A state insurance commissioner can develop expertise on issues particularly relevant to his or her state. Unlike banking or life insurance, property-casualty insurance is highly sensitive to local risk factors such as weather conditions, tort law, medical costs, and building codes. Many state building codes are fashioned to the risk found in that state. In the Midwest, these codes focus on damage from hail and tornados, while in coastal regions, the codes focus on preventing loss from hurricanes. In other states, seismic or wildfire concerns dictate the building codes. Insurers must consider all of these factors in assessing risk and pricing insurance products. State insurance regulation can take account of these state and regional variations in ways that federal regulation cannot. Insurance consumers directly benefit from a state regulators' familiarity with the unique circumstances of his or her state.

Over time, state insurance departments accumulate a level of "institutional knowledge" that has helped regulators develop consumer assistance programs tailored to local needs and concerns. Compared to a federal regulator, state regulators have a greater incentive to fairly and promptly address the needs of consumers. Eleven state insurance departments are headed by commissioners who are directly elected by their states' voters; the others serve at the pleasure of governors who also must answer to voters. A federal regulator, by contrast, would be far less accountable to consumers in particular states, and would thus have less motivation to be responsive to their needs.

Regulatory Reform

The insurance industry lacks consensus regarding the optimal regulatory structure, as evidenced by the varied approaches to insurance regulatory reform. However, there is general agreement among stakeholders – insurance companies, agents and brokers, regulators, state legislators and consumers – that reform and modernization of the current insurance regulatory system is essential to meet the needs of the 21st century marketplace. There is also broad agreement regarding the principles of sound financial regulation.

Free market, competition-based economic structures coupled with a regulatory structure that emphasizes safety and soundness and prompt corrective action should be standard for a modern, vibrant, competitive regulatory structure capable of governing in the twenty-first century marketplace. First and foremost insurance regulatory reform must embrace competition-based regulatory principles and price regulation for all property-casualty insurance lines must be ended. While several states have enacted reforms in recent years, more must be done. In every state that has enacted competitive based rating systems, the market has improved and consumers have more choices.

In addition to ending price controls, insurance regulatory reform must focus on elimination of form control, streamlining producer and company licensing laws and form filing procedures, eliminating underwriting restrictions and expensive and otherwise unwanted coverage mandates, and reducing arbitrary and redundant market conduct examinations. A true, open competitive pricing and service system, based on a set of principles emphasizing efficiency, remediation and better service to consumers should be the underlying basis of regulation across the financial services industry. Open competition models in which rates and forms are allowed to be determined by the marketplace is not tantamount to the absence of regulation as some would argue, but rather will allow the insurance industry to thrive and grow while permitting regulators to focus time and resources on more appropriate regulatory activities.

Looking forward, a viable system of insurance regulation for the twenty-first century marketplace must be based on a new regulatory paradigm that adopts an "open competition" approach to rate and policy form regulation. Under such a paradigm, insurers should be permitted to enter new markets with a minimum of difficulty and "prior approval" should be eliminated as the standard for rate and policy forms. Regulators similarly should adopt a principle of regulation that focuses regulatory resources where needed. Targeting market conduct and other examinations based on analysis of risk and company conditions would free regulatory resources to focus on critical issues and lead to better quality of regulation.

In developing regulatory processes to meet consumer and market needs, it is essential that regulators and lawmakers acknowledge and apply on a uniform and consistent basis fundamental business legal protections, including confidentiality and privilege provisions, due process rights to withhold production, trade secrets, and self-evaluative audits to safeguard the legal and intellectual property rights of financial services entities.

NAMIC supports efforts to streamline the regulatory process and provide greater flexibility to respond to rapidly changing economic and market conditions. However, as regulators evaluate reform proposals careful attention must be given to legal and operational issues. Legal certainty is a serious consideration when developing and implementing principles-based regulation. Whether a particular way of doing business conforms to the principle involved can be a matter of a particular regulator's opinion, and as regulators and circumstances change, so do interpretations. In addition, civil liability concerns must also be addressed if principles-based regulation is adopted. In the United States companies are subject to liability in private class actions in both federal and state courts, civil rule enforcement by federal and state regulators, and criminal enforcement by both the U.S. Justice Department and state attorneys general. Lack of legal certainty could create extreme vulnerability for regulated firms if not properly addressed in conjunction with such a shift in the regulatory paradigm. NAMIC urges regulators and lawmakers to carefully weigh all issues, including ensuring proper legal protection and regulatory transparency and avoiding arbitrary regulator conduct.

Role of Federal Government

Insurance regulatory reform is often considered synonymous with creation of an optional federal charter ("OFC"). Legislation has been introduced in this and previous Congresses to create an optional federal charter modeled on bank regulation. In essence, these bills would allow an insurer to choose between being regulated by the states or by a new federal regulatory system to be administered by an Office of National Insurance. NAMIC opposes adoption of this legislation.

While, an OFC seeks to increase competition among multi-state insurers by streamlining and centralizing insurance regulation; exempting federally chartered insurers from notoriously inefficient and archaic rate regulation; and promoting regulatory competition between federal and state regulators, an OFC is unlikely to achieve these results and NAMIC believes that insurance regulatory reform can be achieved without the creation of a new federal bureaucracy.

While the states retain regulatory authority and responsibility, Congress and the federal government play meaningful roles in the business of insurance, including creation of federal insurance programs such as the National Flood Insurance Program, federal insurance backstops such as the Terrorism Risk Insurance Act, and oversight, including hearings and investigations by congressional committees and the General Accountability Office.

NAMIC supports a reformed state-based insurance regulatory system with an appropriate role for limited Congressional review. Congress could also play a limited and supporting role in achieving national targeted uniformity.

While presently opposed to an OFC, NAMIC believes that Congress could potentially play a limited role in achieving some targeted reforms that the states have not yet acted on, such as a "national targeted uniformity" approach. And, indeed, the House already has taken a positive step in that regard by passing H.R. 1065, which streamlines regulation for nonadmitted insurance and reinsurance carriers. If this is an approach that Congress wishes to follow, two issues that members may wish to consider:

1. Prohibit states from limiting property-casualty insurers' ability to set prices for insurance products, except where the insurance commissioner can provide credible evidence that a rate would be inadequate to protect against insolvency; and,
2. Prohibit states from limiting or restricting the use of underwriting variables and techniques, except where the insurance commissioner can provide credible evidence that a challenged variable or technique bears no relationship to the risk of future loss.

In a similar vein, NAMIC also supports H.R. 5611, the National Association of Registered Agents and Brokers Reform Act (NARAB II). The legislation - approved by the House Financial Services Committee - would provide a mechanism through which licensing, continuing education, and other insurance producer qualification requirements and conditions can be adopted and applied on a multi-state basis, while preserving the right of states. NAMIC believes a similar approach could be taken to streamline company licensing. A uniform approach to company licensing would remove redundancies and inefficiencies, lower costs and increase competition.

NAMIC is also supportive of H.R. 5840, the Insurance Information Act. An Office of Insurance Information, if properly constructed and contained, could help modernize the insurance regulatory marketplace and reduce inconsistencies and redundancies, while recognizing and respecting the rightful and necessary role of state-based regulation.

NAMIC also believes there is an appropriate federal role in providing financial incentives for those states that enact strong state-wide building codes, amending the federal tax code to allow insurers to set aside a portion of premium income in tax-exempt policyholder disaster protection funds and individual homeowners to create tax-free catastrophic savings accounts similar to health savings accounts which could be used to pay hurricane deductibles and costs associated with retrofitting properties.

Business or general commerce issues, such as electronic signatures and credit reporting and privacy standards, effecting insurers also call for a federal role. Establishment of consistent national standards related to credit freezes and social security number use, including preemption of inconsistent state laws, are also areas appropriate for federal action.

Conclusion

NAMIC believes that significant regulatory reforms are necessary to meet the needs of a dynamic, competitive, modern insurance marketplace. A reformed state-based system is best suited to fulfill this need. While not enough states have acted as rapidly or as thoroughly in creating insurance regulatory reforms as are needed, the states have picked up the pace in recent years and appear headed in the right direction.

There is an appropriate role for congressional involvement and review in insurance regulation. NAMIC presently opposes the creation of an OFC, but supports adoption of legislation to streamline surplus lines regulation and producer licensing. NAMIC believes that the creation of an Office of Insurance Information, if accompanied by the strongest confidentiality and privilege protections, limited in scope, coordinated with the advice of a well-balanced advisory panel, with limited preemptive authority and overseen by Congress, could play a vital role in this modernization effort.

We look forward to working with Chairman Dodd and Ranking Member Shelby and members of the committee to achieve our shared goals of a healthy and competitive insurance marketplace.

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PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

Testimony of David A. Sampson
President & Chief Executive Officer
For the Property Casualty Insurers Association of America
To the Committee on Banking, Housing and Urban Affairs
United States Senate
Tuesday, July 29, 2008

Chairman Dodd, Ranking Member Shelby and members of the Committee, thank you for this opportunity to submit testimony regarding the state of the insurance industry and its current regulatory and oversight structure.

I want to thank the Committee, especially Chairman Dodd, for your leadership in increasing congressional knowledge about our complex industry and advancing a healthy marketplace in the 21st century. We appreciate your efforts to foster rigorous dialogues, like today's hearing, which advance the debate on how best to modernize insurance regulation to meet the needs of consumers and drive a competitive economy.

PCI is a trade association with a diverse membership of more than 1,000 members. Our members are writers of nearly every kind, from the multi-line, multi-billion-dollar premium giants to the small, specialty insurers. PCI members write over $194 billion in annual premium—40.1 percent of the nation's property/casualty insurance. Member companies write 51.3 percent of the U.S. automobile insurance market, 39 percent of the homeowners market, 32.1 percent of the commercial property and liability market, and 38.7 percent of the private workers compensation market. The vast range of our membership places PCI in an excellent position to provide advice and expertise on insurance regulation to Congress and the Administration.

The insurance industry positively impacts the free market system on which our nation's economy is built and thus, we advocate for market freedoms and a business environment that is characterized by healthy competition. We realize that as our global economy evolves, so must the regulatory system for the entire financial services sector to ensure our competitiveness and continued success.

Regarding the industry's current regulatory and oversight structure, PCI believes that the states have not reformed the current regulatory system into a model that effectively facilitates commerce in the 21st century. To modernize, we support reforming the state-based system based on sound principles of regulation and preserving the prerogatives of the states. However, where the states continue to fail to make needed improvements, other approaches may need to be considered to create a fair, effective and efficient business environment.

As policymakers consider options for fostering a competitive, global insurance industry, it is vital to understand the principles of good insurance regulation. The primary responsibility of regulation should be to enhance solvency protection for policyholders. Competitive markets are the best regulators of product and pricing, as they promote innovation and product availability, attract capital, and provide incentives for the efficient allocation of resources by consumers and insurers. Regulation should foster education to support consumer choice in a competitive market and should protect consumers against fraud and deceptive practices. Regulation should also enhance private sector function by eliminating unnecessary governmental intervention. And it should minimize economic cost of regulation by using rigorous cost/benefit analysis. Regulatory standards should be consistently applied and be easily ascertainable.

In general, states with freer markets benefit from more consumer choice, rate predictability and insurance premiums that are more reflective of actual risk. I would like to bring to your attention examples of the progress and impact achieved by states that have taken positive action on insurance reform. For many years, Massachusetts and New Jersey were the traditional "poster children" for intrusive over-regulation of auto insurance rates. Recent reforms, however, have resulted in more insurers re-entering auto insurance markets in those states, thus encouraging greater competition and providing more choices for consumers. In New Jersey, the Herfindahl-Hirschman Index, which measures market concentration, reflected a healthy index of 532 for the state in 2007. Herfindahl-Hirschman Indexes between 1000 and 1800 are considered moderately concentrated, and indexes above 1800 are concentrated. Thus New Jersey's low index reflects a healthy, competitive marketplace.

To note other strong examples, Illinois maintains a "no file" system that allows market forces to set nearly all insurance rates, thus avoiding state price regulations that can result in market distortion, which can negatively affect consumers. In South Carolina, prior to deregulation the state had an average of 59 insurers serving consumers, compared to almost 200 insurers in other Southeastern states. After auto reform, the number of insurers serving South Carolina increased by two thirds. Two years before the flex-rating law was enacted, over 1 million cars were insured through the residual market, which typically represented 30 percent of the total market.

Since reform, the residual market has virtually disappeared, decreasing to only 203 cars insured in 2003 (just four years after the reform became effective). In the 12 months ended in September 2005, only 38 new applications for insurance in the residual market were received. In 2007, there were 147 auto writers in South Carolina, up from only 83 in 1997, again showing that more companies are entering the market due to greater competition.

I would also like to point out examples that highlight our concerns about the failure to make sufficient changes and improvements to regulations. Where states do not make needed reforms, taxpayers may face the potential for massive liabilities if poorly funded state insurance systems fail. In February, The Heartland Institute, a Chicago-based think tank, released a *Property & Casualty Insurance Report* giving "F" grades on the effectiveness of property and casualty insurance regulation to states with more restricted markets, such as California, Florida and Texas. The Florida property insurance market in particular still faces great challenges. As an example, Citizens Property Insurance Corporation is Florida's residual market of last resort and has become the largest property insurer in the state.

As in other industries, innovation is critical to developing a successful, nimble and strong insurance marketplace. Innovative efforts, however, can be hampered by burdensome state oversight of insurance forms that makes it difficult for insurers to respond quickly to consumer demand for better, more easily understood information. Colorado, Hawaii, Michigan and Rhode Island have taken positive steps toward imposing fewer restrictions by allowing insurers to "use and file" forms, meaning that insurers can begin using new forms and simply alert state officials that they are doing so. Efforts like these that are designed to foster innovation in our marketplace must be supported.

We commend the states that are leading the way on modernization. Overall, however, the states have not made sufficient changes. In fact, we do not know of any of our members who are completely satisfied with the quality of state regulation.

To adapt to current needs, PCI will continue to work with states, the National Association of Insurance Commissioners (NAIC) and others to advance sound, market-based solutions. It should be noted, however, that it also may be necessary to weigh additional steps not limited exclusively to state-generated change, which could include the federal surplus lines and reinsurance bill, NARAB II, OII, or additional NAIC modernization initiatives.

The insurance industry and lawmakers must come together to consider these issues and recommendations in order to ensure a business environment that is effective and efficient, meets consumers' needs and is free of unnecessary government constraints on market participants. As a cautionary note, this year's turmoil in the financial and mortgage sectors should encourage the industry to proactively consider reforms that ensure proper functioning and stability in the insurance market.

We appreciate the leadership of Chairman Dodd and the Committee and we look forward to working with you on these issues. Your efforts will help ensure we best serve consumers and foster a strong, competitive economy in the 21st century.

Thank you for the opportunity to submit PCI's testimony.