UNITED STATE SENATE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"INSURANCE REGULATION REFORM"

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Good morning, Chairman Shelby, Ranking Member Sarbanes, and members of the committee. My name is Joe Beneducci, and I am President and Chief Operating Officer of Fireman's Fund Insurance Company (Fireman's Fund). Fireman's Fund Insurance Company is a premier property and casualty insurance company providing personal, commercial and specialty insurance products nationwide. Fireman's Fund is a member of the Allianz Group, one of the world's largest providers of insurance and other financial services. Founded in 1863 with a mission to support firefighters, Fireman's Fund proudly continues this mission today through the Fireman's Fund Heritage program.

Through the Fireman's Fund Heritage program, Fireman's Fund employees and its network of independent agents award grants and provide volunteer support to local fire departments, national firefighter organizations and non-profit fire and burn prevention organizations. Since

launching the program in 2004, the company has awarded millions of dollars each year towards the purchase of equipment, firefighter training and community education programs.

I appreciate the opportunity to be here today on behalf of Fireman's Fund and our property-casualty insurance trade group, the American Insurance Association (AIA), and its more than 400 members, to discuss insurance regulation reform – a topic that is critically important to Fireman's Fund and AIA, to the individuals and businesses that we serve, and to the industry that we represent.

We applaud this committee's leadership in recognizing the need to examine the insurance regulatory system. Reform is critical to enhancing competition, fostering innovation, and providing a solid foundation for underwriting the risks necessary to advance a strong U.S. economy – all to the benefit of policyholders and the public at large.

Today, we stand at a regulatory crossroads that may well determine the future of the insurance marketplace in the 21st century, its ability to respond effectively and efficiently to losses – catastrophic or otherwise – and the appropriate role of government. With this context in mind, I would like to start with three observations about the property-casualty insurance market and the best way to regulate the market:

1. Our economy is not static and continues to become more global every day. Consumer needs continue to expand and grow in conjunction with our economy. These evolutions have surpassed the current insurance regulatory environment's effectiveness and viability.

2. The current regulatory system inhibits innovation and actually perpetuates commoditization.

3. A market-based *optional* federal charter can benefit consumers by reforming regulation and encouraging innovation, while retaining the state regulatory system for companies that wish to remain there.

Let me elaborate on these observations. There is little disagreement that the current system is broken. Many proposals have attempted to deal with the inadequacies of that system. Indeed, insurance regulatory reform has been a topic of discussion for more than a century. The National Association of Insurance Commissioners (NAIC), the state regulators' trade association, first pledged to reform the state insurance regulatory system and to achieve uniformity during the Grant Administration in 1871. More recently, since enactment of the Gramm-Leach-Bliley Act, the state regulators have renewed that pledge, and have worked through the NAIC, other organizations, and within their respective states, on a variety of state-based models, laws, and regulations aimed at modernizing the regulatory structure. Although they were and are sincere in their efforts, no one has come close to delivering a modern system that empowers consumers and focuses on real consumer protections. As a result, we remain within a regulatory framework that, by its very nature, lacks uniformity and does not allow insurers to keep pace with ever-changing insurance consumer needs.

It is time for a new approach. We believe that an optional federal charter approach, which relies on a combination of free markets and a tightly focused regulatory system, represents our best opportunity to advance regulatory modernization that works for consumers, the industry, and the economy.

Three basic principles undergird an optional federal charter approach:

- ✓place primacy on the private market, not regulatory fiat, creating an environment that empowers consumers as marketplace actors;

- ✓focus government regulation on those areas where government oversight protects consumers in the marketplace, such as financial integrity and market conduct, rather than on those activities that distort the market, such as government price controls and hostility to innovation; and

- ✓ establish uniform, consistent, and efficient regulation.

We believe it is very important for the committee to judge any reform proposal against these principles to ensure that any legislation that may be enacted does not create or add more unnecessary regulatory burdens, does not inadvertently restrict the options that a vibrant private market can offer to consumers, and adds to the efficiency and strength of insurance regulation.

We strongly support the bi-partisan National Insurance Act of 2006 (S. 2509 or Act), introduced by Senators Sununu and Johnson April 5th, and believe that the reforms contained in the Act reflect these principles. The legislation provides insurers the option of being nationally regulated, while at the same time preserving the current state regulatory system for insurers that believe they can better serve their policyholders within that framework. Importantly, it also would preserve critical elements of the current state system, such as state premium taxes, the state guaranty fund system, and certain local prerogatives with respect to workers' compensation and motor vehicle insurance coverage requirements.

The regulatory system articulated in S. 2509 is modeled after the dual banking system – a system that has worked well for almost 150 years. For insurers, passage of S. 2509 would be an important next step in this committee's work on financial services modernization, building on the Gramm-Leach-Bliley Act.

Most fundamentally for property-casualty insurers that choose a national charter, S. 2509 would "normalize" regulation and allow the marketplace – and, by extension, consumers in that marketplace – to dictate the full range of price and product choices, rather than empowering the government to do so through price and product controls. In implementing a market-driven approach to the regulation of insurance prices, S. 2509 would subject insurer pricing activities to the federal antitrust laws to the extent those activities are not regulated by state law.

Although opponents may try to characterize elimination of government rate and policy form review as "deregulation," it is not. By de-emphasizing those aspects of regulation that tend to politicize insurance and weaken the private market, S. 2509 establishes stronger, re-focused

regulation in those areas where regulation actually is necessary to protect consumers as they navigate the marketplace and when they turn to financially sound insurers for payment of covered claims. Under this modernized system, the federal government will not be a market participant, nor will it exercise business judgment. Above all, enactment of S. 2509 will assure that the insurance safety net remains strong despite the ever-changing nature of risk.

The Critical Need for Insurance Regulatory Reform

The current state insurance regulatory system grew out of the McCarran-Ferguson Act, which was enacted in 1945 largely to deal with federal antitrust and state tax concerns arising from a 1944 U.S. Supreme Court determination that insurance was a product in interstate commerce and, therefore, subject to federal authority.

McCarran is a power-sharing statute that reflects Congress' considered judgment to delegate – *not abdicate* – its authority over insurance to states that regulate the business of insurance themselves. In doing so, McCarran recognizes that Congress has the right to intervene in insurance regulatory matters by enacting specific federal laws and provides insurers with an antitrust regime that is based on the insurance regulatory role being entrusted to the states. Within this statutory structure, it narrowly protects insurers from application of the federal antitrust laws to the extent that the business of insurance is regulated by the states.

Under McCarran, the states have put in place sweeping regulatory regimes that dictate what products insurers can provide, how much they can charge for these products, and how they conduct even the most routine aspects of their business. The result has been a regulatory

scheme that: 1) is focused on government intrusion in the market, particularly in the area of insurance rate and form oversight; and, 2) reflects assumptions about the insurance industry, insurance companies, and insurance consumers that, while perhaps true in 1945, are far from accurate today.

In this connection, the current system relies on outdated, discredited government price and product controls, which are rationalized by regulators in the name of "protecting consumers," but which, in truth, serve merely to interfere with the proper functioning of the private market – to the detriment of consumers. These controls are imposed in virtually every state, often in different and inconsistent ways. Even within each jurisdiction, there are often differing systems for different lines of business, making the process incredibly inefficient and ultimately unresponsive to consumer needs. A limited survey by AIA of state rate and form requirements found hundreds that dictate how rates are to be filed and reviewed, and that relate to the filing and review of new products. This cumbersome apparatus simply is not viable in a society that relies on instant availability to consumers of most other products and services. Indeed, the property-casualty insurance industry remains the only U.S. financial services industry that still labors under a pervasive system of government price and product controls.

A Better Regulatory Alternative

Systemic insurance regulatory reform is urgently needed for the good of insurance consumers and for the health of the insurance marketplace. We need a new regulatory alternative based

not on regulatory red tape and government decisions concerning the “appropriate” rate for an insurer to charge or the “appropriate” insurance policy to offer to consumers, but on a rational reallocation of regulatory resources to focus on the most critical aspects of the insurance safety net. Additionally, the new system must replace the current patchwork of conflicting state requirements with national uniformity for insurers operating at the multi-state or national level. S. 2509 embodies all of the elements of this paradigm and represents the best approach for Congress to move forward in advancing reform.

I would like to discuss some of these concepts in more detail.

- Free market principles allow competition to flourish.

The entrenched state focus on government price and product controls discourages innovation and competition, ultimately denying consumer choice. The current regulatory system concentrates on the wrong principles. Ultimately, it is economically unwise for government to repress prices, since this masks market stresses and problems. Over a period of time, this can lead to a market crisis, forcing sizable subsidized residual markets and market withdrawals that exacerbate the problem. In this way, the use and administration of government price and product controls limits flexibility for both insurers and consumers. It also leads to a stark choice for companies as to whether to continue writing insurance at all, rather than providing the market freedom and range of options necessary for insurers to write as much coverage as possible.

Recent attempts at reforming state rate and policy form regulation have focused on changing the type of review (e.g., from “prior approval” to “file and use”), implementing so-called “flex rating” bands (which allow insurers to depart upwards or downwards from filed rates by a certain percentage – typically from 5% to 12% – without regulatory approval), and adopting exemptions for commercial policyholders that meet identified threshold criteria. While these measures may have been designed to provide modest improvement, they do not address the fundamental problem with the state regulatory approach.

First, altering the type of review required does not change the fact that pre-market intervention should not be occurring in the first place. It also does not address the concern that even the most liberal rate and form review system can be administered in a way that is just as onerous as the most restrictive system.

Second, the creation of rating flex bands simply imposes government restrictions on private markets, and, contrary to their name, limit the flexibility of consumers and insurers outside the band.

Third, based on experience with so-called “exempt commercial policyholder” laws in the various states, setting threshold criteria that will allow certain policyholders to qualify for the exemption results in a “winners and losers” contest that is antithetical to the concept of market-based pricing. *All* policyholders, regardless of size or sophistication or line of insurance, should be entitled to purchase insurance from insurers operating in a free market environment.

Forcing private businesses to submit their products and prices to a government official for review and approval is anathema to the free market environment that forms the backbone of the U.S. economy. Price and product controls are historical artifacts that have turned insurance prices and products into political pawns that are used to artificially suppress the real cost of risk and to delay products from being offered to consumers, or, worse, to keep product options from consumers altogether. This is a dangerous form of government intervention in private markets – one that is at odds with our free market economy – which distorts the real costs of assuming risk and discourages prudent risk management behavior by individuals and businesses. Consumer empowerment in the marketplace should not be replaced by needless regulatory control.

- Uniformity is critical in serving the needs of a national and international economy.

The current regulatory system is a jumble of individual state statutory and administrative requirements. As previously noted, state insurance codes have spawned hundreds of different rate and form regulatory requirements for the various lines of insurance, along with many more disparate market conduct, claims, and other requirements. Companies wishing to launch a national product cannot do so until both the price and product have been separately reviewed or approved in every state; this can take years to accomplish. Moreover, the need for insurers to meet differing regulatory demands in each jurisdiction increases compliance costs, discourages innovation, and makes it difficult for insurers to service customers doing business in more than one state.

- Insurance regulation should focus on solvency and protection of the insurance safety net.

Certainty and security are critically important principles for insurance consumers. A regulatory system ought to focus on ensuring that a company is solvent and able to pay claims to instill confidence among insurance consumers. The property-casualty insurance industry stands out as one of the most heavily regulated sectors of the U.S. economy. However, this is not just a question of regulatory degree, but additionally, of *misguided* regulation that rewards inefficient market behavior, subsidizes high risks, and masks underlying problems that lead to rising insurance costs. Resources are misdirected to “front-end” price and product regulation, while core functions like financial solvency have taken a backseat. This is both unfortunate and dangerous, because less focus on solvency means less security and less confidence by consumers that covered claims will be paid. Financially sound insurers are in everyone’s best interest, because they are the heart of a healthy, vibrant market.

The Market-Based Optional Federal Charter Approach in S. 2509

We believe that a market-based optional federal charter approach provides the best route to insurance regulatory reform. This is a regulatory system that has worked well in the banking industry for well over a century, and will modernize the insurance industry if adopted. It does not regulate prices charged and products offered by market participants, because it recognizes that governments, acting unilaterally in these areas, cannot be effective surrogates for the free

market. Rather, it places regulatory emphasis on ensuring that companies are financially sound and that consumers are protected from misconduct by market participants. These are core regulatory functions for most industries, and insurance is no exception. In addition, the optional federal charter would bring needed uniformity for those choosing a national license, while respecting the decisions of others to remain under state regulatory authority. Fireman's Fund and AIA support the re-direction of regulation that an optional federal charter promises, and look forward to both defending and advocating this regulatory framework for property-casualty insurers.

The structure of S. 2509 creates this modernized regulatory paradigm. Insurers opting for a national charter are regulated by the Office of National Insurance, housed in the Department of Treasury, led by a National Insurance Commissioner appointed by the President with the advice and consent of the Senate.

The Act requires creation of six regional offices, with discretion given to the federal regulator to authorize as many additional local offices as necessary. Those opting in to the federal system directly fund federal regulation, in addition to continuing to pay state premium taxes. The Office of National Insurance is the single focal point of regulation for nationally chartered insurers, and that office applies the standards set forth in the Act or promulgated by regulation, addresses complaints concerning nationally chartered entities, and enforces the requirements of the Act. Thus, the Act supplies the framework for uniformity, consistency, and clarity of regulation that the state system has failed to create.

The Act also effectuates a fundamental shift in regulatory application. Under this approach, the regulatory system for national insurers starts from the premise that governments should not stifle the growth of private markets through rate suppression, product denial, or other intervention, but should allow private markets to flourish, with insurers and consumers agreeing on the sharing of risk of loss.

In exchange for relief from rate regulation, the Act applies federal antitrust laws to insurer pricing activities that are no longer regulated. AIA members, including Fireman's Fund, are willing to take the risks inherent in this approach on the antitrust side because we so strongly believe that a market without government rate and price controls is critical to being able to serve customers in the years ahead.

While S. 2509 relies on markets to determine the price of insurance and trades pricing freedom for application of the federal antitrust laws, it does not abandon aspects of the state system that are necessary. In this respect, the Act recognizes that there always will be a need for markets of last resort – so-called "residual markets" – and that national insurers must participate in those markets when participation is mandated by state law. Consistent with free market principles, however, insurance prices in the subsidized residual market must be adequate to prevent "backdoor" competition with the private market. In addition, the Act requires national insurer participation in state-mandated statistical and advisory organizations, and workers' compensation administrative mechanisms – again, with the proviso that states cannot use mandatory participation to re-impose rate and form regulation over national insurers. This careful balancing of market-based pricing and participation by national insurers

in the data collection mechanisms that support the state structure makes S. 2509 an ideal model for rate regulatory modernization.

As previously noted, the Act also provides for relief from government product controls, particularly from the required use of any particular policy form, but it includes federal supervision of policies used by national insurers in the marketplace. First, the Act requires national property-casualty insurers to submit annually a list of all standard policy forms they use to the Office of National Insurance. Second, under the Act, national insurers must maintain copies of all of the policy forms they use for inspection by the federal regulator. The combination of these two requirements ensures that federal regulators will be aware of the policy forms that are being offered in the market, but that they will not be able to interpose Byzantine review and approval standards. These standards in many states have led to delays of months – and sometimes years – in the roll-out of insurance policy forms intended to be used nationwide.

The Act also includes special provisions that require national insurers to adhere to compulsory coverage standards for motor vehicle and workers' compensation insurance. Even here, though, states may not use these special provisions to re-impose rate regulation on national insurers.

We believe that the market-driven approach for insurance rates and policy forms outlined in S. 2509 is key to cultivating and maintaining a healthy insurance environment that works for both business and individual insurance consumers. Indeed, market regulation of insurance

rates and policy forms empowers consumers, because consumer demands will drive the range of product and pricing options available to them. This stands in sharp contrast to the current regulatory approach, which empowers regulators and often makes them the principal market participant. This, in turn, leads to property-casualty insurance commoditization, as regulators are not well-positioned to understand the evolving insurance needs of individuals and businesses. For these reasons, we support the approach taken by S. 2509, which demonstrates faith in consumers in the marketplace.

Just as S. 2509 allows private markets to thrive through elimination of government price and product controls, it regulates all other aspects of the business of insurance. First, the Act provides broad authority to the federal regulator to protect consumers against misconduct by nationally chartered entities in the market. The Act's market conduct provisions cover all aspects of insurance operations, and contemplate rulemaking to provide the more detailed parameters of that authority.

Second, the Act provides strong federal oversight of national insurers' financial condition in order to ensure that companies are financially sound and able to pay covered claims. It also includes accounting, auditing, actuarial, investment, and risk-based capital standards. For financial solvency, the Act defers to the state guaranty fund system, requiring national insurer participation in that system, but at the same establishing "qualification" standards that the state guaranty funds must meet to avoid triggering the national insurance guaranty corporation established by the Act. In these areas, the Act generally follows uniform standards established by NAIC models.

For insurance consumers, the Act establishes both a federal ombudsman to serve as a liaison between the federal regulator and those affected by the regulator's actions, as well as consumer affairs and insurance fraud divisions to provide strong consumer service and protection.

Over the long-term, it is our view that a federal regulatory option, structured in the way set forth in S. 2509, will modernize regulation of the industry, empowering consumers and emphasizing market conduct and financial solvency oversight in the process. In creating these needed systemic reforms, the Act will consolidate regulation into a single uniform point of enforcement for those that choose the federal charter, without forcing change for those choosing to stay in the state system.

The Critical Need to Move Forward

Insurance regulatory reform is not an academic exercise; it is a critical imperative that will determine the long-term viability of one of our nation's most vital economic sectors, and help define how our economy manages risk in the future. The choice is between the existing state regulatory bureaucracy or a new approach that relies on the hallmarks of the free market and individual choice and recognizes the evolution of our customers' needs in our global economy and insurers' ability to support those needs in a modernized regulatory environment.

Without a doubt, everyone here supports a healthy U.S. insurance marketplace that serves and empowers American consumers. We appreciate that creation of such a modern, dynamic market is not without challenges, and that change can be unsettling for some. However, we believe that creating an *optional* federal charter is imperative to meet the needs of all types of customers and insurers. There is no compelling reason not to fully explore and debate this proposal.

Fireman's Fund and AIA look forward to defending and advocating an optional federal charter that truly would serve consumers by fostering efficiency and innovation. We strongly support S.2509 and thank Senators Sununu and Johnson for putting forth this thoughtful legislation.