Testimony

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Introduction and Summary

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

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

In my opinion, the states have come a long way in improving their regulation of insurance but further reforms are needed, both in terms of the states' structures/processes as well as their policies. I think the preferred institutional route to this goal is strong federal standards for and oversight of the states' regulation of insurance that will move their structures and policies to where they need to be. In essence, the states need to appropriately and efficiently regulate things that need to be regulated and not regulate

things that do not need to be regulated. If this cannot be achieved under the institutional arrangement I favor, then an optional federal charter approach may be necessary to achieve the objectives that the states would be unwilling or unable to achieve.

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

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

The urgency and need for insurance regulatory reform is increasing for several reasons. One, risk and choice regarding health insurance and retirement funding is increasingly being shifted from employers to employees. Two, as the baby boom generation moves into retirement, their purchase of or choices regarding health insurance and retirement funding vehicles will affect a large segment of the population. Privatization of some portion of social security accounts could further increase the importance of this area. Thirdly, environmental and political changes appear to be increasing the risk of natural and man-made "disasters" so it is important that individuals and firms purchase sufficient insurance coverage at risk-based prices. Fourth, insurance companies continue to improve their financial risk management but this remains a continuing challenge because of mega or catastrophe risks, macro-economic volatility, and the use of more complex and novel risk hedging/diversification instruments. Fifth, international trade in insurance is

increasing and this has implications for the regulation of insurers entering US markets as well as US insurers that are seeking to enter foreign markets. Regulators need to keep pace with these developments and update their standards and enforcement activities accordingly. Regulators' resources will be stressed so they need to use their resources efficiently and shift their efforts to areas where regulation is most needed and away from areas where it is not needed.

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

Further, in disputes between insurers and insureds over claims and benefits, insurers tend to have more bargaining power because of their substantial legal resources and ability to outlast an insured who is facing a financial crunch and has small reserves to draw from.

Even nationally prominent insurers with strong brand names may seek to “push the envelope” in certain situations or have particular employees who fail to act correctly. Hence, regulators can improve market performance in these areas by preventing insurers and personnel with bad intentions from taking unfair advantage of consumers either in the sale of insurance or in the payment of claims. Some of my colleagues may take issue with this opinion but there are literally thousands if not millions of examples of where market forces have failed to prevent abuses.[1] Moreover, by going after the “bad actors”, regulators make it easier for the “good actors” to do the right things and maintain a higher quality of service.

In the regulatory system I envision, the states would efficiently enforce a uniform set of regulations (to the extent uniformity is legally feasible) in their respective jurisdictions and the inefficiencies and costs of unnecessary state differences and redundant regulatory processes would be minimized. I recognize that the design and implementation of such a system would require substantial analysis and discussion to resolve a number of issues associated with combining collective and individual state enforcement of uniform regulations in the context of our federal system of government in which the states retain certain prerogatives. Some form of Interstate Compact would probably be needed as one of the vehicles to create and implement the system as well as some sort of arrangement to monitor and audit states’ enforcement activities. Such a system would also require a “Plan B” for states which chose not to join such a system. In the remainder of my testimony, I explain the nature and rationale for my proposed system and reforms in

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

greater detail and address certain issues that might be raised and criticisms that might be made with respect to what I propose.

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

Summary of Proposed Reforms

Among the specific reforms I would advocate are:

1. A uniform set of requirements should be adopted for insurance products sold to persons, small businesses and for government-mandated insurance coverages (e.g., workers' compensation) to the extent that uniformity is legally feasible.

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

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

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

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

5. A rigorous set of uniform financial standards should be established, maintained and properly enforced – we are almost there but have more ground to cover. Also, the laws and process for administering insurance company receiverships should be further rationalized and made uniform among the states.

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

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

8. A comprehensive effort should be made to develop common and uniform systems for reporting of various insurers data that would minimize the cost of such reporting and maximize the value of and access to the information reported with appropriate protection of information that would be considered unsuitable for public access.

9. Competent and qualified state insurance commissioners should be appointed not elected – no one would propose that federal bank regulators be elected and the same principles should apply to state regulatory officials.

10. There should be a comprehensive and strengthened program of consumer and public education and information regarding the risks they must manage and related insurance products and coverages – the high level of consumer and public ignorance and misconceptions regarding insurance frustrates efforts to improve insurance regulation.

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

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

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

Alternative Institutional Structures: Federal and State Roles

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

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

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

The crux of the problem is that the ultimate arbiters of what governments do and the companies that insurance is purchased from – voters and consumers – are woefully

ignorant about insurance and its regulation. I am concerned that many consumers would not understand or be able to evaluate the differences between and the implications of federal versus state regulated insurers or differences between the policies of the two regimes. Hence, more of the power and benefits of choosing the regulatory venue could tend to accrue to the regulated not to the intended beneficiaries of regulation. It could weaken the oversight of state-regulated insurers and encourage states to ease regulations in ways that would be desirable to insurers "on the fence" but not in the best interest of consumers.

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

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

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

The approach that I would prefer arises from my belief that the high tension between the federal and state governments over insurance regulation has had very positive effects. Vesting insurance regulatory authority unequivocally in one entity or the other potentially reduces its incentives to implement needed reforms and could decrease the transparency of its policies and practices. At various times in history, the states have made great strides in improving their regulation of insurance when federal intervention or takeover is threatened. In this struggle, the federal government has a big hammer and the greatest

power that also has increased over time as it has gained more allies. The states, with their remaining allies, have less countervailing power but enough to force a good and transparent debate. For reasons that I do not yet fully understand, the debates and legislative threats that occur during these periods seem to promote a healthy and transparent examination of insurance regulatory systems and policies and the states feel compelled to institute reforms that are generally good ones.

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

In contrast, the NAIC is able to compel much greater uniformity and quality with respect to the financial or solvency regulation of insurance companies (which I distinguish from

market regulation) because of the greater inter-connections between state polices and practices in this area.

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

Detailed Discussion of Specific Reforms

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

Regulation of Insurance Products

The regulation of insurance products refers primarily to the policy forms that insurers must file for approval with state insurance departments before the policies can be used in the market. The term "product" may be more appropriate because insurers may be required to file and receive approval for related materials such as marketing plans.

Insurers are typically required to file for approval both new products and changes to existing products. Typically, the states require prior approval of products sold to persons and small business (e.g., auto insurance, home insurance, life insurance, business owners polices, etc.) or that are subject to state governmental mandates, such as workers' compensation insurance. The level or degree of regulation of products sold to medium size and larger firms tends to be less, especially in states that have embraced NAIC templates for the "reengineering" of commercial lines regulation. These firms, with the assistance of informed risk managers and brokers, should be able to protect their own interests in assessing products and insurers and negotiating contract terms.

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

reduction of unnecessary or excessive requirements would substantially decrease transactions costs, would not harm the consumers in specific states, and would ultimately work to their benefit whether they realize it or not.

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

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

regulation of life, annuity and LTC products and practices. Certain other types of insurance products such as "critical illness" policies may also fall into this category.

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

Deregulation of Rates/Pricing

Because of the highly competitive nature of most insurance markets (title and credit insurance being exceptions), prospective regulation of rates (e.g., prior approval of rates or rate changes) is unnecessary. Numerous studies of price regulation in auto and workers' compensation insurance effectively reveal no benefits but potentially severe problems from insurance rate regulation. For the most part, regulators are compelled to approve the same prices or rates that would otherwise be set by the market. It is also difficult to sustain cross-subsidies through the manipulation of rate structures when low-risk consumers have choices about who they buy insurance from and/or how much insurance they buy. However, there

are instances, some quite notorious, where regulators have sought to forestall or avoid economic reality by suppressing rates below adequate levels and/or substantially compressing rate structures (i.e., the rate differences between risk classes or geographic areas).

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

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

This contributes to the argument for rate deregulation. If regulators have no authority to approve or disapprove rates prospectively, then this should divert some of the political

pressure that they would otherwise face. Of course, deregulation does not totally solve the problem if there is always the danger that voters or special interest groups can reinstitute rate regulation or legislate rate restrictions.[2] Still, if federal standards and interstate compacts make this less likely, then the potential danger and threat is reduced.

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

There is another problem that can last somewhat longer. Certain commercial insurance markets in "long-tail lines" (i.e., lines where there can be a considerable lag between when premiums are set and collected and claims are fully paid) are subject to cyclical shifts in the supply and price of insurance – this is commonly known as the "underwriting cycle". The cycle begins with a chronic "soft market" phase in which insurers tend to under-price the coverage they sell and overly relax their underwriting standards. Academics and practitioners continue to probe and debate why this occurs, but regardless of the causes the

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

reality is that it happens. Ultimately, after insurers lose a lot of money and can no longer ignore their under-pricing, the supply of insurance tends to tighten sharply and prices can rise dramatically – this is called the "hard market" phase. Hard markets tend not to last too long (roughly two years at most unless claim costs continue to escalate) and once insurers begin earning positive profits the supply of insurance begins to increase and prices fall. Hence, the ultimate implications of this cyclical behavior is that commercial insurance buyers have to deal with some volatility in what they pay for insurance but over the long term they tend to get a price break because insurers' long-run profits tend to fall below what would be considered a fair rate of return.

If rate regulation could mitigate this phenomenon it might provide a partial argument for retaining some regulatory control of pricing. However, the research indicates that rate regulation does not mitigate the cycle and may in fact worsen it because of lags between the filing and approval of rate changes. Also, in commercial lines, if insurers want to cut prices they have a number of ways to circumvent any regulatory attempts to stop them.[3]

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

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

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

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

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

distortions. Hence, rate deregulation must be accompanied by responsible management of residual mechanisms in order for voluntary markets to work properly.

Singular Product Filings and Licensing Applications

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

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

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

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

While these developments are commendable, they stop short of a truly singular licensing application process that would allow an insurer to file one application and be approved for licensing in multiple states. Understandably, the states would like to retain their individual authorities to accept or reject license applications according to their standards and assessment of an insurer. I do not know how satisfied insurers are with the current state of affairs and their views of further streamlining the application process. It would not surprise me if a gap remains between what the states are willing to accommodate and what insurers

would like to see. If that is the case, then it seems further progress could be made to "unifying" the application and approval process without admitting "rouge insurers" to quote Commissioner Iuppa. It comes down to how much farther the states are willing to go to concede some of their discretion on approving applications and how much farther insurers think the states should go to achieve an optimal balance of efficiency and regulatory protection.

Financial Regulation and Administration of Insurer Receiverships

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

The reforms that have been instituted are beyond the scope of this testimony. My publications and Commissioner Iuppa's testimony discuss some of these initiatives. Commissioner Iuppa's testimony did not address requirements for "dynamic financial analysis" for property-casualty (p-c) insurers consistent with what is occurring in the development of international insurer solvency standards. In my opinion, this is an important area for consideration and perhaps one of the remaining linchpins that could be incorporated into p-c insurers' financial requirements. However, it appears to be a highly controversial

idea. Most large insurers already engage in this kind of analysis, but many p-c insurers, both large and small, may resist the notion of being compelled to perform this analysis and have it scrutinized by state insurance regulators. Life insurers are already more acquainted and comfortable with this kind of regulation because it has been tied historically to their asset-liability management.

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

As with the regulation of market conduct, financial regulators must deal with a shifting landscape, new developments and threats, insurer practices and mega-events and catastrophes that could have sweeping effects on a number of insurers. It appears that the NAIC has tended to respond to new issues, albeit a little late, but the action or reactions of individual state regulators within existing standards or the revision of standards may occur with too long of lag. Spurring regulators to quicker action within existing standards may be something that could be accomplished through the strengthening of existing NAIC

committees and mechanisms to coordinate state regulatory action. Revising standards is another matter because of the long deliberative process that is somewhat inherent to the NAIC's structure and lack of actual authority. It is not clear how this might be resolved unless some central entity would be given the authority to "fast-track" quickly needed changes in financial standards and requirements (such as that kind of authority that is vested with federal financial regulatory agencies).

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

There is also the issue of how the receiverships of impaired or insolvent insurers are managed. After I and two of my colleagues submitted a critical report on this matter, the NAIC set forth an extensive and ambitious program of reforms that in part will be facilitated and endorsed by the NAIC but ultimately must be implemented by the states. While the reforms are ambitious considering this area has been subject to the greatest inertial resistance by certain vested interests, I still believe they may fall short in a couple of key respects. Most importantly, there must be effective oversight and control over appointed receivers and the domiciliary regulators of insurers in receivership to minimize waste and maximize efficiency. Second, full exploitation of alternative workout plans for impaired p-c

insurers must be explored as an alternative to liquidations that typically result in higher "deficits" that eventually are paid by creditors, the "public" and others that bear little or no responsibility for the insolvency. Some policyholders and claimants are covered by guaranty associations that pass their net costs to other insurers, their insureds and taxpayers.

State Enforcement of Market Regulations

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

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

Based on studies and surveys I have conducted as well as others, it appears that a large number of states and market regulators still seem to be resistant to the kinds of reforms that

are warranted. Some states and regulators seem to zealously defend their prerogative to regulate market conduct the way they think is appropriate, regardless of whether it conforms with NAIC or other national standards or recommended policies and procedures.

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

If market conduct regulation is going to be really reformed in all states there will be a need to establish strong national standards and approved methods that the states will be compelled to implement. These standards and methods will need to be embodied in the vehicles that the federal government and the states will use to unify and rationalize other aspects of insurance regulation. I have co-authored reports and articles that outline a number of recommendations on market conduct regulation but there are three that I will mention

here that should be included in any federal standards. The first is that an insurer should be subject to only one routine or targeted market conduct examination that will serve all interested states. The second recommendation is that all states should be required to give some consideration to insurer self-compliance activities, whether performed individually or cooperatively through an industry self-regulatory organization. The third is that all states should be required to improve their monitoring and detection systems to better target their investigations to potentially significant and emerging problems and not toward massive error-finding scavenger hunts. In sum, all states should stop wasting resources on things that yield little value and focus their resources on serious problems that have the greatest impact on consumers.

Producer (Intermediary) Licensing and Regulation

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

Recently, I had the opportunity to review a survey of state producer licensing and education requirements and it seemed that there was a significant amount of variation that was difficult

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

Other Recommendations

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

profit organizations with an essentially proprietary mission. Insurers are also more zealously guarding access to their data for proprietary reasons.

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

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

Public and private organizations have undertaken extensive consumer education efforts but most people probably do not avail themselves of these services. We need to think about even greater proactive and aggressive public education efforts that reach more people and "encourage" more of them to become informed. Ironically, we seem to accept such a notion when it comes to things like public health but not financial health which is just as important.

Some of my colleagues may object to such efforts but we are paying a heavy price for consumer ignorance that will only increase as people are required to make more decisions. The claimed ignorance about the flood exclusions on homeowners insurance polices, the failure to save and prepare for retirement income needs, and the general misconceptions about what insurance is are exacting heavy tolls and make it harder for legislators and regulators to pursue economically-sound policies. We cannot expect to get every consumer and voter to become well informed but we need to see if we can achieve a significant reduction in the level and breadth of ignorance.

Concluding Observations

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

Designing a regulatory system and setting regulatory policies by necessity is a balancing act. The benefits and costs of relying on "free choice" and market forces have to be balanced against the benefits and costs of regulatory constraints and mandates. The choice of an institutional framework also affects costs and effectiveness and may have implications for how incentive conflicts between different insurance market participants are resolved. I have

offered my opinions on what I think insurance regulation should like but I do not claim to be omniscient or invulnerable to error. The important thing is that the Committee is facilitating a full airing of the issues and opinions that will allow it to make the most informed and best decisions that will serve the public interest. I would be happy to continue to engage in communications with the Committee and comment further on any questions it may have.

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