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Before the Senate Banking, Housing and Urban Affairs

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

INTRODUCTION

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

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

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

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

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

- Potential inefficiency, resulting both from the substance of regulation (especially price and form control) but also from its structure (the inevitable duplication and cost associated with multiple non-uniform regulatory regimes);

- International impediments, both questions of comity (facilitating international firms' operations in the U.S., which benefits U.S. consumers) and competitiveness (facilitating U.S. firms' operations abroad, which provides growth opportunities for U.S. industry and helps diversify their risk exposures);

- Systemic "blind spots", the inability of the official sector to understand and respond to the insurance sector's evolving contribution to risks affecting the financial system as a whole.

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

BACKGROUND

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

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

State insurance regulation can be divided into two broad categories:

- solvency or financial regulation aimed at preventing insurer insolvencies and mitigating consumer losses should insolvencies occur; and

- consumer protection and market regulation focused on potential anti-consumer practices.

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

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

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

KEY ISSUES IN CONSIDERING INSURANCE REGULATORY MODERNIZATION

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

Potential Inefficiencies of the State-based System

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

International Issues

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

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

The U.S. insurance market, in particular the global nature of insurance, is vastly different than it was six decades ago when McCarran-Ferguson was enacted. To give an example of the sort of efforts underway internationally, the European Union (EU) is continuing its work on its Solvency II project focused on insolvency risk for insurers in preparation for its scheduled introduction on an EU-wide basis in 2010. Solvency II is an important undertaking for it encompasses quantitative capital requirements, a supervisory review process expected to harmonize the procedure in Europe, and it will conform to disclosure requirements with those of the international accounting standard-setters. This is all part of the effort to forge one insurance market for the twenty-five member states in the EU.

Reflecting the growing international nature of the markets, the NAIC is working closely with international regulators on a number of projects, such as Solvency II in the EU, on international accounting standards, and others. The NAIC itself is not a regulator but facilitates communications among the states on international regulatory issues. To that the end, it engages in regulatory cooperation with international insurance regulators and through Memoranda of Understanding (MOUs), and supports individual members by providing technical assistance to regulatory agencies. The NAIC also coordinates closely with Office of the U.S. Trade Representative in international financial services negotiations, and it participates in Treasury's financial markets regulatory dialogues with various countries, including China, Japan, and the EU.

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

Lack of Federal Understanding of Risk in the Insurance Market

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

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

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

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

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

CONCLUSION

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

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

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