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on behalf of
The Council of Insurance Agents & Brokers

Before
The Senate Banking Committee
Regarding
Insurance Regulation Reform
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Good morning, Chairman Shelby, Ranking Member Sarbanes and members of the Committee. Thank you for the opportunity to testify before you today on behalf of The Council of Insurance Agents & Brokers (The Council), which I serve as general counsel. We are grateful for the initiation of this effort to explore the contours of the current regulatory structure of the insurance industry and the potential need for change.

Insurance regulatory reform, which is critical for the long-term health of the industry, is long overdue. Modernization of the insurance regulatory structure is an important element in maintaining a strong, vibrant insurance sector and is essential to allow the marketplace to evolve in order to address the needs of insurance policyholders in the 21st century.

The Council represents the nation's leading insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place more than 80 percent – well over $200 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in

employee benefits. Since 1913, The Council has worked in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

Executive Summary

Insurance regulatory reform is long overdue. The State regulatory system is simply not equipped to handle the increasingly complex and sophisticated insurance marketplace, and the patchwork quilt of insurance regulation has a very real impact on the availability and affordability of coverage for insurance consumers. This is why The Council is a strong supporter of insurance regulatory reform and is working so hard for change.

The Council is very grateful for the work of Senators Sununu and Johnson in drafting The National Insurance Act of 2006, S. 2506. We believe the proposal is an excellent framework on which to build a dialogue around the issues of insurance regulatory modernization. We endorse the legislation for many reasons, not the least of which is its purely voluntary nature – voluntary for companies and agents/brokers, as well as consumers. The bill provides real choice for all participants in the insurance marketplace.

The Council has been a strong advocate for such legislation for a number of years. We hope progress is made on S. 2506, but all of us know that this is a difficult set of issues and debate will take a considerable amount of time. It is a major undertaking with a great number of issues to be resolved. Political reality dictates that it will not be an easy process, nor will it be quick. Meanwhile, however, insurance regulation is in desperate need of reform. In order to better serve our policyholders and clients, we need practical solutions to real marketplace problems. We hope that debate over the Optional Federal Charter will not stop the members of this committee from considering less controversial incremental reforms that address fundamental flaws in the system and for which solutions are readily at hand.

Regulation of surplus lines insurance provides a perfect example. Although the purchase of surplus lines insurance is generally considered to be less regulated than the admitted marketplace, in

reality the regulatory structure governing such coverage is quite burdensome and restrains the availability of coverage. When surplus lines activity is limited to a single state, regulatory issues are minimal. When activity encompasses multiple states, however, which is the norm in the surplus lines market, full regulatory compliance is difficult, if not impossible. Thus, the difficulty of complying with the inconsistent, sometimes conflicting requirements of multiple state laws is a real problem. Simply keeping track of all the requirements can be a Herculean task.

The House Financial Services Committee is considering legislation that would fix this problem. H.R. 5637, the Nonadmitted and Reinsurance Reform Act, would streamline surplus lines regulation by consolidating regulatory oversight of surplus lines transactions into a single state – the insured’s home state – thus eliminating the overlapping, conflicting rules that inhibit the non-admitted marketplace and harm consumers. The proposal does not deregulate the non admitted insurance marketplace or reduce consumer protections. Even the National Association of Insurance Commissioner's most recent past president, Diane Koken of Pennsylvania, has acknowledged that this is an area where federal intervention may well be needed “to resolve conflicting state laws regulating multi-state transactions.”

Surplus lines regulatory reform will not detract at all from the debate over the OFC, nor is a substitute for that legislation. But in the meantime, it is an achievable reform, a somewhat uncontroversial reform, and its resolution will save millions of dollars for carriers and consumers and, we believe, ultimately increase compliance with state premium tax requirements by resolving the conflicts that make compliance difficult if not impossible today.

Optional Charter - Introduction

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

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

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

But things have changed. While some risks – and insurance markets – remain local or State-based, in general, insurance has become a national and international marketplace in which risks are widely spread and losses widely felt. The terrorist attack on the World Trade Center and the devastation caused by Hurricane Katrina are, perhaps, the two most notable examples, but many policyholders, particularly in the commercial sector, have risks spread across the country and the globe. Rather than encouraging increased availability and improving the affordability of insurance to cover such risks, the state regulatory system does just the opposite. By artificially making each state an individual marketplace, it constrains the ability of carriers to compete and thereby reduces availability and affordability.

Insurance Regulatory Reform: Despite recent improvements, there remain significant problems in the state insurance regulatory system; because the states cannot solve these problems on their own, congressional action is necessary.

Although the state insurance regulators, through the National Association of Insurance Commissioners (NAIC), have attempted to institute regulatory reforms without federal involvement, the reality is that today's marketplace demands far more dramatic action than the states alone are able to provide. As I have mentioned, insurance is no longer the local market it once was. It is a national and international marketplace, the development of which is far outstripping the pace of reform efforts by state regulators and legislatures. The state regulatory system is simply not equipped to handle this increasingly complex and sophisticated marketplace. Competition and efficiency in the insurance industry lag behind other financial services sectors due to the regulatory inefficiencies and inconsistencies in the state insurance regulatory system. These inefficiencies and inconsistencies must be addressed if the insurance sector is going to be able to keep up with the pace of change in the rapidly evolving global marketplace and thereby provide adequate and affordable coverage to insurance consumers.

The Council regards itself as a pioneer within our industry with respect to regulatory modernization, although reform is a frustratingly long process. We formed our first internal committee to address the problems of interstate insurance producer licensing more than 60 years ago. Our efforts were finally rewarded with the enactment of the NARAB provisions of the Gramm-Leach-Bliley Act (GLBA) a few years ago – a first step on the road to insurance regulatory reform. The proposed National Insurance Act is the next step on the road to modernization.

I want to emphasize at the outset that we are not advocating deregulation of the insurance marketplace or any reduction in consumer protections. What we are advocating – as we did with NARAB and producer licensing reform – is fixing the current regulatory system to allow insurance companies and producers to have a choice between state and federal oversight. Many insurers and producers will likely choose to remain within the state system because it works best based on the size of their business and their customer base. For the same reasons, others will choose the federal option. For this latter group, jettisoning the current multi-state system for a single federal regulator makes eminent good sense, allowing them to avoid the overlapping, burdensome dictates of 55 jurisdictions for a single regulator and thereby easing regulatory burdens – and doing so without sacrificing consumer

protections. We believe the long-term effects of such reform on the marketplace will ultimately benefit the consumer by increasing capacity and improving availability of coverage.

Continuing Problems under the Current Regulatory System

Although the States have made some strides in recent years in simplification and streamlining regulatory requirements, almost all the concrete progress has been in the producer licensing area – thanks to the enactment of GLBA's NARAB provisions. NARAB compliance notwithstanding, there remain several problem areas in the interstate licensing process that impose unnecessary costs on our members in terms of time and money. In addition, insurance companies face problems doing business on a multi-state basis, and recent efforts by the states to streamline rate and policy form approval processes have not proven very successful. The operation of and access to alternative markets – such as surplus lines and risk retention groups – is also hampered by unnecessarily cumbersome and duplicative regulatory requirements. These continuing problems with the state-by-state insurance regulatory process has led us to the following conclusion: regulatory reform is needed, and it is needed now.

1. Producer Licensure: Welcome Improvements, but Incomplete Reform

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

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

Although most of the states have enacted the entire PLMA, a number of States have enacted only the reciprocity portions of the model. Of the states that have enacted the entire PLMA, several have deviated significantly from the model's original language. One state has enacted licensing reform that in no way resembles the PLMA. And two of the largest states in terms of insurance premiums written, Florida and California, have not enacted legislation designed to meet the NARAB reciprocity threshold at all.

The inefficiencies and inconsistencies that remain in producer licensing affect every insurer, every producer and every insurance consumer. Many Council member firms continue to hold hundreds of resident and non-resident licenses across the country. For some, the number of licenses has actually increased since enactment of GLBA. In addition to initial licenses, Council members face annual renewals in 51-plus jurisdictions, in addition to satisfying all the underlying requirements and post-licensure oversight. Undeniably, progress in streamlining the producer licensing process has been made since GLBA's NARAB provisions were enacted in 1999, but these numbers – and, more critically, the regulatory and administrative burdens they represent – vividly demonstrate that the job is not yet finished. Most states retain a variety of individual requirements for licensing, and they all differ with respect to fees, fingerprinting and certifications, among other requirements.

In addition to the lack of full reciprocity in licensing procedures for non-residents, the standards by which the states measure compliance with licensing requirements differ from state to state, as well. These include substantive requirements – pre-licensing education, continuing education and criminal background checks, for example – as well as administrative procedures such as agent appointment procedures and license tenure and renewal dates. While these may seem like small issues, they can easily turn into large problem for insurance producers licensed in multiple jurisdictions: they must constantly renew licenses throughout the year, based upon the individual requirements in each state. In addition to the day-to-day difficulties the current set-up imposes, this inconsistent application of law among the states inhibits efforts to reach full reciprocity. Some states may be disinclined to license as a non-resident a producer whose home state has "inferior" licensing standards, even a state with similar or identical statutory language. In fact, several states that have failed to adopt compliant licensure

reciprocity regimes (notably California and Florida) claim their refusal is based on this absence of uniform standards – thus implying that the standards of other states do not measure up.

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

Thus it is clear that, despite the revolutionary NARAB achievements, comprehensive reciprocity and uniformity in producer licensing laws remains elusive, and it does not appear the NAIC and the States are capable of fully satisfying those goals. Indeed, until recently, Florida completely barred non-residents from being licensed to sell surplus lines products to Florida residents or resident businesses. And several states including Florida required non-resident agents and brokers who sold a policy of an admitted company to their residents or resident businesses to pay a mandated "countersignature fee" to a registered agent in order to complete that transaction. These practices have been terminated only because The Council filed a lawsuit in every jurisdiction in which countersignatures were required. Countersignature laws in Florida, South Dakota, Nevada, Puerto Rico and the Virgin Islands have been struck down by federal judges in those jurisdictions, and the West Virginia legislature repealed its law rather than defend it in court. The rulings tossing out the countersignature laws in Nevada and the Virgin Islands are still in the appeals process and are not yet final.

2. Access To Alternative Markets

In the last several years, high rates for property and casualty insurance have been a serious problem for many mid-sized and larger commercial firms. Hard markets such as these cause availability to decrease and the cost of coverage to increase. During these periods, insureds – particularly sophisticated commercial insureds – are increasingly drawn to the appeal of alternatives to the traditional, regulated marketplace to expand their coverage options and hold down costs. There are two excellent mechanisms in place that offer such alternative markets: surplus lines insurance and risk retention groups. Although surplus lines insurance and insurance purchased through risk retention

groups technically are less regulated than insurance in the admitted market, there are, nonetheless, state regulatory requirements and federal laws that apply to these alternative market mechanisms that prevent this marketplace from fully realizing its potential. Creation of an optional federal charter would transform these markets, increasing options and decreasing costs for insurance consumers.

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

Surplus lines insurance is universally recognized as an important component of the commercial property and casualty insurance marketplace in all states, and commercial property and casualty business is done increasingly through the surplus lines marketplace. In fact, in 2004, $33 billion in premium was purchased by policyholders in the surplus lines market.

Although the purchase of surplus lines insurance is legal in all states, the regulatory structure governing such coverage is a morass. When surplus lines activity is limited to a single state, regulatory issues are minimal. When activity encompasses multiple states, however, full regulatory compliance is difficult, if not impossible. And I should note that multi-State surplus lines policies are the norm rather than the exception because surplus lines coverage is uniquely able to address the needs of insureds seeking coverage in more than one State. Thus, the difficulty of complying with the inconsistent, sometimes conflicting requirements of multiple State laws is a real problem. Simply keeping track of all

the requirements can be a Herculean task. For example: Maryland and the District of Columbia require a monthly "declaration" of surplus lines business placed, but only require payment of premium taxes on a semi-annual basis; Virginia, in contrast, requires that a declaration be filed and taxes be paid quarterly; New Jersey has 36 pages of instructions for surplus lines filings, including a page discussing how to number the filings and a warning not to file a page out of sequence because that would cause a rejection of the filing and could result in a late filing.

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

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

- Single situs approach – 100% of the premium tax is paid to the insured's State of domicile or headquarters State. This approach is imposed by some states regardless of what percentage of the premium is associated with risks insured in the state. Virginia, for example, utilizes this rule.
- Multi-State approach – Premium tax is paid to multiple states utilizing some method of allocation and apportionment based upon the location of the risk(s). Because there is no coordination among the states on allocation and apportionment, determination of the amount of tax owed to each state is left to brokers and insureds. If a policy covers property insured in a single situs state and in an apportionment state, double taxation also is unavoidable. A majority of the states utilize this basic rule but the manner in which it is implemented (including the allocation formula) can vary wildly.
- No clear requirement – More than a dozen states that impose surplus lines premium taxes do not have statutory or regulatory provisions indicating the state's tax allocation method, leaving it up to the insured and the insured's broker to determine how to comply with the state law. In such states, determination as to whether any tax should be paid and whether the allocation of any such tax is permissible and appropriate is often based on informal guidance from state insurance department staff.

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

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

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

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

The States also differ with respect to what is subject to the tax, what is exempt from the tax, whether governmental entities are taxed, and whether brokers' fees are taxed as part of or separately

from the premium tax (if they are taxed at all). As you can see, determining the proper surplus lines tax payment for the placement of a multi-State policy is a daunting task.

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

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

Insurer Eligibility: Most States require that a surplus lines insurer be deemed "eligible" by meeting certain financial criteria or having been designated as “eligible” on a state-maintained list. Although a majority of the states maintain eligibility lists (also called “white lists”), in many of the remaining states the surplus lines broker is held responsible for determining if the non-admitted insurer meets the state’s eligibility criteria. In addition, although the NAIC maintains a list of eligible alien (non-U.S.) surplus lines insurers that is used by four States, this does not seem to have any bearing on the uniformity of the eligible lists in the remaining states. As one would expect, as a result of differing eligibility criteria

from state to state – and changes in individual states from year to year – the insurers eligible to provide surplus lines coverage varies from state to state. This can make it exceedingly difficult to locate a surplus lines insurer that is "eligible" in all states where a multi-state policy is sought.

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

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

Like other surplus lines requirements, State filing rules vary widely. Some States require signed, sworn affidavits detailing diligent search compliance; some require such affidavits to be on legal sized paper, others do not; some States require electronic filings, others require paper; some States have specific forms that must be used, others do not; some States require the filing of supporting documentation, some do not – although some of those States place the burden on the broker, who is required to store the information in case regulatory inspection is required. In addition, although most filings are required to be submitted to the State insurance regulator, in at least one State, Kentucky, municipalities also require submission of surplus lines materials. There are hundreds of cities and counties in the State and each requires a separate quarterly and annual report by the licensee. As with the tax situation, this creates a terrible burden on surplus lines insurers and brokers, and unnecessarily increases consumer costs.

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

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

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

- Producer Licensing: All States require resident and non-resident surplus lines producers to be licensed, and all States have reciprocal processes in place for non-resident licensure. Nevertheless, there remain significant differences among some States with respect to producer licensing that can delay the licensure process, particularly for non-residents. For example, most States require that an individual applying for a surplus lines broker license be a licensed property and casualty producer. The States vary, however, as to how long the applicant must have held the underlying producer license. In addition, some, but not all, States exempt from

licensure producers placing multi-State coverage where part of the risk is located in the insured's home State. In States without such an exemption, the laws require a producer to be licensed even for such incidental risks.

- Sophisticated Commercial Policyholders: Some States exempt "industrial insureds" from the diligent search, disclosure, and/or filing requirements. The definition varies among the States, but generally industrial insureds are analogous to the concept of sophisticated commercial insureds. They are required to have a full time risk manager, minimum premium requirements for selected lines of coverage, and a minimum number of employees. If an insured meets a State's criteria, the insured's surplus lines transaction is exempt from the surplus lines requirements, as provided for by the State.
- Automatic Export: A number of States allow certain risks to be placed directly in the surplus lines market. This is called "automatic export" because no diligent search is required before the risk is exported from the admitted market to the surplus lines market. As with every other surplus lines requirement, however, the States are not uniform in their designation of the risks eligible for automatic export.
- Courtesy Filings: A courtesy filing is the payment of surplus lines tax in a State by a surplus lines broker who was not involved in the original procurement of the policy. Courtesy filings are helpful when a broker places a multi-State filing that covers an incidental risk in a State in which the broker is not licensed. The problem is that most States either prohibit courtesy filings or are silent as to whether they will be accepted. This uncertainty essentially requires surplus lines producers to be licensed even in States where they would otherwise be exempt.

The Nonadmitted and Reinsurance Reform Act: In the House, Representatives Ginny Brown-Waite (R-FL) and Dennis Moore (D-KS) have sponsored H.R. 5637, the Nonadmitted and Reinsurance Reform Act. The bill proposes a common-sense reform that would streamline surplus lines regulation and ease regulatory burdens, while preserving consumer protections and the financial soundness of the surplus lines marketplace, which is the most important protection of all. The proposed legislation would provide an effective resolution to the current regulatory morass by focusing on the home State of the insured: all premium taxes would be payable to the insured's home State and surplus lines insurance transactions would be governed by the rules of the insured's home State.

The Council supports the legislation and efforts to initiate insurance regulatory modernization by focusing on surplus lines. We look forward to seeing the bill move through the Financial Services Committee and on to the full House for consideration. Having said that, surplus lines is but one segment of a huge industry. While H.R. 5637 is an excellent start for insurance regulatory modernization, it is clear that more global reform – such as the National Insurance Act – will be necessary to address the full range of regulatory issues affecting the insurance marketplace.

I note that *Business Insurance*, the insurance trade publication, in its June 26, 2006 issue, published an editorial in support of the Act, stating that "the measure would bring much-needed uniformity to the taxation and regulation of nonadmitted insurers while giving risk managers a streamlined process for tapping that vital market…While we would prefer comprehensive insurance regulatory reform, including the optional federal charter, we support incremental change. Even a little reform is far better than none at all."

In addition, although the state regulators have been silent on the proposed legislation, the NAIC has acknowledged that congressional action on surplus lines reform may be necessary. In testimony in June 2005, before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Diane Koken, the Pennsylvania Insurance Commissioner and then-president of the NAIC, stated

> Either federal legislation, or another alternative such as an Interstate Compact, may be needed at some point to resolve conflicting state laws regulating multi-state transactions. The area where this will most likely be necessary is surplus lines premium tax allocation. Federal legislation might also be one option to consider to enable multi-state property risks to access surplus lines coverage in their home states under a single policy subject to a single set of requirements.

b. Risk Retention Groups. Enacted in 1981, the Product Liability Risk Retention Act was developed by Congress in direct response to the insurance "hard market" of the late 1970s. The current version of the law – the Liability Risk Retention Act of 1986 – was enacted in response to the "hard market" of the mid-1980s and expanded the coverage of the Act to all commercial liability coverages. Risk Retention Groups (RRGs) created under the Act are risk-bearing entities that must be chartered and

licensed as an insurance company in only one State and then are permitted to operate in all States. They are owned by their insureds and the insureds are required to have similar or related liability exposures; RRGs may only write commercial liability coverages and only for their member-insureds.

The rationale underlying the single-State regulation of RRGs is that they consist only of "similar or related" businesses which are able to manage and monitor their own risks. The NAIC has recognized that the purpose of Risk Retention Groups is to "increase the availability of commercial liability insurance."

3. Speed To Market

The State-by-State system of insurance regulation gives rise to problems outside the area of producer licensing that require immediate congressional attention, as well. Although these problems appear to affect insurance companies more than insurance producers, the unnecessary restraints imposed by the State-by-State regulatory system on insurers harm producers as much as companies because they negatively affect the availability and affordability of insurance, and, thus, our ability to place coverage for our clients.

Most Council members sell and service primarily commercial property/casualty insurance. This sector of the insurance industry is facing severe challenges today due to a number of factors, including: the losses incurred as a result of the September 11 terrorist attacks; increased liability expenses for asbestos, toxic mold, D&O liability and medical malpractice; and years of declining investment returns and consistently negative underwriting results. Some companies have begun to exit insurance markets as they realize that they can no longer write these coverages on a break-even basis, let alone at a profit. The end result is increased prices and declining product availability to consumers. This situation is exacerbated by the current State-by-State system of insurance regulation.

The current U.S. system of regulation can be characterized as a prescriptive system that generally imposes a comprehensive set of prior constraints and conditions on all aspects of the business operations of regulated entities. Examples of these requirements include prior approval or filing of rates and policy forms. Although the prescriptive approach is designed to anticipate problems and prevent them before

they happen, in practice, this approach hinders the ability of the insurance industry to deal with changing marketplace needs and conditions in a flexible and timely manner. This approach also encourages more regulation than may be necessary in some areas, while diverting precious resources from other areas that may need more regulatory attention.

It is also important to note that insurers wishing to do business on a national basis must deal with 51 sets of these prescriptive requirements. This tends to lead to duplicative requirements among the jurisdictions, and excessive and inefficient regulation in these areas. Perhaps the best (or worst, depending upon your perspective) example of this are the policy form and rate pre-approval requirements still in use in many States. Over a dozen States have completely de-regulated the commercial insurance marketplace for rates and forms, meaning that there are no substantive regulatory approval requirements in these areas at all. Other States, however, continue to maintain pre-approval requirements, significantly impeding the ability of insurers to get products to market. Indeed, some studies have shown that it can take as much as two years for a new product to be approved for sale on a nationwide basis. Banking and securities firms, in contrast, can get a new product into the national marketplace in 30 days or less. The lag time for the introduction of new insurance products is unacceptable. It is increasingly putting the insurance industry at a competitive disadvantage as well as undermining the ability of insurance consumers to access products that they want and need.

Let me give you an example that all Council members are familiar with: a few years ago, PAR, an errors and omissions captive insurer sponsored by The Council, sought to revise its coverage form. In most States, PAR was broadening coverage, although in a few cases, more limited coverage was sought. PAR had to refile the coverage form in 35 States where PAR writes coverage for 65 insureds. After 2 years and $175,000, all 35 States approved the filing. Two years and $5,000 per filing for a straightforward form revision for 65 sophisticated policyholders is unacceptable and is symptomatic of the problems caused by outdated rate and form controls.

We support complete deregulation of rates and forms for commercial lines of insurance. There is simply no need for such government paternalism. Commercial insureds are capable of watching out for their own interests, and a robust free market has proved to be the best price control available. The

proposed National Insurance Act contemplates this approach by restricting the federal regulator's authority to dictate rates or the determination of rates.

B. Solutions – Congressional Leadership and Action is Critical if Insurance Regulatory Reform is to Become a Reality

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

As we all know, there are, essentially, two approaches to insurance regulatory reform currently under consideration – issue-by-issue reform and the optional federal charter. These approaches, although different, are not necessarily mutually exclusive – partial reform now does not rule out further reform in the future. Indeed, both may be necessary in order to bring comprehensive reform to the insurance marketplace. As we have mentioned, The Council strongly supports the surplus lines reform that is now under consideration in the House and believes such legislation will not detract at all from the debate over the OFC, nor is a substitute for that legislation. In fact, we believe it will help set the stage for creation of an optional federal charter.

Having said that, however, we believe the ultimate solution – at least for the property and casualty industry – is enactment of legislation creating an optional federal insurance charter as contemplated in the National Insurance Act. An optional federal charter would give insurers and

producers the choice between a single federal regulator and multiple State regulators. It would not dismantle the State system, rather it would complement the State system with the addition of a federal partner. It is likely that many insurers and producers – particularly those who operate in a single State or perhaps a small number of States – would choose to remain State-licensed. Large, national and international companies, on the other hand, would very likely opt for a federal charter, thereby relieving themselves of the burden of compliance with 51 different regulatory regimes.

The National Insurance Act creates an optional federal regulatory structure for both the life and property & casualty insurance industries; that option extends equally to both insurance companies and insurance agents and brokers (producers); and the bill carefully addresses essential elements of insurance regulation including licensure, rate approval, guaranty funds, and State law preemption. The Act preserves the State system for those that choose to operate at the State level, but offers a more sophisticated regulatory structure for insurers and producers that operate on a national and international basis in this increasingly global industry.

- ***S. 2509 creates a truly optional insurance regulatory system for all industry players.*** The structure it creates gives insurance companies and producers a real choice as to whether they want to operate under federal or state oversight. The Act preserves the ability of insurers and insurance producers to operate under State licenses, while giving both the option of doing business under a single federal license.

- ***S. 2509 gives insurance producers a choice between federal and state oversight, and in no way increases regulatory burdens on producers.*** Far from creating additional licensure requirements for insurance producers, the Act has the potential of significantly reducing the regulatory burdens producers face in securing licenses. Under the Act, insurance producers can choose to keep their existing State licenses and sell for all insurers – state and national – wherever they hold a State license. Or they can choose a single national license and sell for all insurers – state and national – in all U.S. jurisdictions. An additional benefit for producers that choose a national license is that they would be subject to a single set of requirements covering qualifications to do business, testing, licensing, market conduct and continuing education. Although the States have taken some steps in

recent years toward uniform and reciprocal producer licensing requirements, it will be many years before they will enjoy such a streamlined system at the state level – if ever.

- ***Insurance consumers, too, have a choice.*** Consumers retain complete control to choose the insurers and producers with which they wish to do business. If a consumer deems it important that their insurance company be subject to the rules of a particular State or the federal regulator, they can use that as a factor in their purchase decision.

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

- ***S. 2509 bolsters rather than diminishes current protections for insurance consumers.*** At present, insurance consumer protections are uneven from state to state. Some states have a robust system of consumer protection, while others devote fewer resources to it. Under the Act, consumers purchasing products from national insurers would have the same protections and rights whether they live in Los Angeles, Topeka or Providence. Importantly, their rights under a policy would not change simply because they move across the Potomac from Washington to Alexandria.

- ***The consumer protections in S. 2509 are stronger than those in many states and provide protections that are simply unavailable in many States.*** For example, the Act requires every insurer to undergo both a financial and a market conduct examination at least once every three years. In addition, the Act provides for the creation of a Division of Fraud, Division of Consumer Affairs, and an Office of the Ombudsman to protect consumers. The Act makes the commission of a "fraudulent insurance act" a federal crime and subjects National Insurers to federal antitrust laws.

- ***The Act provides for comprehensive, rigorous oversight of insurers and insurance producers that protects producers in case of insolvency and is comparable to the best practices currently in place***

in the states. In addition to traditional consumer protections, the Act protects insurance consumers in another essential way: federally-chartered insurers will be subject to the financial solvency oversight of a federal regulator with the resources and staff to adequately supervise large corporations that may be beyond the capability of the states. The Act provides for financial and market conduct examinations every three years, allows for self-regulatory organizations to be created to police the industry, ensures that sufficient resources and federal attention will be devoted to insurance oversight, and does not eliminate or reduce in any way the ability or effectiveness of state insurance regulation. In addition, S. 2509 leaves the State guarantee system intact to ensure policyholders are protected in case of insurer insolvency. The Act sets stringent standards that state funds must meet in order to secure national insurer participation. A national guaranty fund is established to protect policyholders in states where the guaranty fund falls short of the national standards.

The Council has been a strong advocate for legislation such as the National Insurance Act for a number of years. We realize this is a major undertaking with a great number of issues to be resolved. Political reality dictates that it will not be an easy process, nor will it be quick. We look forward to being a constructive voice in this debate.

In closing, as I noted above, improvements in the State insurance regulatory system have come about largely because of outside pressure, notably, from the Congress. Despite its ambitious reform agenda, the NAIC is not in a position to force dissenting States to adhere to any standards it sets. Thus, it is clear that congressional leadership will be necessary to truly reform the insurance regulatory regime in the United States. On behalf of The Council, I thank you for your genuine interest in these issues. We stand ready to assist you in any way.

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