Commissioner Donelon

International Keynote Address

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Remarks at the Second Annual General Insurance Exchange

It is my great pleasure to be here with you today. I am highly honored to have been chosen to deliver the International Key Note Address at such an important event. Coming to Australia's most populated and, I might add, most beautiful city is truly a pleasure. The view of the harbor and the Opera House are stunning.

My topic for today is to provide you with perspectives on general insurance in the United States of America. In the USA we generally refer to insurance as including property and casualty insurance (both personal and commercial), as well as life, annuities and health insurance. However, for purposed of my remarks here today, I will focus on property and casualty insurance.

Today I plan to cover five general areas:

- How general insurance works in the USA;
- How the state-based national system of insurance regulation works;
- How U.S. regulators have modernized solvency regulation;
- Changes in consumer behavior in the wake of recent catastrophes;

and

- Lessons learned from recent hurricanes, tornadoes and other natural disasters.

The $1.7 trillion insurance market in the USA represents roughly 1/3 of the world premium volume. While the rest of the world tends to view the U.S. market as a whole, it is really 56 different insurance markets that collectively make up the U.S. market. Each jurisdiction has its own chief insurance regulatory official and collectively these 56 individuals make up the membership of the National Association of Insurance Commissioners or the NAIC. The NAIC is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

To give some perspective on the premium volume of the U.S. states, the largest is California which ranks sixth in the world with 4.36% of the world market—slightly less than the 4.39% of the world market share written in the People's Republic of China. Australia and Pennsylvania have roughly the same premium volume with Pennsylvania having 1.82% of the world market share and Australia having 1.76%. My home state Louisiana ranks 47th in a virtual tie with Austria with roughly $23 billion in premiums and 0.46% market share.

The general insurance markets in the USA are mature markets. They feature almost 2,700 insurers competing for business. The number can be slightly misleading as the average jurisdiction has about 800 property and casualty insurers operating within its borders. The U.S. property and casualty insurers collectively wrote $468 billion in 2011 ranging from $16 million in the Northern Marianas Islands to $51 billion in California. Premium revenue has been relatively flat over the last five years with slight growth shown in 2011 when compared to 2010. Our 2012 figures are just now coming in and confirmed numbers were unavailable at the time I prepared these remarks.

Soft market conditions persevered in 2011 and through early 2012. The first half of 2012 was profitable for the industry. Collectively they reported net industry profits of $20.1 billion compared to $6.6 billion a year earlier. Most of this improvement was attributed to lower catastrophe losses but also due to moderate rate increases within certain lines, particularly commercial lines. Some of the profits will be diminished by the major catastrophe called Superstorm Sandy that hit several insurance markets in the Northeastern part of the USA last fall. While claims are still coming in, at last report there were almost 1.2 million claims reported with ultimate losses projected in the $20-25 billion range. By mid-February over 90% of the residential claims had been settled with over $10.8 billion in paid losses. This is a tribute to the way in which insurers place their policyholders' needs first.

The general insurance markets in the USA are dominated by personal lines policies—auto insurance and homeowners insurance are the largest singles lines of coverage. Collectively the personal auto coverage line of business accounts for $162 billion in premiums. The homeowners line of business is almost $64 billion. The largest premium volume lines for businesses are the liability line and workers' compensation which both come in at $37 billion. If you are interested in details regarding these undertakings, the NAIC publishes a number of reports including market share and profitability for general insurance.

The U.S. regulatory system is often misunderstood. I would like to take this opportunity to shed some light on it for you today. First, the U.S. regulatory system is a state-based national system of insurance regulation that is built on several fundamental principles.

Before I describe the principles, you are all probably wondering why the states, rather than the U.S. Federal Government, are regulating insurance. If you will indulge me for a brief history lesson, I think the reasons will become clear. When the original thirteen colonies declared their independence from Great Britain in 1776, there was great mistrust of a centralized government power. Thus, the governmental framework for the USA was based on states' rights first with limited ceding of authority to a national or federal government. Thus each state has its own judicial system that governs most things to this day. Each state also has a legislative body charged with developing public policy and enacting laws governing the activities of its citizens. State legislatures are the public policymakers that establish broad policy for the regulation of insurance by enacting legislation providing the regulatory framework under which insurance regulators operate. They establish laws which grant regulatory authority to regulators and oversee state insurance departments and approve regulatory budgets.

There have occasionally been challenges to this state-based regulatory authority. The first noteworthy challenge came from a Virginia insurance agent known as Samuel Paul. Mr. Paul was a licensed agent in Virginia who was fined for selling a policy in New York without a license from New York to do so. He took his case all the way to the U.S. Supreme Court. In 1869, the Supreme Court held, in the case Paul v. Virginia, that "issuing a policy of insurance is not a transaction of commerce." As a result, states were left with responsibility over the taxation and regulation of insurance.

Another Supreme Court case (United States v. Southeastern Underwriters) led to the overturning of the Paul v. Virginia decision in 1944. In the Southeastern Underwriters case the U.S. Supreme Court held that insurance was indeed interstate commerce. This caused turmoil as there was a regulatory void that led the U.S. Congress to enact the McCarran-Ferguson Act in 1945. The McCarran-Ferguson Act clarified that states should continue to regulate and tax the business of insurance and affirmed that the continued regulation of the insurance industry by the states was in the public's best interest. The Gramm-Leach-Bliley Act in 1999 and the more recent Dodd-Frank Consumer Protection and Wall Street Reform Act of 2010 both affirmed that the McCarran-Ferguson Act remains the law of the land. Thus, in the USA regulation of insurance is state-based.

Now we can return from my brief history lesson to the principles supporting the state-based system of insurance regulation. The starting point or context for the framework is the U.S. regulatory mission which is to protect policyholders, claimants and beneficiaries first and foremost, while also facilitating an effective and efficient marketplace for insurance products. The fundamental reason for government regulation of insurance is to protect U.S. consumers. Insurance is more heavily regulated than other types of business because of the complexity of the insurance contracts, the lack of sufficient information for insurance consumers to adequately shop for prices and adequacy of coverage and because insurance contracts are generally contracts of adhesion.

Conceptually insurance regulation is very simple. The public wants two things from insurance regulators. They want solvent insurers who are financially able to make good on the promises they have made and they want insurers to treat policyholders and claimants fairly. All regulatory functions will fall under either solvency regulation or market regulation to meet these two objectives. State insurance regulatory systems are accessible and accountable to the public and sensitive to local social and economic conditions. State regulation has proven that it effectively protects consumers and ensures that promises made by insurers are kept. Insurance regulation is structured around several key functions, including insurer licensing, producer licensing, product regulation, market conduct, financial regulation and consumer services.

The U.S. meets preconditions required for effective regulation. These are primarily designed to ensure that regulators have appropriate regulatory authority over insurers, operate independently of insurer and political interference, maintain an adequate staff of sufficiently trained personnel, and treat confidential information appropriately.

The U.S. insurance regulatory system is unique in the world in that it relies on an extensive system of peer review, communication and collaboration to produce checks and balances in regulatory oversight. Each regulatory issue is met with multiple eyes looking at it. The diversity of perspectives and discussion around the issues results in compromise that leads to centrist solutions. These, in combination with a risk-focused approach to regulation, form the foundation for U.S. insurance regulation.

There are seven core insurance principles upon which U.S. insurance solvency regulation is based. They are:

- Regulatory reporting, disclosure and transparency;
- Off-site monitoring and analysis;
- On-site risk-focused examinations;
- Evaluation of reserves, capital adequacy and solvency;
- Regulatory control of significant, broad-based risk-related transactions and activities;
- Preventive and corrective measures, including enforcement; and
- Exiting the market and receivership.

Insurers operating in the USA are required to file standardized annual and quarterly financial reports that are used to assess the insurer's risk and financial condition. These reports contain both qualitative and quantitative information and are updated as needed to incorporate evolving risks. The NAIC collects, cleanses and databases this information for use by state regulators. A typical general insurer will report roughly 200,000 data elements in its annual financial filing.

Off-site solvency monitoring is used to assess on an on-going basis the financial condition of the insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance. The results of the off-site analysis are included in an insurer profile that is readily available to financial regulators in all U.S. jurisdictions for continual solvency monitoring. Many off-site monitoring tools are developed collectively by regulators and maintained by the NAIC for regulators to use.

U.S. regulators carry out risk-focused, on-site examinations in which the insurer's corporate governance, management oversight and financial strength are evaluated, including the system of risk identification and mitigation both on a current and prospective basis. The reported financial results are assessed through the financial examination process and a determination is made of the insurer's compliance with legal requirements.

To ensure that legal obligations to policyholders, contract holders, and others are met when they come due, insurers are required to maintain appropriate reserves and capital and surplus at all times and in such forms so as to provide an adequate margin of safety. The most visible measure of capital adequacy requirements is associated with the risk based capital (RBC) system. The U.S. RBC calculation uses a standardized formula to benchmark specified levels of regulatory actions for weakly capitalized insurers. This helps keep politics out of the solvency surveillance system.

The regulatory solvency framework recognizes that certain significant, broad-based transactions and activities affecting policyholders' interests must receive regulatory approval. These transactions or activities encompass licensing requirements; change of control; the amount of dividends paid; transactions with affiliates; and reinsurance.

State insurance laws require regulators to take preventive and corrective measures that are timely, suitable and necessary to reduce the impact of risks identified during on-site and off-site regulatory monitoring. These regulatory actions are enforced as necessary through a peer review process.

The legal and regulatory framework defines a range of options for the orderly exit of insurers from the marketplace. It defines solvency and establishes a receivership scheme to ensure the payment of policyholder obligations of insolvent insurers subject to appropriate restrictions and limitations.

State insurance regulators maintain a process of continuous improvement to ensure that solvency oversight is state-of-the-art. In June 2008, the NAIC's Solvency Modernization Initiative (SMI) was announced, with one of its objectives being an articulation of the United States Insurance Financial Solvency Framework and its Core Principles which I have discussed with you today. The SMI also gave U.S. regulators a chance to conduct a critical self-evaluation of current framework and systems and make improvements where necessary.

There are several developments related to the SMI. One of the recent changes for insurers doing business in the U.S. relates to the International Association of Insurance Supervisors (IAIS) concept called Own Risk and Solvency Assessment (ORSA) as a key component of regulatory reform. Considerations for a formal Enterprise Risk Management (ERM) requirement led to the development of the ORSA. In essence, an ORSA is an internal process undertaken by an insurer or insurance group to assess the adequacy of its risk management and current and prospective solvency positions under normal and severe stress scenarios. As a result, regulators will gain an enhanced understanding of an insurer's ability to withstand financial stress. Large and mid-sized insurers writing business in the U.S. will be required to file an ORSA in 2015 and beyond.

An ORSA, although not identical to the U.S. ORSA, is a key part of Solvency II. I would like to extend by congratulations to the Australian Prudential Regulatory Authority for its leadership in this area. The APRA will require life and general insurers to have an Internal Capital Adequacy Assessment (ICAAP), which is similar to Solvency II's ORSA, in place by Jan. 1, 2013. Other jurisdictions—including Japan, Canada, Bermuda and Switzerland—are implementing similar changes.

As part of the SMI, insurance regulators reevaluated Risk-Based Capital (RBC) in the U.S. and determined that RBC will continue to form the backstop function for insurer solvency to guarantee regulator action and to provide the legal authority to intervene without extensive litigation.

The U.S. RBC is a minimum capital measurement tool rather than a target capital tool as it is in some other jurisdictions. RBC models are only one among many tools available to U.S. regulators to evaluate an insurer's ability to fulfill its obligations to policyholders. However, regulators decided that an additional capital assessment at the group level will be added to the supervisory process through information obtained through the ORSA. This is intended to complement RBC as a financial regulatory safeguard. The RBC provides a legal-entity view of required capital and a group capital view in some situations, such as for parent insurers, whereas the U.S. ORSA will more often provide a group view of capital.

As you know, catastrophes are always a concern to insurers and insurance regulators throughout the world. The 56 insurance markets in the U.S. are all exposed to some form of catastrophe. However, the exposure is uneven. The jurisdictions located along the Gulf Coast, the Atlantic Coast and our island jurisdictions are exposed to catastrophe loss from hurricanes. Jurisdictions on the West Coast and in the center of the country are exposed to earthquake losses. We have volcanoes on Hawaii and in Washington State and a dormant super-volcano located in Yellowstone, a national park covering several jurisdictions. The Midwest and Southeast states are exposed to tornado and hail damage. Some of our Northern jurisdictions are exposed to severe winter storms. Our Western states have significant wildfire exposure. It is this diversity of risk that is another reason the U.S. regulatory system is state-based rather than national.

We define a catastrophe in the U.S. to be an event that results in $25 million or more in insured losses that impacts a number of policyholders and insurers. In an average year, collectively the U.S. jurisdictions will have about $27 billion in catastrophe losses. It looks like 2012 will turn out to be a bad year with upwards of $60 billion in insured catastrophe losses expected after all the Superstorm Sandy claims are settled. It is expected that Superstorm Sandy will be the third most costly natural disaster in U.S. history after Hurricane Katrina in 2005 and Hurricane Andrew in 1992. In spite of what appears to be a stressful year for catastrophe losses, U.S. insurers have roughly $580 billion in surplus to cover the losses and continue to write general insurance for U.S. businesses and households.

You might wonder why I refer to Superstorm Sandy instead of Hurricane Sandy. It is called Superstorm Sandy because, while it started out as a hurricane, it collided with a winter storm and when it hit land it was no longer categorized as a hurricane but as a post-tropical cyclone.

The distinction between a hurricane and a Superstorm is important as many of the impacted jurisdictions allowed insurers to add hurricane or named-storm deductibles to property insurance policies. If the storm remained classified as a hurricane, then the deductible amounts for consumers would have been significantly higher, reducing the amount of losses paid by insurers, but increasing the amount of out-of-pocket funds contributed by policyholders.

U.S. insurers began to introduce hurricane and windstorm deductibles in the mid-1990s after the wake-up call from Hurricane Hugo (1989) and Hurricane Andrew (1992). A hurricane or named storm deductible applies only to a particular hurricane and only if it meets certain parameters spelled out in the insurance contract and often proscribed or limited in state law. In contrast a windstorm deductible applies to any wind damage. These deductibles were introduced when reinsurance became more expensive and less available following Hurricane Andrew. Reinsurers were encouraging primary insurers to take steps to better manage their catastrophe risk. One of the answers for insurers was to limit potential losses through higher deductibles. Hurricane deductibles are often expressed as a percentage of the home's insured value.

Alabama, Connecticut, Delaware, the District of Columbia, Florida, Georgia, Hawaii, Louisiana, Maine, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Texas and Virginia have legislation in place regarding the use of hurricane deductibles. Other states may allow insurers to include hurricane deductibles in property insurance products. It is safe to say there are similarities among the state laws; however, there are no two that are identical. Insurers and consumers have issues with the use of hurricane deductibles. Insurers are concerned about clarity of state laws and actions of state officials that might limit the use of hurricane deductibles. Consumers are concerned about what to them seems an unjustified cost shifting at a time when they can least afford it. Consumers also complain about lack of meaningful disclosure about the deductibles.

U.S. regulators are discussing these concerns. One of the possible solutions being explored is the introduction of pre-tax deductible savings accounts. Conceptually, the savings account would allow a homeowner to pre-fund disaster-related costs in a tax-free or tax-deferred manner. The NAIC Property and Casualty Insurance Committee will explore the implications of deductible savings accounts and determine whether the NAIC should support legislation to allow or encourage them.

Another issue for the U.S. is coverage for floods. In the 1960s significant flooding in the Mississippi River Valley led to insurers changing property insurance policies to exclude coverage for the flood peril. In 1968, the U.S. Congress enacted the National Flood Insurance Program as a federal program to write stand-alone flood coverage. Flood insurance coverage is mandatory for houses backed by federally guaranteed mortgages. However, the take up rate is generally low. Thus, many consumers are without resource if their house is flooded. Further, the National Flood Insurance Program will be roughly $28 billion in debt after all the Superstorm Sandy flood claims are settled.

The U.S. regulatory system certainly has its challenges -- however, the national system of state-based regulation has successfully overseen a vibrant and highly competitive insurance industry. U.S. general insurers perhaps weathered the recent economic downturn in as good or better shape than U.S. banks and banks and insurers internationally. I like to think that the positive results of the general insurance industry in the 56 U.S. jurisdictions is at least in part due to the experience and expertise of U.S. regulators who collectively supervise the U.S. insurance industry.

Thank you for your attention and providing me the opportunity to speak here today. I look forward to responding to questions if we have time.

