Testimony of the
National Association of Insurance Commissioners

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

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"Perspectives on Modernizing Insurance Regulation"

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On behalf of

National Association of Insurance Commissioners

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Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for inviting me. My name is Michael McRaith. I am the Director of Insurance for the State of Illinois, and I testify on behalf of the National Association of Insurance Commissioners (NAIC). I am pleased to discuss efforts to modernize the State-based structure of insurance supervision and to offer a regulator's description of the fit for that system within the broader context of financial regulatory reform.

Having regulated the US insurance industry for over 135 years, State insurance officials have a demonstrable record of successful consumer protection and industry oversight. Consumer protection has been, is and will remain priority one for State insurance officials. Each day our responsibilities focus on ensuring that the insurance safety net remains available when individuals, families and businesses are in need. We advocate for insurance consumers and objectively regulate the US insurance market, relying upon the strength of local, accountable oversight and national collaboration.

With continually modernized financial solvency regulation, state insurance regulators supervise the world's most competitive insurance markets. Twenty-eight (28) of the world's fifty (50) largest insurance markets are individual States within our nation. As a whole, the US insurance market surpasses the combined size of the second, third and fourth next largest markets. More than 2,000 insurers have been formed since 1995 – leading to a total of more than 7,661 in the US – with combined premiums or more than $1.6 trillion. States derive $17.5 billion in taxes and fees from insurers, with approximately eight percent (8%) used to support regulation and the remainder supporting State general funds.

With this proud record of success, State insurance regulation constantly evolves, innovates and improves to meet the needs of consumers and industry. My testimony today will focus on the prominent place for State-based insurance regulation within systemic risk regulation and discuss continuing State efforts to improve functional insurance regulation.

Insurance companies are integral capital market participants and are not immune from the unprecedented global economic turmoil. However, insurers have not caused the turmoil and, as a whole, the industry is a source of calm in an otherwise turbulent time. Vigilant, engaged and effective prudential supervision by the States fosters this insurance marketplace stability, and we urge caution in any Federal initiative that may jeopardize the State-based platform for such oversight.

To be clear, any reforms to functional insurance regulation should start and end with the States. Federal assistance may be necessary if targeted to streamline insurance regulator interaction and coordination with other functional regulators, but that initiative should not supplant or displace the state regulatory system. The insurance industry, even in these difficult times, has withstood the collapses that echo through other financial sectors.

States Oversee a Vibrant, Competitive Insurance Marketplace

In addition to consumer protection, State insurance officials are adept stewards of a vibrant, competitive insurance marketplace which, in turn, provides tremendous economic benefits for the States. When State insurance markets are compared to other national insurance markets around the globe, the size and scope of those States' markets – and therefore the responsibility of State regulators – typically dwarfs the markets of whole nations. For example, the insurance market in Connecticut is larger than the insurance markets in Brazil or Sweden. Likewise, the markets in California, New York and Florida are each larger than the markets in Canada, China or Spain, and the markets in Ohio and Michigan are each larger than the markets in India, Ireland or South Africa. Each of these markets demands a local, accountable and responsive regulator.

Systemic Risk: State/Federal Partnership

State insurance regulators support Federal initiatives to identify and manage national and global systemic risk. When defining a "systemically significant" institution, empirical or data-driven factors aid but do not conclude an analysis. As described in the Group of Thirty (G30) report released on January 15, 2009, State insurance regulators agree that four considerations are essential: (1) size, (2) leverage, (3) scale of interconnectedness, and (4) the systemic significance of infrastructure services.[1]

[1] See *Financial Reform, A Framework for Financial Stability*, Group of Thirty, January 15, 2009, p. 19.

Insurance is one part of a far larger financial services economic sector. Insurance companies are not likely to be the catalyst of systemic risk but, rather, the unfortunate recipient of risk imposed by other financial sectors, as exemplified by the American International Group (AIG).

Given that the US has the world's most vibrant and competitive insurance marketplace, it is unlikely that any one insurer is "too big to fail." If an insurer were to fail, regardless of size, State-based guaranty funds would protect existing policyholders and pay claims. As history demonstrates, competition and capacity allow other insurers to fill marketplace voids left by the failed insurer. States also operate residual markets to cover those unable to obtain an offer of insurance in the conventional market. Therefore, even a major insurer failure, while traumatic in terms of job displacement and, perhaps, for shareholders, will generally not impose systemic risk.

Insurance risk management differs from risk in the banking sector because insurers are generally less leveraged than banks. Less leverage allows insurers to better withstand financial stress. State insurance regulators impose strict rules on the type, quality and amount of capital in which an insurer can invest. Also, insurer liabilities are generally independent of economic cycles in that the ripeness of a claim is not a function of economic conditions. This long-term reality reduces the likelihood an insurer will have to liquidate assets to satisfy short-term obligations.

An insurance business having special interconnectedness to capital markets may be capable of generating systemic risk, however. The financial and mortgage guaranty lines, for example, have encountered difficulty because of mortgage-related securities which, in turn, have adversely impacted public sector and mortgage loan financing.

Even strict accounting and investment standards do not inoculate insurers from the risks of recent systemic failures. A wholesale collapse of the stock market (to a greater degree than what we have recently seen) or the bond market would have a dire effect on insurance companies and could lead to insurance company failures. A collapse of the dollar and rampant inflation would increase claims costs for property and casualty insurers. A mixture of high inflation and a declining economy (stagflation) and low investment returns could create a perfect storm for all aspects of the economy. Regulation, of course, cannot ensure that insolvencies will not occur in extreme circumstances.

Systemic Risk: Functional Regulators Work Together

Unmanaged risk in one sector can deleteriously affect the viability of other sectors. The current financial crisis illuminates the need for a collaborative approach to regulation of financial conglomerates, or those enterprises of such magnitude that a failure would jeopardize the financial stability of an economy, or a segment of an economy. Cooperation and communication among the functional financial services regulators should be formalized in order to harmonize regulatory dialogue and efficacy.

State insurance regulators support Federal initiatives to ensure or enhance financial stability, while preserving State-based insurance regulation. Functional regulators can work and coalesce in a manner that protects consumers and promotes financial stability. State regulators support financial stability regulation that incorporates the following principles:

(1) Primary Role for States in Insurance Regulation: For systemically significant enterprises, the establishment of a Federal financial stability regulator, *e.g.* the Federal Reserve, will integrate but not displace state-based regulation of the business of insurance. Consumer access to State-based, local regulatory officials will remain the bulwark of consumer protection. A Federal financial stability regulator will share information and collaborate formally with other Federal and State financial services regulators. Appropriate information sharing authority and confidentiality protocols should be established between all Federal and State financial services regulators, perhaps including law enforcement.

(2) Formalization of Regulatory Cooperation and Communication: Federal financial stability regulation should ensure effective coordination, collaboration and communication among the various and relevant State and Federal financial regulators. A Federal financial stability regulator should work with functional regulators and develop best practices for enterprise-wide and systemic risk management. A fundamental aspiration for any supervisory oversight should include the preservation of functional regulation of the business being transacted by each independent entity.

(3) Systemic Risk Management: Preemption of functional regulatory authority, if any, should be limited to extraordinary circumstances that present a material risk to the continued solvency of the holding company, or "enterprise," the demise of which would threaten the stability of a financial system. With the experience of decades of an evolving practice, State regulators know that effective regulation inevitably coincides with comprehensive risk management. "Supervisory colleges" can be utilized to understand the risks within a holding

company structure, and can be comprised of regulators from each financial services sector represented within the enterprise. The financial stability regulator should operate in a transparent, accountable and collaborative manner, and should defer to the functional regulator in proposing, recommending or requiring any action related to a regulated entity's capital, reserves or solvency. One company within a holding company structure should not be compromised for the benefit of another company within another sector.

American International Group (AIG) exemplifies the circumstance in which systemic stability regulation must be bolstered. All reasonable minds accept as fact that AIG's State regulated insurance businesses did not cause AIG's problems. AIG's Financial Products subsidiaries, though, embraced risks that threaten not only the AIG parent company but also may cause reputational harm to AIG's insurers. AIG's insurance companies were not immune from the ripple effects created by the Financial Products division, as the subsequent downgrade of AIG due to credit default swap exposure put pressure on the insurers' securities lending practices when counterparties attempted to unilaterally terminate those transactions. Despite these challenges and others, AIG's commercial insurance lines – its core insurance businesses – generated significant underwriting profit during 2008.

Subject to state regulatory oversight, insurance companies have weathered these extraordinary economic times relatively well while coping with both natural catastrophes (*e.g.* Hurricane Dolly, California fires) and challenging marketplace conditions. State regulators caution that partnership with Federal and other functional regulators is not acquiescence to Federal preemption. On the contrary, State insurance regulators have risk management, accounting standards and investment allocation expertise that can inform any Federal initiative.

Office Of Insurance Information (OII)

The most effective way to anticipate and mitigate systemic risk, both within a holding company and within an economy, is to understand where, and to what extent, that risk exists. The Federal government does need relevant information and financial data on insurance to facilitate that effort. In its final form during the last Congress, the NAIC supported House legislation creating a Federal Office of Insurance Information (H.R. 5840 from the 110th Congress). The OII would construct an insurance database within the Department of Treasury and be available to provide directly to the Congress and Federal agencies the encyclopedic insurance-related data and information presently compiled by the States. State regulators worked constructively to narrow the preemption aspects of the initial proposal.

We agree that, as a key component of financial stability, insurance must be factored into an all-inclusive view of the financial system at the Federal level. This shared objective can, of course, be achieved without a Federal insurance regulator and without preempting state authority over the fundamental consumer protections, including solvency standards.

Modernization Proposals: Optional Federal Charter – A Misguided Solution

While contemplating perspectives on insurance regulatory reform, a group of the world's largest insurers continue to advocate for parallel Federal and state regulation. For more than ten years, insurance industry lobbyists have called for the creation of a massive new Federal bureaucracy known as an optional Federal charter ("OFC"). The current climate of instability and insolvency in the banking sector illustrates this concept cannot work. An optional system where the regulated enterprise chooses the regulator with the lightest touch – as evidenced by AIG – leads to regulatory arbitrage, gaps in supervision, ineffective risk management and disastrous failures.

Through the OFC, some of the largest insurers seek to unravel basic consumer protections and the essential solvency requirements that have nurtured the world's largest and most competitive insurance markets. The State-based system benefits both consumers and industry participants. The facts do not support the need for an OFC – it is a solution in search of a problem.

Modernization Proposals: OFC Alternative - Interstate Insurance Compact

Life insurers argue that life insurance provides wealth protection and, as a product, competes against banking products. This, in turn, warrants a streamlined approval process for entry into the national marketplace. While agreeing with the premise, insurance regulators know that such streamlined regulatory approval cannot come at the cost of consumer protection and solvency regulation. Insurance regulators have worked successfully to bring more cost-effective and sound insurance products to the market more quickly. Central to this effort has been the Interstate Insurance Compact ("the Compact") for filing and regulatory review of life, annuities, long-term care and disability insurance products. The States heard the call for a more competitive framework in the life insurance sector, and have responded.

The Compact is a key State-based initiative that modernizes insurance regulation to keep pace with global demands, while upholding strong consumer protections. Under the Compact, insurers file one product under one set of rules resulting in one approval in less than sixty days that is valid in all Compact Member jurisdictions. This example of State-based reform allows insurers to quickly bring new products to market according to strong uniform product standards. At the same time, the Compact preserves a State's ability to address front-line problems related to claims settlement, consumer complaints, and unfair and deceptive trade practices.

States have overwhelmingly embraced the Compact, as to date 33 States and Puerto Rico have joined by passing enabling legislation.[2] Over one-half of U.S. nationwide premium volume has joined the Compact. More States are expected to come on board in the near future, with legislation pending in Connecticut, New York, New Mexico, and New Jersey.

Modernization Proposals: Producer Licensing Reform

By developing and utilizing electronic applications and databases, State insurance officials have created much greater efficiencies in licensing insurance producers. Nevertheless, State insurance officials continue efforts to achieve greater uniformity in the producer licensing process.

The National Insurance Producer Registry (NIPR) is a non-profit affiliate of the NAIC that assists regulators and insurers when reviewing an agent or broker license. With information on more than 4 million producers, NIPR also provides an electronic format for non-resident producer licensing.

In 2008 State insurance regulators worked with the Independent Insurance Agents and Brokers of America (the "Big I"), and others, to offer refinements on H.R. 5611 ("NARAB 2") designed to achieve the non-resident licensing uniformity goals of the 1999 Gramm-Leach-Bliley Act ("GLB"). While States were in compliance with nearly every aspect of GLB, State regulators continue to work to improve the system and efficiency of producer licensing. The NAIC

[2] Currently, 34 jurisdictions have joined the Interstate Insurance Product Regulation Commission (IIPRC). Compacting members are Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming

supported the compromise legislation and continues working with the Big I to address the Constitutional concerns raised by the Department of Justice. Producer licensing is a topic that would benefit from uniformity nationwide, and State regulators are not averse to Federal government involvement to achieve such uniformity. Our good faith, constructive efforts demonstrate our commitment to achieve the best possible insurance regulatory system.

Modernization Proposals: Surplus Lines and Reinsurance Reform

In both the 109th and 110th Congress, a bill known as the "Non-admitted and Reinsurance Reform Act" (the "Act") was introduced and passed the House of Representatives. Title I of the proposed Act refers to "Non-admitted Insurance." State insurance regulators, through the NAIC, testified publicly in support of uniformity and modernization of surplus lines multi-state placement and recognize the need to improve uniformity for tax collection, form filing and non-admitted carrier eligibility. Working collectively, in April, 2008, State insurance regulators also submitted proposed improvements to Title I of the Act to Senator Jack Reed, Chairman Dodd, and others.

Title II of the Act refers to "Reinsurance" and contains provisions wholly opposed by State regulators. While espousing principles in support of reinsurance reform, the NAIC opposed the Title II provisions as overtly threatening the solvency and other financial standards for ceding carriers. Consumer protection cannot be sacrificed to ease the industry's financial standards. Through the NAIC, State insurance regulators adopted a framework to modernize the regulation of reinsurance in the United States, and are drafting a specific legislative proposal to implement the reforms. State insurance regulators have publicly stated that implementation of the reform will necessarily include Congressional involvement.

Consumer Protections: Strong Prudential Supervision

As the current financial crisis graphically illustrates, effective solvency supervision is the ultimate consumer protection. The concepts of prudential supervision and consumer protection are not severable because the core obligation of an insurer is a promise to pay. Since 1989, when the NAIC adopted a solvency agenda designed to enhance the ability of State regulators to protect insurance consumers from the financial trauma of insurer insolvencies, State insurance departments have continually improved this most elemental consumer protection. At the very core of those improvements is the NAIC's accreditation program, which requires each State to have statutory accounting, investment, capital and surplus requirements embedded in State law to further strengthen the solvency of the industry. Many of these laws increase regulators' ability to identify and act when a company's financial condition has weakened. These laws further benefit from the coordinated activity of the States.

Financial Analysis Working Group

The NAIC's Financial Analysis Working Group ("FAWG") is a confidential, closed-door forum that allows financial regulators to assess nationally significant insurers and insurer groups that exhibit characteristics of trending toward financial trouble. FAWG evaluates whether appropriate supervisory action is being taken.

Through FAWG and other standing committees and reporting mechanisms, States work together and form a complex network of "checks and balances," ensuring that even basic judgments of one primary financial regulator are subject to the oversight of a similarly skilled colleague from another State. These improvements have allowed regulators to identify more easily when insurers are potentially troubled and react more quickly to protect policyholders and consumers.

Solvency II

The myth of the "Solvency II" directive, currently under consideration by the European Union, has been touted as the beacon of global insurance regulatory reform. In fact, Solvency II would lower reserve requirements – appealing to a large insurer, of course – that would threaten the independent solvency standards of US-based insurers. At this moment in our nation's history, given that the paradigm of financial institutions appropriately pricing and managing risk has largely unraveled, a reduction in reserve requirements for insurers would not serve the interest of the consumer or the investing public. Today's headlines illustrate that an industry motivated by profit and market pressures does not always have the consumer's best interests at heart.

Solvency II is years away from implementation. Under the current timetable, the Directive is not scheduled to be implemented by the various member countries until 2012. However, at this time, even the previously agreed upon standards are being re-evaluated and many will likely be disposed of entirely. Several smaller EU States have expressed reservations about its effect on their resident insurance consumers. Solvency II is far from a reality, even where it originated, and has a lore that far outshines its factual merits.

State regulators are carefully evaluating aspects of Solvency II and principles-based regulation for potential application within the State-based system. We urge careful analysis of any proposal to achieve modernization of insurance supervision in the United States by applying global standards. Even well intended and seemingly benign "equivalence" standards can have a substantial adverse impact on existing State protections for insurance consumers.

Consumer Protections: Local, Personal Response in the States

Consumer protection has been, is, and will remain priority one for State insurance regulators. State insurance supervision has a long history of aggressive consumer protection, and is well-suited to the local nature of risk and the unique services offered by the insurance industry. State regulators live and work in the communities they serve, and respond accordingly. In a year, we resolve 400,000 formal complaints and respond to nearly 3 million consumer inquiries. This kind of consumer-oriented local response is the essential hallmark of State insurance supervision.

Insurance is a uniquely personal and complex product that differs fundamentally from other financial services, such as banking and securities. Unlike banking products, which provide individuals credit to obtain a mortgage or make purchases, or securities, which offer investors a share of a tangible asset, insurance products require policyholders to pay premiums in exchange for a legal promise. Insurance transfers risk while investments and even deposits are an assumption of risk.

Insurance is a financial guarantee to pay benefits, often years into the future, in the event of unexpected or unavoidable loss that can cripple the lives of individuals, families and businesses. The cost to insurers to provide those benefits is based on a number of factors, many of which are prospective assumptions, making it difficult for consumers to understand or anticipate a reasonable price. Unlike most banking and securities products, consumers are often *required* to purchase insurance both for personal financial responsibility and for economic stability for lenders, creditors and other individuals. Most consumers find themselves concerned with their insurance coverage, or lack thereof, only in times of critical personal vulnerability – such as illness, death, accident or catastrophe. State officials have responded quickly and fashioned effective remedies to respond to local conditions in the areas of claims handling, underwriting, pricing and market practices.

State insurance regulators encourage consumers to be aggressive, informed shoppers. Through the NAIC, State regulators have proactively developed the latest and best tools to educate consumers on important insurance issues. These have included outreach campaigns, public service announcements and media toolkits. With its landmark *Insure U – Get Smart about Insurance* public education program, (www.insureuonline.org), the NAIC has demonstrated its deep commitment to educating the public about insurance and consumer protection issues. Insure U's educational curriculum helps consumers evaluate insurance options to meet different life stage needs. Available in English and Spanish, the Insure U website covers basic information on the major types of insurance – life, health, auto and homeowners/renters insurance. Insure U also offers tips for saving money and selecting coverage for young singles, young families, established families, seniors/empty nesters, domestic partners, single parents, grandparents raising grandchildren and members of the military.

Conclusion

State insurance regulators, working together through the NAIC, are partners with Congress and the Obama Administration, sharing jointly in pursuit of improvement to the financial regulatory system and, ultimately, improving consumer protections. The state-based insurance regulatory system includes critical checks and balances, eliminating the perils of a single point of failure and opaque or omnipotent decision-making. With a fundamental priority of consumer protection, and with a system that has fostered the world's largest, most competitive insurance market, State insurance regulators embrace this opportunity to build on our proven regime.

The NAIC and its members – representing the citizens, taxpayers, and governments of all fifty States, the District of Columbia and U.S. territories – commit to share our expertise with Congress and to work with members of this Committee, and others. We welcome Congressional interest in our modernization efforts. We look forward to working with you.

Thank you for this opportunity to testify, and I look forward to your questions.

Appendix 1:

State Insurance Regulatory Reform Efforts

Area of Reform	States Response	Status
Life Insurance – Speed-to-Market: Life companies want to get products approved under one set of rules and into the market quickly to keep pace with global demands and to compete with banks.	The Interstate Compact: Creates a single point of speed-to-market filing for life, annuity, long-term-care, and disability insurance. Products are approved by the Compact under Uniform Standards in under 60 days and can be rolled out in every participating State.	34 Jurisdictions have adopted the Compact to date: Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina (1/1/09), Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.
Solvency Oversight and Accreditation Program	Dramatically enhanced statutory & regulatory authority over the last 15 years through the NAIC accreditation program to ensure strong, harmonized solvency oversight. All accredited States must pass numerous common laws/rules to ensure consistency nationwide.	49 States are now accredited by the NAIC. Reforms have led to a 65 % reduction in insurer insolvencies. Investment holding limitations and disclosure requirements have limited the insurance industry's exposure to the instability in the debt and equity markets today. Standardized accounting and reporting allow for comparability and advanced financial analysis techniques to identify potentially troubled insurers at an earlier date.
Consumer Assistance & Education	Establishment of proactive consumer education program: www.insureuonline.org Bilingual advice about life, health, auto, and homeowners/renters ins. Assistance for families, seniors, military service-members, singles, & domestic partners	Over 850 million impressions since the launch in March of 2006. The program won the American Society of Association Executives' Award of Excellence and was a finalist for a 2007 SABRE Award.
Fraud Detection	Developed online fraud reporting mechanism to allow for interstate coordination Minimized industry data requests & increased	System has allowed for focused fraud detection where problems arise. Continued regulatory collaboration avoids duplicative and excessive data requests that delay responses from the producer and insurer industries and hinder appropriate State regulatory action.

	collaboration	
Rate Form & Filing	NAIC developed the System for Electronic Rate and Form Filing (SERFF). SERFF offers a decentralized point-to-point, web-based electronic filing system. The system is designed to improve the efficiency of the rate and form filing and approval process and to reduce the time and cost involved in making regulatory filings.	Used by 50 States, D.C., Puerto Rico, and 3000+ insurance companies and third parties. • 2001 – 3,694 Filings • 2002 – 25,528 Filings • 2003 – 76,932 Filings • 2004 – 143,818 Filings • 2005 – 183,362 Filings • 2006 – 269,101 Filings • 2007 – 381,377 Filings
Producer Licensing	Conducted nationwide on-site State producer licensing assessment to evaluate State practices for resident and non-resident licensing. Worked with interested parties and Congress on legislation to improve non-resident licensing.	State regulators are committed to non-resident producer licensing reciprocity in all States and will work with Congress as necessary.
Company Licensing	NAIC established the Uniform Certificate of Authority Application, an electronic system and support designed to help insurers navigate State-specific requirements and provide a single entry opportunity when filing in all jurisdictions	Using the UCAA, Berkshire Hathaway was licensed by 49 States in less than 3 months.