Testimony of the
Special Committee on Banks and Insurance
of the
National Association of Insurance Commissioners

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

regarding
HR 10 and Financial Modernization

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Testimony of George Nichols III, Chairman
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Introduction

My name is George Nichols, and I serve as Commissioner of Insurance in Kentucky. I am testifying today on behalf of the National Association of Insurance Commissioners' (NAIC) Special Committee on Banks and Insurance, which I chair. The NAIC established this Special Committee in 1996 to assure that State regulation of insurance will continue to meet the demands of the Nation's rapidly evolving marketplace for financial products.

We support Congressional efforts to modernize and improve Federal laws that govern how banking, insurance, and securities products are regulated in the United States. Removing unnecessary barriers for the benefit of consumers is a worthy goal. Achieving that goal, however, will require that Congress preserve current State regulatory authority to protect all Americans who purchase or depend upon insurance for financial security – including those who rely upon bank-related entities to provide such coverage. In its current form, HR 10 broadly preempts the authority States need to regulate the insurance activities of banks and their affiliates.

The States have the authority and responsibility for regulating insurance under both present law and HR 10. There is no Federal agency for supervising the business of insurance. If the Federal government prevents the States from adequately regulating insurance, it won't get done at all.

With that in mind, let me address what Congress should know about insurance-related products, the ways they are regulated, and how HR 10 could prevent State insurance regulators from handling the critical regulatory tasks which we alone perform. I will also recommend changes needed to fix HR 10.

State Regulators, with Assistance from the NAIC, Handle Insurance Supervision in the United States

At present, all insurance providers doing business in the United States are supervised by State insurance departments operating under legal authority conferred by individual States and the Federal government. These departments work together with other State and Federal agencies to form a national regulatory system strengthened by the checks and balances associated with separate scrutiny.

To enhance the effectiveness of State regulators, the NAIC was formed in 1871 as a non-profit organization for coordinating the supervision of insurance providers, developing higher standards, and providing expert technical and professional support services to State insurance departments. The NAIC's members are the chief insurance regulatory officials of the 50 States, the District of Columbia, and four U.S. territories. Many regulatory functions which are best done centrally – such as data collection, securities valuation, financial analysis, and liaison with international regulators – are performed through the NAIC.

State insurance departments, together with the NAIC, have two primary mission goals:

(1) Protect the public interest, promote competitive markets, and facilitate fair treatment of insurance consumers; and
(2) Promote the reliability, solvency, and financial soundness of insurance providers selling products in the United States.

The record of State regulators in meeting these goals is quite impressive. During the 1980's, many insurers faced severe financial strains similar to those encountered by Federally-insured deposit institutions. However, the level of insolvent insurers under State supervision never approached the crisis level of insolvent deposit institutions that were rescued by the Federal government. We plan to continue building and improving on this record of success.

Congress specifically recognized the strength and expertise of the State regulatory system in the McCarran-Ferguson Act (15 U.S.C. Sec. 1012). That Act states in part: "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business." Congress has consistently refused to grant insurance supervision powers to any Federal agency.

States Regulate Insurance at No Cost to the Federal Government

The existing State system of insurance solvency and market conduct regulation does not cost the Federal government anything. The direct and indirect benefits for Federal taxpayers are substantial because they do not pay for running the system.

Unlike the banking and securities industries, there is no Federal guarantee program to compensate insurance consumers when insolvency occurs. Instead, States bear the costs of insurer failures through State-sponsored guarantee funds. If the States do a poor job of regulating, their taxpayers and citizens directly feel the costs of insolvent companies. State governments thus have a powerful incentive to do the job well.

Insurance is an enormous industry that generated $748 billion in premiums during 1996. Across the country, State insurance departments employ nearly 10,000 people and spend more than $700 million each year on regulation. These extensive human and financial resources are focused exclusively on the monitoring and enforcement tools needed to supervise thousands of insurers, agents, and brokers participating in the insurance business.

Recent Federal Intervention Threatens State Insurance Authority

The State insurance regulatory system is currently in place and working well, but we are facing a wave of confusion and uncertainty caused by unwise Federal intervention. Our ability to deliver quality solvency and market conduct protection to insurance consumers is being seriously threatened, both by legislative proposals in Congress and by administrative actions of the Comptroller of the Currency (OCC).

Confused drafting in the House version of HR 10 would permit bank-related entities to argue that many of their insurance activities are beyond the reach of State regulators (despite the bill's sponsors saying the language does not mean what it says). As a result, State insurance departments could be left effectively out of the loop when banks acquire insurers or sell insurance products to the public. We would be prevented from reviewing capitalization, loss reserves, reinsurance, investments, financial reporting, unfair pricing, and transfers of funds to affiliates.

On the regulatory front, the Comptroller is issuing many controversial orders and interpretations that openly allow banks to conduct insurance businesses which seem to contradict existing Federal and State laws covering regulation of insurance products (though the Comptroller has denied any intent to take over insurance regulation). These new insurance activities are deemed by the OCC to be "banking" under Federal law, which means they will escape normal safety and fair conduct review by State insurance regulators. The OCC's actions have resulted in significant litigation and regulatory uncertainty which harms the marketplace.

Federal Banking De-regulation Must Not Lead to Zero Regulation

There are sound reasons why insurance, banking, and securities have been regulated separately over the years. Fundamentally, they are different businesses with different regulatory requirements. What these businesses have in common is that each one provides personal financial security for millions of Americans who put their trust in government regulators to assure a high level of safety and soundness.

Congress long ago made a clear decision to leave insurance regulation entirely with the States. Consequently, businesses and consumers know that State governments handle insurance regulatory matters. Congress made an equally clear decision to exercise its jurisdiction over banking and securities by establishing specific Federal agencies and a complete framework – including Federal financial guarantees – to regulate them.

Clear jurisdiction is a necessary element in making State insurance regulation a success. However, recent Federal intervention has created confusion regarding who, if anybody, has authority to regulate the insurance-related activities of banks and their affiliates. Unhappily, we know from experience with the Employee Retirement Income Security Act (ERISA) that regulatory uncertainty offers dangerous opportunities for those inclined to exploit regulatory confusion for personal gain.

In the push to remove marketing and operating restrictions on financial services, Congress and Federal agencies must be careful to clearly preserve the ability of State regulators to exercise their specific industry expertise over insurance. Otherwise, we will not be able to protect insurance consumers dealing with banks and their affiliates.

Functional Regulation of Banking and Insurance Works

Some people have questioned whether functional regulation of insurance by the States is necessary or workable for Federally-regulated banks. Such doubters fail to realize that financial modernization and HR 10 do not change the basic nature of banking and insurance. They are still inherently different businesses requiring different regulatory methods and skills.

The fundamental differences between banking and insurance are readily apparent to customers from their everyday personal experiences. The particular elements of each business can be recognized, even when products are combined and sold by different institutions. Consider the following example:

Typical Bank Statement	Typical Insurance Policy
• One or two pages.	• Easily 10 – 20 pages or more.
• Report of a custodial relationship regarding money owned by you (through deposits or securities) and the bank (through the money it lends you).	• Commercial contract describing what you and the insurer must do. Premiums belong to the insurer unless stated otherwise.
• Very little explanatory language because not much is needed.	• Lots of conditions, exceptions, and legal riders. Usually confusing.
• Exact amounts and timing shown for deposits, withdrawals, loans, and interest rates. You know you can get your money back.	• Price you pay can fluctuate. Amount you get paid is subject to later determination, a range of values, and possible litigation.
• Shopping for best rates and service is straight-forward since most banks offer similar products.	• Shopping for best rates, coverage, and service can be complicated and time consuming. Consumer comparison of products is very difficult.
• Banking relationship is normally voluntary.	• Purchasing insurance is often required by law or commercial contract.
• Deposits guaranteed by the Federal government.	• No Federal guarantee. Policy may be backed by a State guarantee fund.

As experienced insurance regulators, we know that functional regulation works with banks because we have been doing it successfully for many years. Using common sense and cooperation, insurance departments and bank supervisors in several States have long applied functional regulation to banks selling insurance.

In addition, State regulators and the NAIC are making practical functional regulation a reality with Federal banking agencies by using our resources and expertise to assist them in doing their jobs. Recently, we began working closely with the Federal Reserve Board and the Office of Thrift Supervision (OTS) on insurance matters relating to the financial institutions they supervise. We have also taken steps to cooperate with the OCC.

Beware of Buzzwords Which Encourage a Regulatory Vacuum

Buzzwords are often used to drive marketing strategies, but they do not alter the reality of the products being sold. When used too loosely, however, buzzwords in the financial industry can be very misleading and damaging. For example, the life insurance industry was shaken a few years ago when the values of certain overly touted "high yield" bonds plummeted as soon as they were re-defined by market forces and public opinion to be low quality "junk bonds." In the end, these bonds were just what they always had been – high risk securities that deserved special scrutiny by regulators.

There is similar talk these days about wondrous new financial products which will greatly benefit the public if banks are granted enough freedom from regulation. The implication is that these products are somehow so novel that they are immune to sensible scrutiny by traditional insurance regulators. Financial managers are fond of terms such as hybrid financial services, cross marketing, and financial integration, but there is very little clarity regarding the meaning of these terms in real world situations.

Past experience has taught State insurance departments to exercise caution regarding solvency and safety regulation when financial markets start buzzing with new terms and concepts. We have found that insurance sold by banks or combined with other products is still basically an insurance product that needs to be regulated. The risks and problems remain the same, no matter what the name of the institution or the product being sold.

That is why preserving State authority over all insurance-related products is so important. The Federal Reserve Board, OCC, and OTS have each said they have no intention of regulating the insurance activities of financial institutions under their control. Taking them at their word, it is crucial that Congress not create a regulatory vacuum which prevents State regulators from supervising the business of insurance. To do so will inevitably lead to financial trouble for banks, insurers, their customers, and taxpayers.

HR 10 Must Be Fixed to Preserve State Authority to Regulate Insurance

As the sole regulators of insurance in the United States, State governments are equal partners with the Federal government in assuring that financial integration of banking, insurance, and securities products is handled prudently. We are concerned that HR 10, as

passed by the House of Representatives does not adequately preserve State authority to regulate insurance activities of banks and their affiliates. This serious defect seems unintentional, but its harmful impact on consumers and taxpayers will nonetheless be very real if the House version becomes law.

Safety must be the first consideration for everyone who has a role in de-regulating financial products and markets which have been long separated by law and tradition. Although existing restrictions on financial services are rooted in the Great Depression, we need only look to recent history in the savings and loan industry to see what can happen when Federal banking laws and regulations are relaxed without proper regard for maintaining safety and soundness. The arguments made for expanding the business opportunities of thrift institutions in the 1980's are strikingly similar to the arguments banks are making now. Yet hard experience shows that good intentions are not enough when Federally-insured deposit institutions enter new and unfamiliar markets.

The NAIC and State regulators strongly urge Congress to amend HR 10 so the bill clearly provides that State insurance departments will maintain their traditional powers to supervise all insurance activities, no matter what type of entity offers them to the public. Otherwise, we predict there will be substantial market pressures for banks and insurers to move their operations into bank-related entities which could escape regulation entirely.

How HR 10 Should be Fixed

Fortunately, we believe the Senate can fix the insurance regulation problems in HR 10 without adversely affecting the consumer and business benefits which the bill's sponsors hope to achieve. Today, we pledge our strong commitment to help you do just that.

1. Limit the Broad Preemption Sections that Gut State Insurance Authority

Sections 104 and 309 treat State insurance regulators as enemies of banks, rather than equal partners with Federal regulators in assuring that insurance products are financially sound and marketed fairly to consumers. Both sections use extremely broad language to stop States from doing almost anything which might "prevent or significantly interfere" with the ability of banks to do things the Federal government permits, even if the result will harm insurers, policyholders, consumers, and taxpayers.

These sections are massive legislative overkill which guts State authority in order to correct a few fair treatment concerns. Essential State powers which would be preempted include supervision of capitalization, investments, affiliations, reinsurance, financial reporting, market conduct, consumer privacy, unfair pricing, management companies, and transfers of funds to affiliates.

Section 104 is particularly onerous because its blanket preemption of State authority extends to other sections of HR 10, as well as to all other Federal laws – past, present, and future. Furthermore, the language in this section dealing with insurance is so confusing that nobody really understands what it means. The only certainty in

Section 104 is its negative effect on State powers which is expressed clearly in the section's title – "Preemption of Certain State Laws".

We recommend fixing Section 104 by turning its negative language into a positive legislative statement that State regulators are an essential and equal part of the financial regulatory system for bank-related entities which engage in insurance. This statement preserving general State insurance authority should be followed by narrowly constructed exceptions that supersede specific State laws which obstruct the provisions in HR 10.

The NAIC will provide the Senate with suitable language that fixes Sections 104. Section 309 should be deleted entirely.

2. Delete the NARAB Provisions in Subtitle C (Sections 321-336)

HR 10 includes a hodge-podge of special interest provisions sought by certain industry groups. One of those is the creation by statute of an entirely new organization that would substitute its judgment on agent and broker licensing matters for the decision-making of insurance commissioners empowered by State law. Called the National Association of Registered Agents and Brokers (NARAB), this organization would exercise quasi-official powers to take over the most important tools which State insurance departments have for controlling fraud and abuse by agents and brokers.

We strongly object to NARAB because it is the first step for industry groups seeking a Federal detour to evade the State regulation process when they are unhappy with the results. If NARAB becomes law, there will be a parade of industry groups seeking help from Congress to undermine State authority by slipping amendments into Federal laws. We do not believe Congress should subject itself and State governments to a war of attrition regarding the powers we need to meet our regulatory responsibilities.

NARAB is also unnecessary because the NAIC is now implementing well-designed programs which will achieve the same goals sought by NARAB's proponents. If the NARAB provisions become law, there will be needless regulatory confusion, legal problems, and administrative nightmares regarding the extent of its powers and who actually runs the organization. We urge you to delete NARAB from HR 10 because it will cause more problems than it is intended to correct.

3. Delete the Mutual Redomestication Provisions in Subtitle B (Sections 309, and 311-316)

Subtitle B is another attempt by industry groups to have the Federal government needlessly intervene in State affairs. In this case, the issue is differing approaches by States using their consumer protection authority to help policyholders of mutual insurers. A number of mutual insurance companies, which are legally owned by their

policyholders, want to use short-cuts to convert certain business operations to stock ownership in order to raise capital and reward management.

Some States have passed laws which allow mutual insurers to redomesticate so they may change to stock ownership without getting approval from their existing policyholders. Other States have refused to permit such short-cuts because they believe it treats policyholders unfairly. In both cases, this is a classic example of States being more attuned to local consumer protection issues than the Federal government. There is no reason for Congress to substitute its judgment for those of the individual States regarding the redomestication of mutual insurers.

4. Refine Title I Provisions to Make State Insurance Regulators Equal

Title I of HR 10 has several provisions which set forth the relationships among the Federal Reserve Board and other regulators. Generally, these provisions grant final approval authority to the Federal Reserve when the jurisdictions of regulatory agencies may overlap. We note that the SEC is given final authority where securities is the primary business involved.

State insurance regulators should be granted authority to have final approval over the matters for which they are the lead regulator. The NAIC plans to work with the Senate and other regulators to fix Title I so that States are granted equal authority with Federal regulators to make final decisions where State insurance departments are the dominant regulator. This seems only fair, since States must bear the costs of any insurer failures which may result from decisions made by Federal regulators.

Banks, Operating Subsidiaries, and Insurance Regulation Don't Mix

The banking industry and the Treasury Department have argued that HR 10 should be amended to permit banks to provide insurance to the public directly through their operating subsidiaries. The OCC is now permitting national banks to conduct insurance businesses by defining such activities as "banking" under Federal law.

We strongly urge Congress to reject that approach if you want to prevent insurance activities from threatening the solvency of banks. Insurance is a business with enormous risk exposures that are quite different from those faced by banks. These include managing relationships with agents and brokers, making underwriting decisions, pricing the product properly, following reinsurance chains, setting loss reserves, and investing assets to match uncertain liabilities.

State regulators control the actions of insurers by tracking their flow of funds to affiliated entities, as well as to unrelated companies. We rely upon our industry experience and State laws and regulations that give us extensive authority to restrict the actions of separately identified companies, a regulatory method also used by the Federal Reserve Board. Attempting to track and control the flow of insurance funds within a bank would be exceedingly risky and impractical, if not impossible.

Conclusions

Three industries – banking, securities, and insurance – are covered by HR 10 and other financial modernization efforts. Of the three, insurance is the only industry which is entirely supervised by State governments with no Federal financial guarantees. We take pride in our work, our record of accomplishments, and our ongoing efforts to keep abreast of changes in the marketplace which affect insurers and consumers.

As banks increasingly enter non-banking businesses, they have sought to preempt State laws and regulations which they believe are unfair, as well as inconvenient to the ways they are used to doing business in the world of banking. They must realize when they choose to enter insurance that it is a very different business, with different risks and regulatory needs. State insurance regulators and the NAIC will treat bank-related insurance providers the same as any other provider, but we will insist on applying our State consumer protection laws to assure that solvency and fair market conduct requirements are met.

Some people have framed the political debate over financial modernization as a conflict between Federal and State regulation, or between the banking and insurance regulatory systems. The real issue, however, is whether insurance-related activities of banks will be regulated at all if Federal law prevents the States from doing the job. The Federal Reserve Board, OCC, and OTS have each said they do not intend to regulate insurance. If we are prevented from doing it, who will?

We want to continue keeping unwise or rogue insurance operations from damaging consumers, banks, and insurance companies. Doing that job will also protect Federal and State governments from unnecessary financial exposures caused by weak and insolvent institutions. Accordingly, State insurance regulators and the NAIC ask the Senate to help us by fixing HR 10 to preserve the authority we will need to get the job done.