OPENING STATEMENT
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON "HOW SHOULD THE FEDERAL GOVERNMENT OVERSEE INSURANCE?"

MAY 14, 2009

We meet today to continue the review by the Capital Markets Subcommittee of insurance regulation. Our panel has taken the lead in Congress during the last few years in debating insurance matters and finding consensus reforms to modernize our national insurance laws.

Unlike other financial sectors that have evolved over time to include some degree of Federal and State regulation, States alone continue to have the primary authority to regulate insurance today. For that reason, Congress has historically only passed insurance legislation to respond to a crisis, address a market failure, or adopt narrowly-focused insurance reforms.

For example, after September 11, Congress ultimately passed the Terrorism Risk Insurance Act so that construction could continue after the terrorist attacks and businesses could obtain coverage to protect their viability. After a series of hearings debating insurance reform last Congress, this Subcommittee considered and approved four narrow insurance bills. One of those bills, the Insurance Information Act, could help the Federal government build a knowledge base on insurance matters so that the Federal government could see the complete picture of the insurance industry rather than intermittently seeing the brush strokes of a particular problem in the industry or at a particular company.

We are very fortunate that this Committee has a long history of working in a bipartisan fashion. I hope we continue in that vein and find common ground on these matters. Thoughtful, broadly supported legislative reforms are usually the most successful. We must, however, also move swiftly, yet deliberatively, in developing a new game plan to involve the Federal government in more direct oversight of the insurance industry. Today, we are both responding to a crisis of sizable proportions and seeing the big picture of an interconnected modern financial services system for the first time.

After the turmoil in the bond insurance marketplace, the decisions to provide substantial taxpayer support to American International Group, and the requests of numerous insurers to get capital investments from the Treasury Department, we can no longer continue to ask the question about whether the Federal government should oversee insurance. The answer here is clearly yes.

The events of the last year have demonstrated that insurance is an important part of our financial markets. The Federal government therefore should have a role in regulating the industry. As such, we now must ask how the Federal government should oversee insurance going forward. This question is the topic of today's hearing.

The answer to this question is difficult. The bond insurance crisis showed that even small segments of the industry can have a large economic impact. AIG taught us that the business of insurance has become complex and no longer always fits nicely into the State regulatory box.

Moreover, some companies operate unlike traditional insurers in today's markets. Instead of insuring assets, these companies insure financial transactions and use substantial leverage.

My assessments should not be taken as criticism of the present State regulatory system. By and large, State regulators have performed well, despite the growing complexity of the financial services system. That said, I am also not suggesting that we expand the mission of State insurance departments beyond insurance.

At the very least, this Congress must address insurance activities as it creates a new legislative regime to monitor systemic risks and unwind failing non-depository institutions. The Administration's proposal to create a resolution authority properly includes insurance holding companies. Oversight of any financial activity – insurance or otherwise – as it relates to the safety and soundness of our economic system must also be mandatory. Insurance is complex, and it is time for the Federal government to appreciate its importance.

Equally important to me is that Congress not limit itself to simply responding to this latest crisis. Many insurance products are either of national importance or uniform in nature. We must therefore consider whether to regulate these elements of the industry nationally.

In sum, we have asked our witnesses to help us to examine these issues. Their fresh perspectives can point us in the right direction as we think about these matters in a new light.

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EMBARGOED UNTIL DELIVERY
Thursday, May 14, 2009

Contact: Erica Elliott
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Garrett Opening Statement for Financial Services Insurance Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ) released the following opening statement for today's House Financial Services Subcommittee on Capital Markets hearing entitled "How Should the Federal Government Oversee Insurance?":**

"Thank you Chairman Kanjorski. I look forward to an interesting discussion today on the appropriate role for the federal government to regulate insurance going forward, particularly in the context of proposals for a systemic risk regulator and a resolution authority for large non-bank financial institutions.

"As I have outlined in previous hearings, I have concerns about these proposals and the likely unintended consequences if they are implemented. As for a systemic risk regulator, we have been told throughout history that more regulation will solve all our problems.

"The Federal Reserve, itself, was created to "ensure" that asset bubbles and panics never happened again. Back in 1914, the then- Comptroller of the Currency had high expectations when speaking about the law that created the Fed. He said: "Under the operation of this law, such financial and commercial crises or 'panics' as the country experienced in 1873, 1893, and 1907...seem to be mathematically impossible." Clearly he was mistaken, but he's had a lot of company over the years.

"A certain level of regulation is appropriate, but many of the reforms being talked about now will reduce market discipline and increase moral hazard.

"With the resolution authority being proposed by Secretary Geithner and others, for instance, I have real doubts that this can be implemented without institutionalizing an entire segment of too big to fail companies.

"So I have these concerns in general about systemic risk regulation and the resolution authority, but they seem particularly inappropriate for the insurance industry.

"Insurance companies, especially those dealing primarily with retail customers, are different in nature from banks, for example. They are not nearly as interconnected with the rest of the financial services sector and the economy as a whole.

"Additionally, we already have the state guaranty funds to deal with insolvent insurance companies, and these funds have historically worked well.

"Bond insurance, of course, is a bit of an outlier, and the committee will address some of the unique challenges facing this sector on a different track.

"I have concerns in this current environment, and with the makeup of the present administration and congressional leadership, with proposals calling for significant regulatory changes. To supporters of these proposals I would say, "be careful what you wish for". And when you think about it, it's not too far-fetched to see a tri-layered or even quadruple-layered regulatory structure for insurance when all the dust settles – state regulation, federal regulation, systemic risk regulation, and resolution authority regulation.

"While the topic of federal vs. state regulation of insurance fosters intense debate, I believe we can all agree that a multi-layered regulatory structure for the insurance industry would not provide the best model for a competitive and robust marketplace.

"One piece of the regulatory reform puzzle that Congressman Dennis Moore and I have been directly involved in is the Nonadmitted and Reinsurance Reform Act. This legislation, which has passed the House of Representatives unanimously the last two congresses would update and streamline state regulation in the nonadmitted (or surplus) lines and reinsurance marketplaces.

"The surplus lines bill is an area of insurance regulatory reform where there is broad consensus, and I look forward to working with interested parties in the insurance industry so that this legislation can finally become law during this Congress."

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Statement of Baird Webel

Specialist in Financial Economics

Congressional Research Service

Before

The Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

United States House of Representatives

May 14, 2009

on

How Should the Federal Government Oversee Insurance?

Mr. Chairman, Ranking Member,

My name is Baird Webel. I am a Specialist in Financial Economics at the Congressional Research Service. Thank you for the opportunity to testify before the Subcommittee. This statement responds to your request for hearing testimony addressing the question "How Should the Federal Government Oversee Insurance?" It begins with a brief introduction focusing on insurance and the current financial crisis, and differentiating between lines of insurance. Following is a discussion of seven options for the federal government's role in insurance regulation. These options should be seen as encompassing a continuum of possibilities and it may be possible to combine aspects from different options, particularly for different lines of insurance. Many of these options have been embodied in legislation considered by this committee or discussed in previous hearings, so I will focus particularly on new suggestions that have largely arisen out of the current financial crisis.

CRS's role is to provide objective, non-partisan research and analysis to Congress. CRS takes no position on the desirability of any specific policy. The arguments presented in my written and oral testimony are for the purposes of informing Congress, not to advocate for a particular policy outcome.

Insurance Regulation and the Current Financial Crisis

As reaffirmed by Congress in the McCarran-Ferguson Act of 1945,[1] the primary locus of insurance regulation rests with the individual states. Since the passage of this act, however, both Congress and the federal courts have taken actions that have somewhat expanded the reach of the federal government into the insurance sphere. Examples of this include Employee Retirement Income Security Act of 1974 (ERISA),[2] which effectively federalized health insurance regulation for a large swath of the American population; various court decisions limiting the phrase "the business of insurance" contained in McCarran-Ferguson;[3] and the Liability Risk Retention Act (LRRA),[4] which preempted the ability of non-domiciliary states to regulate certain types of property/casualty insurance.

Nevertheless, the Gramm-Leach-Bliley Act of 1999 (GLBA),[5] which enacted the most sweeping financial regulatory changes since the Great Depression, specifically continued to recognize the states as the functional regulators of insurance. GLBA also removed legal barriers between securities firms, banks, and insurers. This legal freedom, along with improved technology, has been an important factor in creating more direct competition among the three groups. Many financial products have converged, so that products with similar economic characteristics may be

[1] 15 U.S.C. §§ 1011-1015.

[2] P.L. 93-406, 88 Stat. 829.

[3] See CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for "Business of Insurance": Viability of "State Action" Doctrine as an Alternative*, by Janice E. Rubin.

[4] P.L. 97-45 as amended by P.L. 98-193 and P.L. 99-563, 15 U.S.C. § 3901 *et seq*.

[5] P.L. 106-102, 113 Stat. 1338.

available from different financial services firms with different regulators and different regulation. Increasing competition between insurers, banks, and securities firms has played a role in increased industry demands for a wide-ranging federalization of the insurance industry. These demands have typically focused on various inefficiencies in navigating the multiple regulators in the state system as well as what some characterize as the overbearing content of some state regulation, particularly state rate and form regulation.

The current financial crisis can at least partly be traced to failures or holes in the financial regulatory structure. This has given increased urgency to calls for overall regulatory changes and federal oversight of insurance. While insurers in general have appeared to weather the crisis reasonably well so far, the insurance industry has seen two significant failures, one general and one specific. The first failure was spread across the financial guarantee or monoline bond insurers. Before the crisis there were only about a dozen bond insurers in total, with four large insurers dominating the business. This type of insurance originated in the 1970s to cover municipal bonds but the insurers expanded their businesses since the 1990s to include significant amounts of mortgage-backed securities. In late 2007 and early 2008, strains began to appear due to exposure to mortgage-backed securities. Ultimately some smaller bond insurers failed and the larger insurers saw their previously triple A ratings cut significantly. These downgrades rippled throughout the municipal bond markets, causing unexpected difficulties for both individual investors and municipalities who might have thought they were relatively insulated from problems stemming from rising mortgage defaults.

The second failure in the insurance industry was a specific company, American International Group (AIG).[6] AIG had been a global giant of the industry, but it essentially failed in mid-September 2008. To prevent bankruptcy in September and October 2008, AIG was forced to seek more than $100 billion in assistance from, and give 79.9% of the equity in the company to, the Federal Reserve. Multiple restructurings of the assistance have followed, including up to $70 billion through the U.S. Treasury's Troubled Asset Relief Program (TARP). AIG is currently in the process of selling off parts of its business to pay back assistance that it has received from the government; how much value will be left in the 79.9% government stake in the company at the end of the process remains an open question.

The near collapse of the bond insurers and AIG could be construed as regulatory failures. One of the responsibilities of jobs of an insurance regulator is to make sure the insurer remains solvent and is able to pay its claims. Since the states are the primary insurance regulators, some may go further and argue that these cases specifically demonstrate the need for increased federal involvement in insurance. There are aspects of both the bond insurer crisis and AIG's failure that may mitigate the arguments for federal involvement, particularly because AIG was also regulated by the federal Office of Thrift Supervision.

[6] See CRS Report R40438, *Ongoing Government Assistance for American International Group (AIG)*, by Baird Webel.

Lines of Insurance and Federal Involvement in Insurance

The insurance industry is not monolithic, but rather very diverse, serving multiple markets. Companies range in size from multiline insurers serving the entire country to small "captive" insurers that may insure a single company. In general, insurers fall into two broad segments: life insurers and property/casualty insurers. Some companies are organized as stock companies, whereas others operate as mutual or fraternal companies. Some companies are very large in size, whereas others are mid-size or small. Some companies specialize in large commercial accounts, whereas others write personal lines of business such as homeowners, automobile, or individual life and health policies. Still others concentrate on reinsurance, or the selling of insurance to insurance companies to assist them in spreading their risks. With this diversity of insurers, an argument could be made to focus federal involvement in insurance oversight differently for different types of insurers.

Life Insurance

Life insurers[7] in general face long-term and relatively stable risks and losses. Life insurance contracts typically last decades and actuarial tables are well developed. It may be impossible to estimate which individual people are going to die in a given year, however, with a large pool, actuaries can be very accurate in projecting the overall number of deaths and thus the overall losses a life insurer will likely incur. This increases the importance of the investment side of the life insurance business to generate profits. If life insurers face solvency problems, it is likely to be a result of poor investment decisions rather than huge unexpected losses. The risks covered in life insurance are much more uniform across the country and policyholders are relatively likely to be covered by a policy purchased in a different state from their current residence. Life insurers also offer many annuity products, which combine aspects of insurance and investment products. These annuity products also represent a significant exposure to investment gains and losses for life insurance companies.

Property/Casualty Insurance

Property/casualty insurers face a very different set of economic challenges. Most property/casualty contracts are relatively short-term, often six months or one year. The risks to these insurers can be much more variable than those faced by life insurers. In some lines, catastrophic losses can occur that will wipe out years of previously accumulated premiums. Accordingly, investment returns are important to the business, but to a lesser degree than they are in life insurance. Property/casualty policies can be much more localized and tailored to specific risks in specific areas. With relatively short-term contracts, policyholders are much less likely to maintain their policies as they move from state to state. Property/casualty policies are often required by a third party. For example, purchase of state licensed auto insurance is a common requirement for auto licensing and banks often require specific insurance purchases for a property loan. The near mandatory nature of some property/casualty insurance purchases has

[7] Health insurers are often included within the category of life insurers. Since health insurance is largely outside of the scope of the committee's interest, this analysis concentrates purely on life insurance.

tended to engender increased regulatory oversight and various mechanisms to ensure availability and affordable pricing for insureds.

Such differences have led to suggestions for different federal involvement for different lines of insurance. The most common proposal in the past has been to provide for a federal charter for life insurers while leaving property/casualty insurers in the state system. During the current financial crisis, life and property/casualty insurers have sometimes favored different government policies. Several life insurers have sought assistance through TARP, even going so far as to convert their corporate form to a federal bank or thrift holding company to qualify for TARP. Property/casualty companies have generally shunned federal aid, with one industry group arguing strenuously that property/casualty insurers typically do not present systemic risk and the federal government should avoid providing assistance to them.[8]

Options for Insurance Regulatory Reform

Seven particular options for federal involvement are presented in the following sections. These options range from minimal, or no, federal involvement to a federal takeover and complete restructuring of insurance regulation. To some degree many of these options have elements that are not mutually exclusive. Congress could take various aspects and apply them differently, for example, to different lines of insurance or to different aspects of regulation. Most of these options have been present in some form in proposals that predate the current crisis.

1. Do Nothing

While insurers have unquestionably been affected by the financial crisis, the instruments and practices generally identified as driving the crisis, the outsized losses, and the bulk of the federal assistance are in other areas of the financial services industry. This may be due to good regulation, good business practices, or simply good fortune for insurers, and it may very well change in the future, but for the moment the financial crisis is focused elsewhere. It could be argued that effort and attention should also be focused on the areas in crisis. One could even go further and argue that in such a time of general market uncertainty, it is not helpful to the market to be introducing additional regulatory uncertainties. "First do no harm" may be a principle to be applied to sick financial markets as well as sick medical patients.

2. Create of a Federal Office of Insurance Information

One of the correlates of the absence of direct federal regulatory authority over insurance has been a relative lack of awareness, information, and expertise on non-health insurance matters within the federal government. Other testimony before Congress has indicated that the Office of

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[8] See, for example, an op-ed by the President and CEO of the Property Casualty Insurers Association of America, David A. Sampson, "Property, casualty insurers don't pose systemic risk," *The Hill*, April 27, 2009 available at http://thehill.com/op-eds/property-casualty-insurers-dont-pose-systemic-risk-2009-04-27.html.

Thrift Supervision, which oversaw AIG, had only one insurance expert on staff[9] and informal inquiries have indicated to CRS that the Treasury Department does not have all that many more.

This lack of information and insurance expertise has been noted before the crisis, and how large an impact it had on the crisis may be debated; however, the crisis has generally shown how important accurate information can be. Much of the market uncertainties can be traced to lack of information about specific companies' exposures to mortgage-backed securities. Lack of information on the size of and exposures in the credit default swap market has also complicated regulatory responses to the crisis. Should a significant crisis event arise involving large insurers, additional information and expertise on the issues at the federal level would likely be helpful.

Some, particularly those strongly supporting the current state regulatory system, have expressed concern that such a federal office might be essentially a precursor to an eventual federal regulator. An alternate response to address such concerns might also be to increase cooperation and communication between federal officials and the National Association of Insurance Commissioners (NAIC). The NAIC is currently a major source of information regarding insurance issues and would likely be significant source of information for any federal office, particularly if, as was included in the proposed Insurance Information Act of 2008 (H.R. 5840 in the 110th Congress), the federal office would be limited to collecting publicly available data.

3. Harmonization of State Laws Via Federal Preemption

Most stakeholders in the insurance industry recognize the need for some harmonization, if not uniformity, of insurance regulation among the different state regulators. The NAIC has served as the primary forum for this since its founding in 1871. For harmonization to occur through state efforts, however, every state legislature must pass substantially similar legislation, a very difficult task. Federal law, however, would have the power to preempt state legislation and create such harmonization without state legislative approval. This is the approach, for example, taken by the Liability Risk Retention Act, which preempts most state insurance regulation of risk retention groups, except for regulation by the home state regulator. Application of similar principles to other areas, such as surplus lines or the licensing of agents, has been a feature of several bills before the committee in the past few years. Federal preemption of state regulation of the business of insurance is a congressional prerogative, and even the McCarran Ferguson Act which declared a policy of "the continued regulation and taxation by the several States of the business of insurance,"[10] recognizes the congressional authority to regulate the insurance industry.

This approach could be argued to be a "best of both worlds" approach, combining the experience and many of the strengths of the state regulatory system while ensuring greater efficiency through the ability of insurers to operate throughout the country. Much of the effectiveness of

[9] Testimony by Max Stier, President and CEO, Partnership for Public Service, before the House Oversight and Government Reform Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia, April 22, 2009. Retrieved through CQ Congressional Testimony.

[10] 15 U.S.C. § 1011.

this approach, however, would depend on the specific details chosen. As an approach, it is very broad. Congress could choose to preempt specific aspects relating to a single line of insurance, or a state's entire approach to insurance regulation. Without specifics about what state laws are being preempted and what they might be replaced with, it is difficult to analyze the partial preemption approach. If one were specifically trying to address issues related to the financial crisis, it may be difficult to do so through piecemeal federal preemptions. Much of crisis management and avoidance will be a question of individual regulatory decisions, which are more difficult to address through broader preemption efforts.

4. Create a Federal Systemic Risk Regulator

One new regulatory option being discussed in the current financial crisis is the concept of a "systemic risk regulator." The committee has held an entire hearing devoted to the subject, so I will focus on the systemic risk regulator and the insurance system.

Given the near systemic collapse that the financial system experienced last September, the need for someone to look after the entire system may seem self-evident to some. As concepts for a systemic risk regulator have become more advanced, however, the difficulties of going from the concept of needing someone to look after the system to how this concept would work in practice have become more apparent. Particularly with regard to the insurance regulatory system, there are a number of questions to consider, including:

Do any insurers present a systemic risk? If so, what criteria would be used to identify these systemically significant institutions?

> In the past, a familiar concern was that financial institutions may become "too big to fail." In the current crises, however, the concept of "too interconnected to fail" has also been injected into the debate. Metrics for "interconnectedness" are even less clear than those for size. Historically, insurers have generally not been considered to present systemic risks; insurers' liabilities are much more stable than those of banks and insurers have not suffered from depositor runs like banks have. The current crisis, however, has brought a different sort of run on financial institutions, namely the withdrawal of short term credit and demand from other counterparties for collateral payments. Such a "run" brought AIG down and other insurers might be vulnerable, although none have failed since AIG.

Who would make the decision on which institutions would fall under the systemic regulator's purview?

> The state insurance regulators would most likely expect some role in the process of identifying systemically significant insurers. If the insurance regulators and the systemic regulator disagree, however, a mechanism must be in place to arrive at a final decision.

Would a systemic regulator have day-to-day oversight over insurers judged to be systemically significant?

If it were to have day-to-day oversight, then the systemic risk regulator would be tantamount to a federal insurance regulator, which is the heart of the federal chartering debate and will be explored further later in this testimony.

If not, what specific preemptive powers would a systemic regulator have over the state regulators' decisions?

A particularly controversial aspect of such preemptive powers may surround regulation of insurance rates. Many states require specific regulatory approval for insurance rates. If these rates were insufficient to cover an insurer's risks, thus making insolvency more likely, it could directly concern a systemic risk regulator.

Would the systemic regulator have resolution authority over failed systemically significant institutions or would this be left to the state regulators and the guarantee funds?

The failure of large institutions like AIG and Lehman Brothers, who did not fall under existing resolution provisions as banks do, has been identified by many as a particular issue to be addressed by a systemic risk regulator. Treasury has released a proposal calling for such resolution authority. Such authority could, however, have a significant impact on the current system for resolving insurance company failures. Under current law, failed insurance companies are resolved by the state insurance regulators and guarantee funds. Generally, insured policy holders are paid off by the guarantee funds under certain guidelines with the guarantee funds then occupying a senior position with regard to claims on insurer assets. What position individual policyholders or guarantee funds might have under a federal resolution authority, however, is up to whatever laws would be approved by Congress. The current Treasury proposal for resolution authority does not change the current authority over insurance subsidiary assets. If the enacted resolution authority did change this, a systemic risk regulator might have an incentive to use the assets of a company such as AIG to satisfy creditors who are themselves systemically significant rather than directing these assets to satisfy policyholder claims.

What impact would identifying particular insurers as systemically significant have on the marketplace, particularly on competitors of these firms?

Competitors of AIG today have voiced many complaints that AIG is using federal support to undercut their prices. If an insurer were identified as systemically significant, and thus presumably one that is not allowed to fail, this could give such firms a competitive advantage. If this occurs, others would presumably seek to merge or otherwise grow in size so they might gain this advantage. This could have the paradoxical effect of making a future crisis worse as more financial institutions would have the potential to spread systemic harm in the event of their collapse.

Would being identified as systemically significant promote risk taking in these institutions, and thus make future crises more likely?

> The problem of "moral hazard" is well known in the insurance industry. In order to deal with it on the individual level, insurers institute a variety of policies, such as deductibles and copayments. Identifying an institution as systemically significant implies it will not be allowed to fail, which also creates moral hazard. To address this, a systemically significant designation could also include other policies, such as increased capital requirements or other regulatory scrutiny.

5. Create a Federal Solvency Regulator

Regulation of insurers can be broken down broadly into oversight of the company's interaction with customers (market conduct or consumer protection regulation) and oversight of its future ability to pay claims (solvency or prudential regulation). In the United States, regulation of both aspects is done by the individual states. Some other countries, however, separate these functions and have two distinct agencies for the two tasks. In theory, this could allow for increased focus on both tasks as each agency only has one goal. Adapting this approach to the United States could lead to the possibility of assigning consumer protection functions to the individual states, while giving solvency regulatory powers to the federal government. Such an approach would also dovetail with some arguments already advanced in the optional federal chartering debates. Proponents of the state regulatory system often cite consumer protection as a particularly successful area for the states and one in which the states can give much more individual attention to citizens than they are likely to receive from a federal bureaucracy, while proponents of a federal chartering system cite the increased complexity of financial instruments and company balance sheets which makes solvency regulation more difficult, thus requiring additional expertise which would presumably come with a federal regulator.

The operation of such a mixed system would ideally include substantial communication and trust between the consumer protection regulators and the solvency regulators. Establishing this trust in the aftermath of a federal takeover of solvency regulation could be a challenge. Another flashpoint might be the regulation of rates, as mentioned previously. Rates have a direct impact on insurer solvency, but regulation of rates is seen by many as a bedrock aspect of consumer protection. To limit conflict between the states and federal regulators, implementing legislation would need clarify what power the federal solvency regulators might have to overrule state regulators, or vice versa.

6. Establish a Federal Insurance Charter

The debate over the possibility of a federal charter for insurers has been ongoing for the past several years with the committee hearing on numerous occasions from both the proponents and opponents of the idea. A common proposal has been for an Optional Federal Charter (OFC) for insurers modeled on the dual banking system.

Current focus on the idea of a federal charter dates largely to the passage of GLBA, which specifically reaffirmed the states as the functional regulators of insurance but also unleashed market forces encouraging a greater federal role. This has led to increasing industry complaints of overlapping, and sometimes contradictory, state regulatory edicts driving up the cost of compliance and increasing the time necessary to bring new products to market.

Arguments advanced for federal chartering have included the following:

- The regulation of insurance companies needs to be modernized at the federal level to make insurers more competitive with other federally regulated financial institutions in the post-GLBA environment.
- The recent financial crisis has shown that some insurers present systemic risk and should be regulated by a regulator with a broad, systemic outlook.
- Insurance needs a knowledgeable voice and advocate in Washington, DC.
- The current system is very slow in approving new products, putting insurers at a distinct disadvantage in product creation and delivery.
- Insurers have difficulty in expanding abroad without a regulator at the national level.
- Consumers will benefit from a greater supply of insurance and lower cost to consumers as insurance companies are forced to compete on a national scale.

Arguments for state regulation have included the following:

- State regulated insurers have performed relatively well through the financial crisis, underscoring the quality of state regulation.
- State insurance regulators have unique knowledge of local markets and conditions and are flexible and adaptable to local conditions.
- The diversity of state regulation reduces the impact of bad regulation and promotes innovation and good regulation.
- Strong incentives, such as direct election, exist for state regulators to do the job effectively at the state level.
- A substantial and costly new federal bureaucracy would need to be created in a federal system.
- States would suffer substantial fiscal damage should state premium taxes be reduced by the federal system.
- A "race to the bottom" could occur under an optional federal charter as state and federal regulators compete to give insurers more favorable treatment and thus secure greater oversight authority and budget.

In the abstract, the federal chartering question could be simply about the "who" of regulation. Should it be the federal government, the states, or some combination of the two? In practice, however, OFC legislation has had much to say about the "how" of regulation. Should the government continue the same fine degree of industry oversight that states have practiced in the past? The OFC bills that have been introduced to this point have tended to answer the latter question negatively—the federal regulator that they would create would exercise less regulatory oversight than most state regulators. This deregulatory aspect of past and present OFC bills can be as great a source of controversy as the introduction of federal regulation itself.

7. Reform the Complete Financial Service Regulatory System

The question of federal involvement in insurance regulation could expand beyond the confines of insurance and instead be subsumed within a more comprehensive reform to the whole approach to regulating the U.S. financial system. General financial regulation in the United States is carried out by an overlapping set of bodies created at various periods during the past 150 years. Historically, the regulatory body was dictated by the charter of a given institution: banks were regulated by various banking regulators, thrifts by thrift regulators, insurers by insurance regulators, etc. Although GLBA aimed to refocus the system along functional lines, so that, for example, insurance regulators would regulate insurance activity whether it was carried out by banks or by insurers, regulation has still largely fallen along institutional lines. Simplification of the regulatory system is not a result that most observers would ascribe to GLBA. Even before the financial crisis, arguments were advanced that the system needed a significant overhaul, perhaps by combining overlapping institutions or completely rethinking the structure of the regulatory system. Several other countries have confronted similar policy choices in the past two decades with two regulatory models gaining favor: a “unitary” regulator and a “twin peaks” model.

A unitary model calls for a single regulator to oversee financial institutions regardless of the charter type or business activity that the institutions engage in. Such a regulator could oversee all aspects of financial activity, from systemic stability to individual institution solvency to consumer protection. Advantages of such an approach include a focus on financial regulation that avoids consumer confusion about who to call in the case of problems; clear regulatory authority over innovations in the financial system; and no possibility that financial institutions would “game the system” by playing one regulator off against another. The strengths of a unitary system when the regulator gets things right, however, are also its weakness if the regulator gets things wrong. With only one regulatory body, there are few checks and balances. If a mistake is made, it can more easily affect the whole system rather than be isolated within a particular type of institution or geographic area. Examples of countries adopting a unitary approach include Japan and the United Kingdom.

A twin peaks model typically separates the regulatory authority between solvency and consumer protection functions, with separate entities responsible for each. Such an approach arguably can offer many of the same advantages of a unitary system with relative uniformity of regulation across different financial institutions regardless of charter and an even clearer regulatory focus within each of the two regulators. Overlap between the two regulators could be minimized, but having two voices in the system offers at least the possibility of minimizing the impact of regulatory mistakes rippling throughout the system. Examples of countries adopting a twin peaks approach include Australia and the Netherlands.

In March 2008, then-Secretary of the Treasury Henry Paulson released a “Blueprint for a Modernized Financial Regulatory Structure.” Although the current financial crisis had begun at that time, the Treasury blueprint was not primarily a response to the crisis, but instead an attempt to create "a more flexible, efficient and effective regulatory framework"[11] The final structure envisioned in the Treasury blueprint could be described as "twin peaks plus." The Treasury model was to ultimately create a prudential regulator overseeing the solvency of individual companies, a business conduct regulator overseeing consumer protection, and a market stability regulator overseeing risks to the entire system. As interim steps to its final shape, the Treasury blueprint called for the initial creation of a federal office of insurance oversight to be followed by a full federal charter for insurers.

[11] U.S. Treasury, "Treasury Releases Blueprint for Stronger Regulatory Structure," press release, March 31, 2008, http://www.ustreas.gov/press/releases/hp896.htm.

Subcommittee Testimony
May 14, 2009

TOWERS PERRIN

"How Should the Federal Government Oversee Insurance?"

Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
U.S. House of Representatives

Patricia L. Guinn, CERA, FSA, MAAA
Managing Director,
Risk & Financial Services
Towers Perrin

Chairman Kanjorski, Ranking Member Garrett and members of the subcommittee, it is an honor to testify on behalf of Towers Perrin. I appreciate this opportunity to offer my firm's perspective on the important issue of insurance industry oversight.

Towers Perrin is a global professional services firm that helps organizations improve performance through effective people, risk and financial management. In the area of risk and financial management, our services include risk and capital management, insurance and reinsurance intermediary services and actuarial consulting. The insurance industry is an area of particular focus for our firm.

With the notable exception of AIG, the insurance industry in general has not felt the impact of the financial crisis to the degree experienced by the banking industry. However, the crisis has exposed certain issues – such as systemic risk – that raise valid questions about regulatory oversight. As I will explain in more detail, any new federal oversight role should take into account certain distinctive features of the insurance industry and its stakeholders and leverage the existing regulatory framework.

Insurers have been impacted by the economic crisis

Without a doubt, the financial crisis has had a significant adverse impact on insurer balance sheets and profitability.

For life insurers, 2008 was among the poorest on record for operating performance, largely because of significant realized and unrealized losses on investment portfolios, large reserve increases to support product guarantees, higher costs of capital and a declining revenue base.

The property/casualty industry experienced its worst financial performance since 2001.[1] P/C insurers reported an annualized statutory rate of return on average

[1] 2008 – Year End Results, Insurance Information Institute, 2009.

surplus of 0.5% in 2008, down from the 12.4% return in 2007. Net investment gains fell 47%. The mortgage and financial guaranty segments reported a collective underwriting loss of $15.1 billion.[2]

Insurers Have a Significant Impact on the Economy

The insurance industry, a comparatively small part of the financial services industry, has a disproportionately large impact on the general economy. Think of your own experience. The businesses you rely on couldn't open their doors without liability insurance. You can't drive a car or get a mortgage without appropriate insurance.

Insurance companies also are huge investors, with pools of capital that are vital for the U.S. financial markets. In 2007, on the eve of the economic crisis, life companies held cash and invested assets of $3 trillion, while P/C companies held cash and invested assets of another $1.3 trillion. P/C companies are among the largest holders of municipal bonds.

The financial crisis has highlighted one of the industry's less commonly known roles in the economy – as the provider of financial guaranty insurance to enhance the credit quality of a wide range of structured securities.

Although Current Regulation Is Generally Effective, There Are Gaps

The fact that U.S. insurers, in general, are weathering the financial crisis in a stronger position than the banking industry can be explained by a number of factors. They include:

- Effective risk management with an emphasis on an appropriate spreading of risks, especially among P/C companies.

- An existing regulatory framework that concentrates primarily on solvency and policyholder protection.

Any new federal-level role in insurance regulation should build on these two very positive features of the current regulatory environment while addressing new challenges presented by systemic risk and the complexities of a financial services sector in which the lines are increasingly blurred between insurers and other financial services players.

The AIG situation is instructive. AIG's most significant problems were primarily at the holding company level and within the Financial Products unit. Those problems sparked policyholder concerns about the insurance operations. Few regulators could have anticipated problems of this nature and, in any case, neither state nor federal regulators had the oversight authority to regulate or monitor effectively the relationship between the insurance and non-insurance operations.

[2] A.M. Best Co., 2009

With the current regulatory structure, which is based primarily on legal entity by legal entity oversight, no state insurance department is in a position to exercise comprehensive oversight of a diversified, multinational financial services company that includes insurance operations. The current state regulatory system, with its focus on policyholder protection for each legal entity, dates back to a time when insurers were smaller and less complex, typically with only one or a very small number of separate legal entities. Many insurers were mutuals, a model that lent itself to state regulation. The landscape changed with the growth of huge, non-insurance holding companies, cross-sector multiline insurance companies and multinational insurers.

In addition to these limitations, the current system can in certain circumstances inadvertently encourage regulatory and capital arbitrage, the notion that products gravitate to the financial services sector that requires the least regulatory capital. This is an unintended consequence of our current system, with different regulators overseeing banks, securities firms, asset managers and insurance companies. Some sectors, such as hedge funds, have little regulatory oversight.

Credit risk, for example, can be transferred using either a financial guaranty insurer or through a credit default swap (CDS), each of which has very different capital regulatory requirements. The insurer is obliged to allocate capital to the transaction but there is no uniform requirement for a credit default swap writer to do the same. The result is that financial guaranty insurers are still generally solvent while the CDS market has been severely impaired.

Systemic Risk Oversight Should Consider Distinctive Features of Insurers

The unfolding financial crisis has revealed that the current regulatory structure does not adequately anticipate or address financial “contagion” or systemic risk. Risks that were once thought to be independent turned out to be linked in unanticipated ways and have had far-reaching consequences for the U.S. and global economy. More coherent oversight is needed by a single regulator or unified group of regulators with clear lines of authority and responsibility.

A more holistic regulatory framework should include economic capital requirements based on enterprise-wide stress testing. Such requirements would improve transparency into the ability of the consolidated enterprise to withstand extreme loss scenarios.

State regulators already have resolution authority for insurers under their jurisdiction. Any new federal-level resolution authority should be designed to address multi-jurisdictional and multi-entity conglomerates, in coordination with state authorities.

Implementing Federal Regulatory Oversight Needs To Be Done Cautiously

While there may be advantages to the federal government taking a more active role in regulating insurance solvency, simply extending a regulatory regimen designed for banks would not work well for insurers.

The insurance industry has many distinctive features and market practices. The federal government should build a knowledge base about the insurance industry by collecting information and by leveraging the collective knowledge and expertise of state regulators and industry associations.

Regulation at the federal level needs to be carefully structured and designed to supplement and improve the existing regulatory framework, not replace it. A strong argument can be made for including insurance in a broad financial services regulatory framework that might include commercial banks, investment banks and hedge funds. There are models for comprehensive financial services regulation in the United Kingdom, Australia, Canada and elsewhere. This path presents issues that will require careful attention:

1. There are significant risks to simply imposing a whole new regulatory structure on top of the existing system. Any reforms should avoid duplication and complexity while preserving state regulatory powers that have proven to be effective.

2. Reform should recognize that there is a great body of expertise in the state regulatory system that should be retained and leveraged. A company's size, complexity and global reach could be determining factors in decisions concerning federal vs. state regulatory responsibilities. Insurers should be given the option of selecting a charter from a federal regulator.

3. In regulatory terms, the Subcommittee may want to look at solvency and market conduct differently. While solvency and policyholder security might be best handled on a federal level, an argument can be made that market conduct is best regulated at the state level, closer to the customer.

4. Direct federal participation in the insurance markets should not be necessary except in unusual circumstances that present systemic risks. For example, while natural catastrophe risk can be extreme, the insurance markets have developed effective pricing mechanisms. Terrorism risk that led to the enactment of TRIA, on the other hand, was an appropriate intervention because the risk was seen as systemic and normal insurance market characteristics did not apply.

5. Because banking is many times the size of the insurance industry, there is a danger that all regulatory talent on the federal level will come from the

banking industry, and banking-oriented regulators might attempt to impose an unworkable banking model on the insurance industry.

6. U.S. regulatory reform should be coordinated with reform at the global level. Systemic risks in the current crisis have had global implications. In addition, effective oversight of multinational insurers requires cooperation on a global scale. A federal regulatory structure would benefit from close relationships with global insurance regulatory organizations such as the International Association of Insurance Supervisors.

Any regulatory structure will require appropriate insurance knowledge and expertise, including both solid grounding in traditional insurance regulatory theory and practice and an appreciation for the interaction of insurance and other financial services that may contribute to systemic risk. Perhaps there should be a distinct insurance department in an overarching regulatory structure with specific attention paid to the industry. There are certain insurance concepts and principles that are not present in the banking industry. The very essence of insurance is to provide protection against unknown future risks -- sometimes providing guarantees far into the future.

Complement Regulatory Oversight with Strong Professional Standards

The current financial crisis has demonstrated that systemic risk can arise from the failure to understand and evaluate risks and properly value complex financial instruments.

Current state insurance regulations require appropriately credentialed professionals, i. e. actuaries, to value certain insurance liabilities that, by their very nature, are complex financial obligations. Towers Perrin provides actuarial consulting services and is one of the world’s largest employers of actuaries. In our experience, actuaries have the skills, objectivity, credentials and professional standards to understand and value complex risks for both internal management purposes and for financial reporting.

These same skills qualify actuaries to examine and value complex and risky financial instruments. When the market for an asset is active, the market typically sets the asset value. When a market is thin and illiquid, alternative means of asset valuation are necessary to approximate as closely as possible the value an active market would produce. This valuation challenge is acute for mortgage-backed securities, CDOs and other hard-to-value assets.

Whether it is to analyze the risks associated with complex financial obligations or to generate alternative market-consistent value in the absence of liquid markets, financial institutions generally are relying on internally generated models and a range of outside advisors. There are no established guidelines for how such valuations are to be done, and no particular credentials required of those performing the valuations.

Drawing on their deep resources, insurance companies are increasing the involvement of actuaries in the analysis and valuation of complex financial obligations and assets. A potential benefit of federal involvement in the regulation of insurers and other financial institutions could be to require actuarial valuation of all complex financial obligations and hard-to-value assets.

Conclusions

- There are specific regulatory issues that can best be resolved at the federal level. They include, for example, eliminating regulatory arbitrage, addressing systemic risk and developing a comprehensive approach to the risk management landscape for financial services institutions.

- But a new regulatory regime should retain and leverage the strengths and best practices that have been proven over time by state regulators.

- While it might make sense to regulate banks and insurers under a single administrative framework, it is important that such a framework recognize the distinctive needs and attributes of the insurance business.

- The financial performance of insurers during the financial crisis may hold lessons for other financial services institutions, particularly as they relate to the integration of risk and capital management and the spreading of risk. Any regulatory regime should be structured to encourage the transfer of best practices from one industry segment to another.

- Complex risks are best evaluated and managed by risk management professionals, including actuaries, who have the requisite skills and objectivity and who conduct their work consistent with a well-developed body of professional standards.

Thank you for this opportunity to express Towers Perrin's views.

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CFA

Consumer Federation of America

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TESTIMONY OF

J. ROBERT HUNTER
DIRECTOR OF INSURANCE
CONSUMER FEDERATION OF AMERICA

BEFORE

UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE
FINANCIAL SERVICES COMMITTEE

REGARDING

HOW SHOULD THE FEDERAL GOVERNMENT OVERSEE INSURANCE?

MAY 14, 2009

Good morning Chairman Kanjorski, Ranking Member Garrett and members of the subcommittee. My name is Bob Hunter, and I am Director of Insurance for the Consumer Federation of America (CFA). Thank you for inviting me here today to discuss perspectives on modernizing insurance regulation. I have served as Federal Insurance Administrator under Presidents Ford and Carter and as Texas Insurance Commissioner. I have 50 years of experience in insurance, including in the private sector, in state government, in the federal government and with consumer groups.

CFA is a non-profit association of some 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy, and education.

CFA Is Reviewing Its Policy Positions on State and Federal Regulation

CFA is nearing the end of a detailed review of our policy positions on insurance regulation to take into consideration the lessons we are learning from the economic meltdown. We are also reviewing the problems and successes of state regulation that occurred before the current crisis erupted. We expect to have the review completed shortly and will present our findings to date in this testimony.

I can report to you today that some issues are settled in our minds, including the need for an expanded role for the federal government in regulating insurance generally.

WHAT THE FEDERAL GOVERNMENT SHOULD CONSIDER REGULATING

Our review shows that there is systemic risk in insurance, requiring a federal systemic risk regulator. In order to fully understand and control systemic risk, we believe that the federal government should take over solvency/prudential regulation of insurance. This conclusion is made even in light of the fact that, looking backward, a case can be strongly made that the states have done a good job in solvency regulation of insurers in recent years. However, looking forward, we see that a single solvency/prudential regulator with national systemic risk part of the portfolio is required to eliminate any potential national systemic risk. Therefore, Congress should consider the following actions:

1. There are significant systemic risk issues associated with certain lines of insurance. Congress should consider creation of a systemic risk regulator for insurance.

2. In order to properly oversee insurer financial condition, CFA believes that the federal government should be the solvency/prudential risk regulator for all insurers. This federal oversight office would also be a mechanism to monitor any systemic risk. It is difficult to understand how a systemic regulator could function properly without the sort of understanding gained from total solvency/prudential analysis.

3. A federal office should also be a repository of insurance expertise, data collection[1] and analysis and to engage in international insurance issues. While a federal insurance office should be knowledgeable about insurance matters to help Congress and the Administration sort through the tremendous complexities of this industry, the office should not be granted vague and open-ended powers of preemption regarding state consumer protection laws or rules in areas that Congress has chosen not to explicitly preempt.

WHAT THE FEDERAL GOVERNMENT SHOULD NOT CONSIDER REGULATING

The states are well established in insurance regulation with great expertise and experience in regulating insurance. States regulate over 7,000 insurers using over 10,000 staff working on insurance matters, spending well over a billion dollars are year on the effort. We have complained about many weaknesses of the state systems but there are some things we find that the states do that the federal government cannot match. These things relate to dealing with people. States handle almost a half million complaints and an additional 3 million requests for information. Several states average more insurance inquiries and complaints than the entire federal banking system does. The Fed and the OCC combined only handled about 130,000 calls and written complaints for the entire nation, below states like California, Florida and Texas in insurance regulation. Our recent study of state web sites found quite good information for consumers, and the sites are consistently getting better. While many states are inadequate in rate and form regulation and in market conduct examinations (law suits uncover much more that really hurt consumers than the states do), we believe that, with some notable exceptions, there has been less gouging in state-regulated insurance pricing than in, for example, credit card, mortgage lending and other federally regulated lender practices.

The states, being nearer to the people, seem to be more responsive to consumer needs. Here is what we think the federal government should not be tasked with doing:

1. While CFA supports a greater federal insurance role, we vigorously oppose an optional federal charter (OFC), since such a system cannot control systemic risk, has failed miserably in protecting banking consumers and sets up pressures that can only lead to reduced consumer protections through regulatory arbitrage.

2. We believe that consumer protection is best accomplished at a government regulatory level close to the people and we therefore believe that the states should continue to handle consumer protection regulation at this time. Such regulation must address all key consumer issues, such as claims abuses, unfair risk classification criteria, the unavailability of needed insurance, complaints and requests for information on insurers,

[1] The federal government should require insurers to report HMDA-style market performance data. The same type of salutary effects HMDA has brought to the mortgage market could happen with insurance. State regulators and state legislatures have shown themselves unable or unwilling to provide consumers with any meaningful market performance data. Despite insurers using credit scores for close to 15 years in insurance, there is not one state insurance department that collects any data to monitor the impact of insurance scores on the availability or affordability of insurance – even during the current severe economic downturn. The availability of these data would create much greater transparency of the job performance of insurance regulators and would enable the public to gain market power needed to create more competitive insurance markets.

prices and other information. In order to properly accomplish consumer protection, any emerging regulatory system must contain, among other things, the capacity to regulate rates (including classifications) and policy forms. Our study of decades of auto insurance data from all states proves that tough, thoughtful regulation, including rate regulation, is most effective in protecting consumers. Such a system also works well for insurers and enhances competition in the states with tough regulation.

OTHER IMPORTANT STEPS CONGRESS SHOULD CONSIDER

1. Repeal of the antitrust exemption in the McCarran-Ferguson Act must be part of any efforts by Congress to reform insurance regulation. Collusion in the pricing of property/casualty insurance should not be allowed in the 21st century. CFA endorses H.R. 1583, the "Insurance Industry Competition Act of 2009," introduced by Rep. Peter DeFazio.

2. As Congress attempts to create an agency that has knowledge about insurance, it should restore the ability of the FTC to study insurance and assist the states in identifying consumer protection issues that have national ramifications.

After responding to the questions you raised in your letter of invitation, Mr. Chairman, I will briefly discuss each of these conclusions and then I will highlight the CFA research on the future of insurance regulation that is nearing completion.

Responses to Your Questions

CFA's responses to the questions contained in your letter of invitation to testify dated May 8, 2009 follow:

a) There is a wide spectrum of options with regard to how or whether the Federal Government should oversee insurance. Please provide options along this spectrum and the pros and cons of each.

The range of options extends from the status quo to a full federal takeover of insurance regulation. Many of the options are discussed in the following testimony. A listing of advantages and disadvantages of federal vs. state regulation is in the testimony, which follows. We conclude that it is not as simple as the states or the federal government being the sole regulator, so the status quo or a full federal takeover, the end points of the spectrum of options, should be rejected. We conclude that the states have better experience and staffing, better ability to provide information and greater access for individual consumers. We conclude that the federal government is better at dealing with bigger issues, national trends, international and systemic issues. We rule out any optional approach, where the insurer picks and chooses a regulator. That is impossible for systemic risk and would create an unacceptable regulatory arbitrage situation. We conclude that some combination of state and federal oversight other than an OFC is required. We conclude that the split in regulation that best deals with the pros and cons of each level of government is to have the federal government deal with systemic risk, solvency and international issues but to have the states deal with consumer protection, complaints and market conduct issues.

I should point out that neither the federal or state regulatory systems have distinguished themselves recently.

The Federal government has failed to adequately deal with both financial and market regulation (e.g., no action on predatory lending, attempts to usurp state efforts to control it, and failure to monitor the financial condition of many institutions).

And, the federal government's involvement in insurance has been grossly negligent. For instance, the National Flood Insurance Program that I once administered has failed to do the sort of loss mitigation or stop building in uninsurable areas that it was intended to do. Maps are antiquated and the Write Your Own Program is inefficient, all leading to huge taxpayer subsidies of unwise construction and bad insurance administration. Another example is ERISA health insurance where consumer requests for help often go unheeded.

As to the states' performance – by and large, all substantive regulation is done either by the biggest states – New York, Florida, Texas and California[2] or through National Association of Insurance Commissioner (NAIC) models. State insurance regulators have a weak record of consumer protection and a long history of being captured by the industry they regulate.

We had thought that the accreditation program had provided consistency of financial regulation across states. We also thought that states had incentives to maintain strong financial solvency regulation for domestic insurers so the insurers would not fail. Recent events have proved us wrong.

In 2008, the life insurance industry came to NAIC officers and in secret meetings, the NAIC decided to fast track several significant accounting and reserve practices – rules for how much money insurers must have readily available for paying claims. The proposed changes would have, in our opinion, weakened the financial condition of insurers, while maintaining the appearance of strong financial condition. The changes would have reduced the amount of money insurers needed to hold in reserve or allowed non-liquid assets to be counted as the capital cushion to protect consumers in the event reserves were inadequate. After strong opposition from consumer groups, the NAIC voted not to adopt these changes, stating that the industry had not made the case the changes were needed. But, then, a dozen individual states started granting "permitted practices"-- state exceptions to accounting rules, which resulted in the creation of billions of dollars of capital or reserves. The states granting the reserves were responding to political pressure from domestic insurers. This debacle laid bare the problem with state-based financial regulation.

As for market regulation, the states have a poor record. Some states at some times have done well for consumers, but states as a group routinely fails to identify market problems or pro-actively protect consumers.

b) Should the Federal Government collect information on the insurance industry to start building a knowledge base?

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[2] These four states account for about half of the staff and financial resources used nationally to regulate insurance.

Absolutely. The federal government needs to know how insurance works, what the systemic risks are, how consumers are treated, what the national macro trends in insurance are and such information. HMDA-type information is critically needed to protect low-income and minority consumers of insurance.

c) Should the Federal Government monitor insurance as a part of systemic risk oversight?

Yes. First, Congress should consider re-imposing restrictions similar to those of the Glass-Steagall Act so insurers are not engaged in risky non-insurance practices.

Second, it depends on the type of insurer. Bond insurers and mortgage guaranty insurers have shown themselves to be able to wreak havoc on the bond and mortgage markets. One aspect of this problem is the small number of such insurers and the high market concentration of just a few insurers. One approach would simply be to limit the market share of any insurer to, say, 10%, of the market to avoid the failure of a single insurer bringing down an entire market.

Title insurers also may pose systemic risk. Two companies hold over two-thirds of the national market and the failure of one or both of these insurers could be catastrophic. The title insurance policies would become void and there is no guaranty fund system in the vast majority of states. Banks require title on mortgages, so there could be havoc in the mortgage markets.

Life insurers, by virtue of their holdings of financial assets and investments, might also pose systemic risk.

Property/casualty insurers – other than bond, private mortgage insurance and title, have little systemic risk, but there is risk from a weak guaranty fund system and from reinsurance in a combination of extreme loss events. A prefunded federal guaranty fund system, modeled after FDIC, would be much superior to the current state-based system.

The best way to avoid systemic risk might not be through a systemic regulator. The best approach is to limit the activities and size of insurers to avoid any danger of systemic risk. However, a systemic risk regulator would be needed to accomplish the identification of size and activity risk and is therefore part of the solvency/prudential regulator we suggest be created.

d) Does the difference in accounting for insurers (statutory accounting) versus other financial services institutions (GAAP) pose a difficulty in how the federal government can assess an insurer's financial health?

No. There are relatively simple crosswalks between SAP and GAAP that the federal government can use to understand the strength of an insurer. Insurers can be required to report both ways in any event. Publicly traded insurers report their financials both ways already.

e) Is a Federal Resolution Authority needed for insurance holding companies? If so, how should it interact with the current state regulator and guaranty fund resolution powers?

If Congress creates or designates a separate systemic risk regulator and houses the resolution authority in that entity, then that entity would need to have authority to demand corrective actions if an insurer is in their view taking on undue risks. In that case, should they simply supersede state regulatory authority or should they seek to work with state regulators? We think the systemic risk regulator has to have ultimate authority in such cases, particularly given the lack of independence in so many state insurance regulators.

You could, for example, encourage the systemic risk regulator to work with the state regulator to implement corrective actions, but give the systemic risk regulator ultimate authority to act should state regulators prove uncooperative or ineffective. Congress could also encourage the systemic risk regulator to communicate any concerns about emerging risks to state regulators in order to enhance state regulators' ability to police companies for risky conduct before it becomes a problem that results in a failure that requires resolution.

Later in the testimony we show that state guaranty funds have serious problems and could fail if one or more large insurers failed. Surely companies that are too large to fail should not be handled through the state guaranty funds but should handled by a federal resolution authority. It couldn't be a determination that was made at the point of failure, however, since any company subject to federal resolution would have to also be subject to federal corrective action authority (at least in my opinion). If we give the federal systemic risk regulator authority to conduct broad surveillance of the insurance industry, then that regulator could be given authority to determine when a particular company would be subject to federal resolution authority. This leads me toward a position of not separating systemic risk regulation from solvency/prudential risk regulation.

If Congress goes with a systemic risk panel, instead of a single regulator, then state insurance regulators would presumably be part of that panel. If they were, they could help to make the determinations with regard to resolution authority. Would their incentives be to retain maximum authority or to dump as much as possible onto the feds, is an important question. I believe that state behavior over recent years makes it likely that the answer is the former, given their highly refined turf-consciousness. Congress should study just what are the implications of those incentives if a panel approach is adopted. This is another issue that leads me more toward a single federal systemic risk/solvency/prudential regulator.

If Congress creates a federal insurance regulator, then that regulator would presumably work with the systemic risk regulator/resolution authority in the same way that federal banking and securities regulators would. Again, I think that the agency that bears the responsibility for resolution has to have the authority to require corrective actions.

If Congress puts resolution authority in one place (e.g., FDIC) and systemic risk regulation authority in another, you obviously need coordination between these two agencies. How is that likely to work? I can see the potential for problems, if the two agencies disagree about the nature or extent of any risks and the need for corrective actions. This may be an argument for keeping these two functions together in the same agency. On the other hand, I think there is a case for giving resolution authority to the FDIC, which already has expertise in that area.

f) Is there a need for a Federal regulator of insurance? Who should determine which insurers should be regulated at the Federal level?

We believe that the situation in the nation has reached a point where the federal role in insurance regulation must be increased. Our position is that the federal government should regulate all insurers for systemic/solvency/prudential risk and international issues, with the states regulating market conduct and consumer protection matters, as discussed in detail in this testimony.

g) Do certain insurance products or companies impact the national economy? If so, how should they be regulated?

Yes, as detailed in my testimony. Imagine a situation where insurers refuse to write insurance because of economic damage or other issues. The coasts of America are an example. There, insurance is not available at affordable prices so states have had to create pools and take on risks themselves. Doctors march on state capitals when the economic cycle of insurers cause periodic price spikes. What if bond insurers fail? What if guarantee associations fail? All of these pose significant risks that impact millions of Americans and can undermine the nation's economy. As a Presidential commission once noted, "Communities without insurance are communities without hope."[3] Insurance has become a necessity, not an option. States require it, lenders require it, and people and businesses cannot function without insurance protection. Insurance has taken on a role not unlike a public utility, essential to grease the wheels of our economy.

h) Should all functions of insurance regulation be handled at the same level of government?

No. Experience shows that the states can best handle consumer issues, such as complaints, price and form regulation, market conduct and other people-to-people matters. The federal government would best handle systemic risk and the closely related solvency/prudential regulation as well as international affairs.

i) What are the current and appropriate roles of state regulation of insurance?

This question is discussed at length in the testimony below. Suffice it to say that the current, near total state insurance regulatory role should be made far more limited.

Systemic Risk and Insurance

In the past year, the government has stepped in to bail out or otherwise rescue a number of financial institutions not backed by an explicit federal guaranty, from Bear Stearns, to Fannie Mae and Freddie Mac, to AIG. The government's decision not to bail out Lehman Brothers is blamed by many for the sudden freezing of global credit markets last fall and the precipitous stock market decline that ultimately convinced Congress to put hundreds of billions of dollars of taxpayer money on the line to prevent a broader financial collapse. This chain of events has

[3] National Advisory Panel on Insurance in Riot-affected Areas," 1968.

prompted a nearly universal call for improved systemic risk regulation as an essential component of any regulatory reform package.

The fact that one of the institutions rescued, AIG, is a major insurance firm and the fact that some insurers have lobbied to receive rescue funds, puts insurers in the middle of that debate. As a result, decisions about how best to regulate insurance must take into account issues related to systemic risk. The decisions Congress makes about how to regulate systemic risk could, in turn, have implications for other types of insurance regulation issues, particularly the issue of whether a federal insurance regulator is needed.

Some in the insurance community have argued – correctly, to a degree[4] – that it was not AIG's insurance activity that created the systemic risk that prompted its rescue. Instead, it was AIG's ties to other financial institutions through hundreds of billions of dollars in unregulated credit default swaps that caused the government to conclude that a failure at AIG would have devastating consequences for the global financial system. Many observers have concluded that, although there are some very large insurers, their failure would be unlikely to pose a comparable systemic risk. Although there would doubtless be temporary market disruptions from such a failure, the existence of numerous competitors ready to step in and assume the coverage they provided would mitigate the risk to consumers. The existence of state guaranty funds is also cited as a factor that limits the systemic risk associated with an insurance company failure. Finally, state insurance regulators have been quick to note that capital standards, reserve requirements, and investment limitations imposed on insurers to guaranty their ability to pay claims have protected them from taking on the excessive risks that have proved so troubling for their colleagues in commercial and investment banking.

Although there is some validity to these arguments, they have their limitations. It is ironic, for example, that state regulators are boasting in Congress about the effectiveness of their capital and reserve requirements in stabilizing insurers even as several states act quietly at the individual state level to massively loosen those requirements to make their domestic life insurers look better on their 2008 balance sheets. Meanwhile, the state guaranty funds may create the illusion of safety where it does not exist. While the funds <u>might</u> be able to absorb the failure of a single large insurer, it is almost certain that they would not be able to handle the simultaneous failure of several large insurers in a timely fashion.[5] Moreover, there are other specialized insurers, most notably the bond insurers, whose role in the financial markets has clear systemic implications. The credit downgrade of bond insurers last year spilled over into the credit default swap market in ways that contributed to the freezing of credit markets. Current concerns with Directors and Officers Insurance for banks, where prices have doubled and the availability of insurance are questionable for some banks, may threaten to undermine bank recovery. Clearly, enough insurance-related systemic risk potential exists for insurers to be included in any plan to enhance systemic risk regulation.

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4 It appears that some $21 billion in losses in the AIG life insurers "securities lending program" did occur and was the basis for some federal taxpayer-backed relief.

5 CFA has grave doubts about the Guaranty Funds and even think they might present some systemic risk, as discussed below.

Although proposals on how to regulate to mitigate systemic risk are just taking shape, it appears likely that systemic risk will consist of at least three components:

1. Efforts to better monitor the financial system for the build-up of risks that could have systemic implications;

2. Standard-setting to reduce the risk of failure at a large or otherwise systemically significant institution; and

3. Creation of a mechanism to allow the orderly failure of non-bank financial institutions similar to the power the Federal Deposit Insurance Corporation (FDIC) currently has with regard to banks. Many have further suggested that a systemic risk regulator also needs FDIC-like authority to intervene in troubled financial institutions before a crisis to force them to take corrective actions to head off a threatened failure.

As Congress moves to provide for enhanced regulatory focus on systemic risk, insurers are clearly among the financial institutions that should expect to have their activities monitored. Beyond that, however, the issues for insurance regulation become more complicated. The following are among the key issues that need to be resolved:

- **What authority should a federal systemic risk regulator have to restrict conduct by insurers that it views as posing a systemic risk?**

CFA believes the ability to monitor for risks without the ability to act to constrain those risks is meaningless. Whether this authority is accomplished through preemption of state solvency regulation, as some have suggested, will depend in part on the model of systemic risk regulation that Congress adopts. Should Congress decide to designate a single, central systemic risk regulator, it is likely to give that regulator authority at a minimum to override any state or federal risk-related regulations, such as capital and liquidity standards, that it believes are insufficiently rigorous to protect against a risk to the financial system. It could go further, authorizing the systemic risk regulator to directly set such standards for institutions or practices deemed to be systemically significant, a category that would almost certainly include some insurers, or to intervene at such institutions to demand corrective actions under certain circumstances.

On the other hand, should Congress adopt a model of systemic risk regulation in which a “college” of financial regulators, presumably an expanded and refocused version of the Presidential Working Group on Financial Market Stability, works together to monitor systemic risk, actions to constrain those risks are likely to be carried out through the existing regulatory entities. State insurance regulators could reasonably expect to play a direct role in that coordinating council. Even under this latter model, however, state securities regulators could find themselves under intense pressure to act according to federal directives regarding systemic risk. The difference is that they are likely to have a more active role in developing those policies. To the degree that state insurance regulators want to be taken seriously as partners in the effort to constrain systemic risks, they would strengthen their case if they would call an immediate halt to state-level measures designed to loosen industry capital and reserve requirements being pushed by insurers who are reluctant to acknowledge the shakiness of their finances at a time of economic crisis. They also need to reform the National Association of Insurance Commissioners (NAIC), which acts more like a trade organization than a regulator, with ex-parte meetings, secret meetings, no freedom of information requirements, no limits on leaving NAIC office and immediately start lobbying for the regulated entities and other such failings (discussed in greater detail below).

- **Will all insurers be affected by federal systemic risk regulation or only the largest, most "systemically significant" insurers?**

Here again, the degree of intrusiveness of federal systemic risk regulation into the insurance industry will depend on the model of regulation Congress chooses to adopt. Some have suggested designating certain institutions as "systemically significant" and subjecting them to heightened regulatory standards to prevent them from taking on excessive risks. Because only a small number of insurers would likely be designated as systemically significant, this approach would likely require the least federal intrusion into insurance regulation, even though that role could be extensive with regard to that small number of systemically significant insurers. This view is based on a too-narrow focus on preventing the failure of large institutions. To be effective, systemic risk regulation must focus not just on risks within large institutions, but also on risks in smaller institutions or in particular markets with the potential to infect the broader market. Also, the use of reinsurance to spread risk around the world can also have systemic impacts on the primary insurance markets should one or more large reinsurers fail.

Moreover, CFA shares the views of those who have argued that designating institutions as "systemically significant" is unworkable. Decisions about where to draw the line would be hopelessly arbitrary. Systemic risk is likely to be determined by an interaction of various factors, including at a minimum size[6], the nature of activities engaged in, and degree of interconnection with the financial markets as a whole. Even if you could set a meaningful dividing line based on these various factors, it would require constant adjustments based on changing market conditions and constant monitoring of institutions on the borderline. A far more logical approach is to monitor all, or nearly all, financial institutions and to impose capital standards on those institutions that ratchet up significantly as the institution takes on more risk – either by growing to a size that makes it "too big to fail," by engaging in risky activities, or by entering into risky relationships with other players in the broader financial markets. Such a model is likely to affect a far broader segment of the insurer population and, in doing so, prompt a debate about the need to preempt state standards. This is part of the reason why CFA now believes that solvency/prudential regulation should be handled by the federal government in the future.

Another approach that would lessen the possible systemic impact of insurance is simply to restrict insurance companies to the business of insurance and prohibit companies or conglomerates from mixing insurance with credit, investment banking and other financial services (i.e., repeal part of the Gramm Leach Bliley Act). Standing alone as pure insurers, most insurers have little systemic risk.

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6 This determination would have to be made for entire groups of insurance companies, not individual members of the group, since reinsurance and other cooperative arrangements within groups often share risk across the corporate enterprise.

- **Would large insurers be subject to a federal system for the orderly failure of non-financial institutions or do state guaranty funds suffice to fill that role for the insurance industry?**

One of the misconceptions about systemic risk regulation is that its intent is to protect large financial institutions from failure. CFA is convinced that the possibility of failure must be restored in order to provide accountability for assuming excessive risks. To accomplish that goal, a key focus of systemic risk regulation must be on creating a mechanism to allow the orderly unwinding of large non-bank financial institutions comparable to the authority the FDIC already has with regard to banks. After all, it was the absence of such a mechanism that forced the government to improvise in devising its rescue strategies.

The question for the insurance industry is whether insurers would be covered by such a mechanism or whether they would continue to rely on state guaranty funds to serve this function. CFA has grave concerns about the adequacy of state guaranty funds, particularly with regard to their ability to handle the simultaneous failure of several large insurers. At a minimum, large insurers facing failure would be expected to rely on a federal mechanism and therefore should be expected to contribute to its funding, assuming it is to be funded through some form of insurance premium. An alternative approach, and one that would be clearer in its applicability, would be to expand access to the program to a larger population and to impose premiums based on the degree of risk posed by those institutions. If the program included regulatory authority to intervene in advance of a crisis to force corrective actions, insurers could expect greater federal involvement in certain types of regulatory issues.

CFA's concerns with the state guaranty associations are that the associations, being post-assessment plans in nearly every case (New York is the exception), are very vulnerable to a large failure. It is very possible that the system could be overwhelmed by a series of large failures and stop functioning to promptly restore policyholders and claimants to their pre-insolvency position in a timely way.[7]

The guaranty associations can assess for claims beyond the ability of a failed insurer. They do this by assessing the remaining, solvent insurers. So today, with several life insurers in some trouble, a string of failures would put a call for money on other already stressed insurers. To ease this problem, these assessments for money are capped at various percentages of premiums from the last (or recent) year(s) and that would mean that, once the limits on assessments are exceeded, claims and demands for money from an insured's account could not be fully paid. So the risk is not just that the system taps insurers at a time of weakness, but that insureds, including individuals and businesses, might not be able to collect the money they need to get back to normal activity, adversely impacting the recovery of a stressed economy. Thus, the guaranty associations have a degree of systemic risk built into their structure.

Let's focus on life insurance -- currently more at risk of seeing failures (beyond AIG) than the property/casualty industry. In 2007, life insurance premiums were $142.7 billion and

[7] Some will argue that the system could tolerate a large failure, but even they will admit to do so would require freezing funds for quite a long time, likely bringing knock-on impacts to the economy.

annuities premiums were $314.6 billion. (Property/casualty insurance premiums were $452.4 billion in 2007.)[8]

If failures happen, the national capacity for life insurance is limited by two factors in a state: the way assessments are limited and the way accounts are set up in the state.

Assessment limits vary. In most states, it is two percent of premiums from the previous year.[9] But there are exceptions. In Alabama, for example it is one percent of premiums from the previous year. In California, it is one percent of the average of the premiums for the prior three years. In Connecticut it is two percent of the average premiums over the last three years. It would be reasonable to estimate the national assessment capacity at two percent of the latest year premium.[10]

The second limit on assessment is the state account structures that divide the life insurance premiums into various categories. For instance, Alabama has three accounts, life insurance, disability insurance and annuities.[11] Florida breaks it down as health, life and annuity. Sometimes life and annuity are combined in one account.

It is safe to say that the national assessment capacity is far less than $9.1 billion (this figure is calculated as two percent of the total of life and annuity premiums from 2007). This is a very high estimate of potential money available to help in the situation of life insurer and annuity insurer insolvencies in the first year because: (1) the premiums from the pre-funded state of New York are included; (2) two percent is more than would be achieved on average as discussed above; (3) some states split life and annuity into separate funds, further minimizing the available funds, and (4) the available premiums for assessment would drop because the amount of premium of the insurers that become insolvent (or appeal the assessment because of being in fragile solvency condition) being removed from the calculation.

Less than $9 billion would not go far should even one major insolvency involving a deep "hole" (shortfall) occur. Heck, it would hardly cover AIG's bonuses and parties! Insureds would be unable to get their money out of the funds, perhaps for years. Some claims would not be fully paid (even without the insolvency funds melting down, there are limits on what these funds pay out – usually in the range of $100,000 to $300,000 per policy) perhaps for many years, if ever, in the case of a series of insolvencies.

CFA believes enhanced systemic risk enforcement is an essential component of regulatory reform and that the focus should be broad. As such, we believe it is both inevitable

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[8] Life and annuity premiums from ACLI's "Life Insurance Fact Book," 2008 and P/C premiums from Best's "Aggregates and Averages," 2008. Health insurance premiums written by life insurers were $151.5 billion, excluding Blue Cross/Shield and HMOs and some health insurance written by P/C insurers. I should note that New York is a pre-funded plan, but over the years money has been taken out of the fund by the government for other purposes and replaced by an IOU.

[9] State-by- state data are available at www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/16.

[10] In fact, this estimate is somewhat high as some states have a one percent assessment cap and others use averages, which, since premiums are growing, are lower than simple use of the latest year.

[11] The Account Structure information on a state-by-state basis is found at www.nolhga.com/factsandfigures/main.cfm/location/lawdetail/docid/1.

and appropriate that insurers be brought under a system of systemic risk regulation. Because issues of systemic risk regulation are directly relevant to the broader policy debate over insurance regulation, these two issues cannot easily be divorced. We would note, however, that those who have sought to use the focus on systemic risk regulation to argue for an optional federal charter have the issue exactly backwards. Whatever else it is, systemic risk regulation is not optional. For systemic risk regulation to be effective, the regulator must have broad authority to determine the scope and extent of their authority. Moreover, if we have learned nothing else from the current crisis, we should have learned that giving financial institutions the ability to choose their regulator seriously undermines the quality of oversight and the rigor of regulation. That, in turn, has the potential to create serious systemic risks.

- **What potential systemic risks might insurers pose to the nation?**

Congress should study the potential systemic risk of bond insurance, title insurance, mortgage guarantee insurance and reinsurance. Reinsurance and retrocession spread risk around the world in ways that normally lower risk but could, in certain circumstances, cause massive failure if a series of major impacts were to be felt at once (i.e., a "black swan" could cause great failure worldwide if reinsurance failed to deliver in its secondary market function). Major storms, earthquakes, terrorism attacks and other catastrophes could occur at about the same time that might bankrupt some of these significantly inter-connected secondary-market systems, for instance.

Currently, banks are paying double last year's rates for directors and officers' coverage, if they can get it at all. If the degree of unavailability grows, Congress should study just what are the systemic implications if banks cannot hire officers or get directors to serve due to the lack of D&O coverage. Would the recovery of a bank be retarded by the flight of directors and officers from the institution if no insurance protection was available to protect them from shareholder or consumer suits?

Some state regulators themselves have recently introduced an element of systemic risk because of their willingness to cut consumer protections for life insurance by slashing reserves and other dollars of policyholder cushion at this time of great risk. Their theory seems to be that when consumers do not need to worry about the soundness of insurers they will keep high cushions of protection, but when policyholders most need this protection, they will change accounting standards at the request of insurers. Several states have lowered capital and reserve requirements for life insurers despite the fact that the NAIC ultimately refused to do so. NAIC acknowledged that it had not done the due diligence necessary to determine if the proposed changes would weaken insurers excessively. (See attachment 2 for the detailed comments I made prior to the NAIC action to not adopt the ACLI proposals.)[12]

In summary, CFA has come to a number of conclusions about the proper role of systemic risk regulation of insurance:

1. Insurance should be covered by any systemic risk regulatory structure that Congress develops.

[12] See Attachment 2.

2. Systemic risk regulation of insurance must include monitoring and enforcement components that are mandatory for insurers, not optional. An optional approach to systemic risk will fail.
3. Systemic risk regulation of insurance should take into consideration bond insurance, title insurance, the possible impact on other financial sectors of the unavailability or un-affordability of certain lines of coverage (such as the emerging difficulties for banks in obtaining Directors and Officers Insurance), reinsurance, where very large risks are shared among many insurers, post-assessment guaranty funds and possibly other insurance risks.
4. Dividing the insurance industry "systemically significant" and non-significant companies is not feasible. Instead, the regulator should monitor all, or nearly all, insurers to impose capital standards on those institutions that ratchet up significantly as the institution takes on more risk – either by growing to a size that makes it "too big to fail," by engaging in risky activities, or by entering into risky relationships with other players in the broader financial markets.
5. Regulation for solvency/prudential regulation should be moved over to federal control in order to properly understand and control risk.
6. Congress should consider taking several steps that would lower the overall systemic risk of the insurance industry, including repealing the provisions of the Gramm-Leach-Bliley Act that allow firms to sell insurance in conjunction with other financial services, particularly credit and securities products.
7. Eliminating post-assessment guaranty funds could also lower insurance systemic risk and replacing them by state directed, nationally based, pre-assessment funds, or by a federal insurance guaranty agency modeled on the FDIC. We favor a federal guaranty system based on the FDIC approach.

Can Solvency Regulation be Separated from Consumer Protection Regulation?

The insurers might argue that splitting solvency regulation from consumer protection regulation would be dangerous since consumer protection regulation would include regulation of rates so that the rate regulator, not being involved in solvency regulation, would have no pressure to keep rates adequate. We disagree.

First of all, our extensive search of large insolvencies over the decades has not found one insolvency in insurance history directly attributable to rate regulation. Congress has not found such effects either, to our knowledge.[13] Secondly, our research into the best systems of auto insurance regulation found conclusive evidence that the state with the best consumer results, California, had the toughest rate regulation producing the lowest rate changes in the nation but very healthy insurer profits (and with the fourth most competitive auto insurance market in the nation as well). Third, any new system Congress develops will require close coordination between the federal regulator and the state regulators, at least through a lengthy transition period. No state would fail to respond to the federal regulator's call for a review of a situation that might be problematic from a solvency point of view. In fact, federal control of solvency would allow a national perspective on insurance trends that would help in controlling risk of solvency. One of the few times insurers might under price is at the end of the so-called "soft market" in the

[13] See, e.g., Failed Promises," House Commerce Committee, 1990.

"cycle" of insurance profits. Property/casualty insurance profits are cyclical and the pattern typically is several years, around 8 to 10 years, of a soft market where prices are flat to down, followed by a short, 2 to 3 year hard market, where prices spike. A national solvency regulator would, for the first time, have the data and national focus to be ahead of the cycle and could alert states to upcoming price trends and conditions, thus easing the cycle's impact.

In short, there are simply no major, irresolvable issues stemming from splitting solvency from consumer protection when regulating insurance.

Consumers Do Not Care about the Locus of Regulation, but Care a Great Deal about the Quality and Effectiveness of Consumer Protections. (From CFA's Ongoing Study of Insurance Regulation and the Impact of the Financial Meltdown On the Prospects for State or Federal Regulation)

A) What is better, state or federal regulation of insurance?

There are certain regulatory functions that the states can do better than the federal government, and other functions that could potentially be more effective at the federal level. For example, it is very likely that a federal complaint handling system would not be as consumer-friendly as is the present state system. Contrarily, a state system would likely not approach the effectiveness of a federal system when it comes to systemic risk identification and control.

Here is a chart of some major areas comparing state and federal system capacities:

Item	**Federal**	**State**
Experience overseeing all aspects of insurance regulation?	No	Yes
Responsive to local needs?	No	Yes
Handle individual complaints promptly and effectively?	No	Some States
Limited impact if regulatory mistakes are made?	No	Yes
Not subject to political pressure from national insurers?	No	No
Not subject to political pressure from local insurers?	Yes	No
Efficient solvency regulation?	No	Yes*
Effective guaranty in event of insolvency?	Yes	No
Adequately restricts revolving door between regulators and industry?	Maybe	No
More uniform regulatory approach?	Yes	No
Can easily respond to micro-trends impacting only a region or a state?	No	Yes
Can easily respond to macro-trends that cross state borders?	Yes	No
Has greater resources, like data processing capacity?	Yes	No
Systemic risk analysis and control	Yes	No
Web page information excellence	Maybe	Yes

* Jury still out on this issue as the economy falters and some states lower capital standards for life insurance.

This sort of chart provides several indications of how to change the current insurance regulatory system to make it more effective. For instance, the states have more experience, are more responsive to local needs and better at handling complaints, and may be better at solvency monitoring than federal agencies. This argues for a role for the states in dealing with consumers' needs at the ground level. However, the federal government is likely to be better at the very important big issues of assessing macro-trends that cross state borders, as well as determining and controlling systemic risk. This argues for federal oversight of national risks.

These differential capacities thus may suggest some sort of hybrid approach that allows states to deal with local issues and the federal government to deal with over-arching issues that might impact the nation, such as bond insurance and other systemic risks cited above. The state expertise might also imply a strong role in the overall decision-making process once the federal systemic regulator identifies macro trends.

The chart may also support differential treatment of property/casualty insurers, where local issues such as weather catastrophes and legal requirements (e.g., no-fault vs. tort for auto) are vital matters for regulation, whereas the life insurance market is more national in scope and may lend itself to federal regulatory requirements.

I should warn you, as I am sure you already know Mr. Chairman, to beware of insurers seeking to help you create their "new" regulatory system. Insurers have, on occasion, sought federal regulation when the states increased regulatory control and the federal regulatory attitude was more laissez-faire. Thus, in the 1800s, the industry argued in favor of a federal role before the Supreme Court in *Paul v. Virginia*, but the court ruled that the states controlled because insurance was intrastate commerce.

Later, in the 1943 *SEUA* case, the Court reversed itself, declaring that insurance was interstate commerce and that federal antitrust and other laws applied to insurance. By this time, Franklin Roosevelt was in office and the federal government was a tougher regulator than were the states. The industry sought, and obtained, the McCarran-Ferguson Act. This law delegated excusive authority for insurance regulation to the states, with no routine Congressional review. The Act also granted insurers a virtually unheard of exemption from antitrust laws, which allowed insurance companies to collude in setting rates and to pursue other anticompetitive practices without fear of federal prosecution.

From 1943 until about seven years ago, the insurance industry has violently opposed any federal role in insurance regulation. In 1980, insurers successfully lobbied to stop the Federal Trade Commission from investigating deceptive acts and practices of any kind in the insurance industry. They also convinced the White House that year to eliminate the Federal Insurance Administration's work on insurance matters other than flood insurance. In other words, the industry killed the federal insurance office they now covet. Since that time, the industry has successfully scuttled any attempt to require insurers to comply with federal antitrust laws and has even tried to avoid complying with federal civil rights laws.

Notice that the insurance industry is very pragmatic in its selection of a preferred regulator. They always favor the least regulation. It is not surprising that, the industry would again seek a federal role at a time, seven years ago, when they perceived little regulatory interest at the federal level. But, rather than going for full federal control, they have learned that there are ebbs and flows in regulatory oversight at the federal and state levels, so they seek the ability to switch back and forth at will. Thus an "O" is added to their preferred approach, the "OFC" – the Optional Federal Charter. And, even though the federal government now seems more intent on regulating as a result of the economic lessons of late, the industry can still support an OFC since they do not have to opt for a federal regulator now if they choose against it.

Further, the insurance industry has used the possibility of an increased federal role to pressure NAIC and the states into gutting consumer protections over the last seven years. Insurers have repeatedly warned states that the only way to preserve their control over insurance regulation is to weaken consumer protections.[14]

This strategy of "whipsawing" state regulators to lower standards benefits all elements of the insurance industry, even those that do not support any federal regulatory approach. Even if Congress does nothing, the threat of federal intervention is enough to scare state regulators into acceding to insurer demands to weaken consumer protections.

Unfortunately for consumers, the strategy has paid off. In the last few years, the NAIC has moved to sharply cut consumer protections adopted over a period of decades. The NAIC is terrified of Congressional action and sees reducing state consumer protections as the way to "save" state regulation by placating insurance companies and encouraging them to stay in the fold. This strategy of saving the village by burning it has made state regulation more, not less vulnerable to a federal takeover.

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[14] The clearest attempt to inappropriately pressure the NAIC occurred at their spring 2001 meeting in Nashville. There, speaking on behalf of the entire industry, Paul Mattera of Liberty Mutual Insurance Company told the NAIC that they were losing insurance companies every day to political support for the federal option and that their huge effort in 2000 to deregulate and speed product approval was too little, too late. He called for an immediate step-up of deregulation and measurable "victories" of deregulation to stem the tide. In a July 9, 2001, *Wall Street Journal* article by Chris Oster, Mattera admitted his intent was to get a "headline or two to get people refocused." No commissioner challenged Mattera and many commissioners went so far as to beg industry representatives to grant them more time to deliver whatever the industry wanted.

Jane Bryant Quinn, in her speech to the NAIC on October 3, 2000, said: "Now the industry is pressing state regulators to be even more hands-off with the threat that otherwise they'll go to the feds." As a result, other observers of the NAIC see this pressure as potentially damaging to consumers.

Larry Forrester, President of the National Association of Mutual Insurance Companies (NAMIC), wrote an article in the *National Underwriter* of June 4, 2000. In it he said, "…how long will Congress and our own industry watch and wait while our competitors continue to operate in a more uniform and less burdensome regulatory environment? Momentum for federal regulation appears to be building in Washington and state officials should be as aware of it as any of the rest of us who have lobbyists in the nation's capital…NAIC's ideas for speed to market, complete with deadlines for action, are especially important. Congress and the industry will be watching closely…The long knives for state regulation are already out…"

In a press release entitled "Alliance Advocates Simplification of Personal Lines Regulation at NCOIL Meeting; Sees it as Key to Fighting Federal Control" dated March 2, 2001, John Lobert, Senior VP of the Alliance of American Insurers, said, "Absent prompt and rapid progress (in deregulation) … others in the financial services industry – including insurers – will aggressively pursue federal regulation of our business…"

In the NAIC meeting of June 2006, Neil Alldredge of the National Association of Mutual Insurance Companies pointed out "states are making progress with rate deregulation reforms. In the past four years, 16 states have enacted various price deregulation reforms…(but) change is not happening quickly enough…He concluded that the U.S. Congress is interested in insurance regulatory modernization and the insurance industry will continue to educate Congress about the slow pace of change in the states (Minutes of the NAIC/Industry Liaison Committee, June 10, 2006)."

The NAIC has also failed to act in the face of a number of serious problems facing consumers in the insurance market.

NAIC Failures to Act

1. Failure to do anything about abuses in the small face life market. Instead, NAIC adopted an incomprehensible disclosure on premiums exceeding benefits, but did nothing on overcharges, multiple policies, or unfair sales practices.

2. Failure to do anything meaningful about unsuitable sales in any line of insurance. Suitability requirements still do not exist for life insurance sales even in the wake of the remarkable market conduct scandals of the late 1980s and early 1990s. A senior annuities protection model was finally adopted (after years of debate) that is so limited as to do nothing to protect consumers.

3. Failure to call for collection and public disclosure of market performance data after years of requests for regulators to enhance market data, as NAIC weakened consumer protections. How does one test whether a market is workably competitive without data on market shares by zip code and other tests?

4. Failure to call for repeal of the antitrust exemption in the McCarran-Ferguson Act as they push forward deregulation model bills. Indeed, the NAIC still opposes repeal of the antitrust exemption even as they deregulate…effectively seeking to deregulate cartel-like organizations.

5. Failure to do anything as an organization on the use of credit scoring for insurance purposes. In the absence of NAIC action, industry misinformation about credit scoring has dominated state legislative debates. NAIC's failure to analyze the issue and perform any studies on consumer impact, especially on lower income consumers and minorities, has been a remarkable dereliction of duty.

6. Failure to end use of occupation and education in underwriting and pricing of auto insurance.[15]

7. Failure to address problems with risk selection. There has not even been a discussion of insurers' explosive use of underwriting and rating factors targeted at socio-economic characteristics: credit scoring, check writing, prior bodily injury coverage limits purchased by the applicant, prior insurer, prior non-standard insurer, education, occupation, not-at-fault claims, not to mention use of genetic information, where Congress has had to recently act to fill the regulatory void.

8. Failure to heed calls from consumer leaders to do something about contingency commissions for decades (until Attorney General Spitzer finally acted).

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[15] Florida has held hearings on the practice.

9. Failure to even discover, much less deal with, the claims abuses relating to the use of systems designed to systematically underpay claims for millions of Americans.

10. Failure to do anything on single premium credit insurance abuses.

11. Failure to take recent steps on redlining or insurance availability or affordability. Many states no longer even look at these issues, 30 years after the federal government issued studies documenting the abusive practices of insurers in this regard. Yet, ongoing lawsuits continue to reveal that redlining practices harm the most vulnerable consumers.

12. Failure to take meaningful action on conflict-of-interest restrictions even after Ernest Csiszar left his post as South Carolina regulator and President of the NAIC in September 2004 to become President of the Property Casualty Insurers Association of America after negotiating deregulation provisions in the SMART Act desired by PCIAA members. Other recent NAIC presidents took similar lobbying and other jobs in the industry and about half of all commissioners come from and return to their industry perches.

13. Failure to act to create regional catastrophic pools to spread hurricane risks or to effectively deal with inappropriate short-term, unscientific models which have sharply raised consumers' home insurance prices along the coasts.

NAIC Rollbacks of Consumer Protections

1. The NAIC pushed through small business property/casualty deregulation, without doing anything to reflect consumer concerns (indeed, even refusing to tell consumer groups why they rejected their specific proposals) or to upgrade "back-end" market conduct quality, despite promises to do so. As a result, many states adopted the approach and have rolled back their regulatory protections for small businesses.

2. States are rolling back consumer protections in auto insurance as well. New York, New Jersey, Texas, Louisiana, and New Hampshire have done so in the last few years.

3. NAIC has terminated free access for consumers to the annual statements of insurance companies at a time when the need for enhanced disclosure is needed if price regulation is to be reduced.

4. NAIC almost cut the safety of life insurance capital and surplus cushions protecting consumers, but relented at the last minute after it became obvious that the basic research on whether this was wise and would not lead to insurer failure was not finished. After the NAIC acknowledged that this was not ready for action, many states proceeded to implement the very same changes anyway, sharply weakening consumer protection in the face of the mounting danger of insurer failure.

B) CFA's research into best regulatory systems in the states: Why competition alone does not control unfair classes or hold down price increases and why price regulation is necessary in insurance.

In April 2008, CFA released a detailed, national study of automobile insurance regulation over the last two decades that found that rates have risen more slowly in the fifteen states that require insurers to receive advance approval of rate increases from the state.[16] States with "prior approval" regulation also performed well in spurring competition and generating reasonable profits for insurers. The top-performing state in keeping rates down and providing comprehensive consumer protections was California. Among the worst performing states were those with weak or no regulation of rates at all. These states had the steepest rate increases, less competitive markets and among the highest profits for insurers.

The study assessed automobile insurance regulation in all 50 states and the District of Columbia. It examined a number of factors that are important to consumers and insurers, including rate increases from 1989 through 2005, insurer profits from 1997 through 2005, as measured by return on net worth, and the current level of competition.

The chart below shows the results for each of these factors for the six different systems that states use to oversee insurance rates. With the exception of the one state that mandates the rates insurers can charge, the fifteen states that require insurers to receive approval for rate changes before they go into effect had the smallest increase in rates (54 percent) from 1989 through 2005. In fact, column 3 shows that the weaker the regulatory system, the greater the price increase consumers have faced. States with a prior approval regime also had a similar level of competition and slightly lower, but reasonable, insurer profits compared to states with different forms of regulation. According to the widely used Herfindahl-Hirshman Index (HHI), states with prior approval rules have insurance markets that are on the border between competitive and moderately concentrated. The states that provided the lowest level of consumer protection used the regulatory system known as "Competition," in which the state has no authority to control rates. These states had sharper rate increases, higher profits and greater market concentration than all other regulatory systems other than the one state that set prices for insurers.

PRIVATE PASSENGER AUTO INSURANCE

Column 1	Column 2	Column 3	Column 4	Column 5
Regulatory System	**Number of States Using the System**	**1989/2005 Change in Expenditure**	**1997/2005 Return on Net Worth**	**HHI Index**
State Set	1	52.8%	6.4%	1371
Prior Approval	15	54.0%	8.6%	984

16 "State Automobile Insurance Regulation: A National Quality Assessment and In-depth Review of California's Uniquely Effective Regulatory System," April 2008, at http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

File & Use	23	68.1%	9.0%	1016
Use & File	8	70.0%	9.7%	935
Flexible	2	70.8%	7.0%	1292
Competition	2	73.9%	9.6%	1111

State Set: state establishes rates insurers can charge.
Prior Approval: insurers cannot put rate changes into effect without state approval.
File and Use: rate changes can take effect without state approval, but must be filed with the state before use and can be later disapproved.
Use and File: rate changes can go into effect without state approval but must be filed after use and can be later disapproved.
Flexible: rate changes can be filed and used without approval unless they change by more than a particular amount, when filing and approval are required.
Competition: state has no authority to control rates.

California's regulatory system, which was adopted by state residents when they voted for Proposition 103 in 1988, performed well in virtually every category examined by the report, including all of the factors cited above. Two exceptions were insurer profit levels over the longer term (1989 through 2006), which were somewhat high, and a large population of uninsured motorists. The California system's positive results for consumers include the following:

- Generated estimated savings of $61.8 billion for consumers over the sixteen years that Proposition 103 has been in effect;
- First among all states in holding down rate increases (to 12.9 percent);
- Fourth in market competitiveness as measured by the HHI (716);
- The only state to totally repeal its antitrust exemption for automobile insurers;
- The only state to put reasonable limits on expenses passed through to consumers, such as fines and excessive executive salaries;
- Has a very low number of residents participating in higher cost "assigned risk" insurance plans;
- Among the eleven states with the highest ranking from the Insurance Institute for Highway Safety for strong seat belt laws;
- One of only four states that guarantees that good drivers can receive a policy that can be renewed from an insurer of their choosing;
- The only state to require that a person's driving record is the most important factor in determining insurance rates, followed by the number of miles driven and years of driving experience. All other factors used by insurers must have less impact on rates than these criteria;
- One of only three states to ban the use of credit scoring for setting rates or granting coverage;
- The only state to require that insurers offer consumers the lowest price available from all of the companies in the insurer group;
- The only state that funds consumer participation in the ratemaking process if a substantial contribution is made. [17]

[17] "State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California's Uniquely Effective Regulatory System," April 2008, http://www.consumerfed.org/pdfs/state_auto_insurance_report.pdf.

Consumers, who over the last 30 years have been the victims of vanishing premiums, churning, race-based pricing, creaming, and consumer credit insurance policies that pay pennies in claims per dollar in premium, are not clamoring for such policies to be brought to market with even less regulatory oversight than in the past. The fact that "speed-to-market" has been identified as a vital issue in modernizing insurance regulation demonstrates that some policymakers have bought into insurers' claims that less regulation benefits consumers. We disagree. We think smarter, more efficient regulation benefits both consumers and insurers and leads to more beneficial competition. Mindless deregulation, on the other hand, will harm consumers.

The need for better regulation that benefits both consumers and insurers is being exploited by some in the insurance industry to eliminate the most effective aspects of state insurance regulation such as rate regulation, in favor of a model based on the premise that competition alone will protect consumers.[18] We question the entire foundation behind the assumption that virtually no front-end regulation of insurance rates and terms coupled with more back-end (market conduct) regulation is better for consumers. First of all, there are many reasons why competition in insurance is weak (see below). The track record of market conduct

[18] If America moves to a "competitive" model, certain steps must first be taken to ensure "true competition" and prevent consumer harm. First, insurance lines must be assessed to determine whether a competitive model, e.g., the alleviation of rate regulation, is even appropriate. This assessment must have as its focus how the market works for consumers. For example, states cannot do away with rate regulation of consumer credit insurance and other types of insurance subject to reverse competition. The need for relative cost information and the complexity of the line/policy are factors that must be considered.

If certain lines are identified as appropriate for a "competitive" system, before such a system can be implemented, the following must be in place:

- Policies must be transparent: Disclosure, policy form and other laws must create transparent policies. Consumers must be able to comprehend the policy's value, coverage, actual costs, including commissions and fees. If consumers cannot adequately compare actual costs and value, and if consumers are not given the best rate for which they qualify, there can be no true competition.
- Policies should be standardized to promote comparison-shopping.
- Antitrust laws must apply.
- Anti-rebate, anti-group and other anti-competitive state laws must be repealed.
- Strong market conduct and enforcement rules must be in place with adequate penalties to serve as an incentive to compete fairly and honestly.
- Consumers must be able to hold companies legally accountable through strong private remedies for losses suffered as a result of company wrongdoing.
- Consumers must have knowledge of and control over flow and access of data about their insurance history through strong privacy rules.
- There must be an independent consumer advocate to review and assess the market, assure the public that the market is workably competitive, and determine if policies are transparent.

Safeguards to protect against competition based solely on risk selection must also be in place to prevent redlining and other problems, particularly with policies that are subject to either a public or private mandate. If a competitive system is implemented, the market must be tested on a regular basis to make sure that the system is working and to identify any market dislocations. Standby rate regulation should be available in the event the "competitive model" becomes dysfunctional.

If the industry will not agree to disclosing actual costs, including all fees and commissions, ensuring transparency of policies, strong market conduct rules and enforcement then it is not advocating true competition, only deregulation.

regulation has been extremely poor in most states. Insurance regulators rarely are the first to identify major problems in the marketplace.

Given this track record, market conduct standards and examinations by regulators must be dramatically improved to enable regulators to become the first to identify and fix problems in the marketplace and to address market conduct problems on a national basis. From an efficiency and consumer protection perspective, it makes no sense to lessen efforts to prevent the introduction of unfair and inappropriate policies in the marketplace. It takes far less effort to prevent an inappropriate insurance policy or market practice from being introduced than to examine the practice, stop a company from doing it and provide proper restitution to consumers after the fact.

The unique nature of insurance policies and insurance companies requires more extensive front-end regulation than other consumer commodities. And while insurance markets can be structured to promote beneficial price competition, deregulation does not lead to, let alone guaranty, such beneficial price competition.

Front-end regulation should be designed to prevent market conduct problems from occurring. It should also promote beneficial competition, such as price competition and loss mitigation efforts, and deter destructive competition, such as selection competition, and unfair sales and claims settlement practices. Simply stated, strong, smart, efficient and consistent front-end regulation is critical for meaningful consumer protection and absolutely necessary to any meaningful modernization of insurance regulation.

The insurance industry promotes a myth: that regulation and competition are incompatible. This is demonstrably untrue. Regulation and competition both seek the same goal: the lowest possible price consistent with a reasonable return for the seller. There is no reason that these systems cannot coexist and even compliment each other. They do very successfully, as we have documented in California under the pro-competitive but tough regulatory system created by the adoption of Proposition 103 by the people of that state.

Insurance cannot be effectively regulated by competition alone. There are several key reasons for this truth:

1. ***Insurance is a Complex Legal Document***. Most products are able to be viewed, tested, “tires kicked” and so on. Insurance policies, however, are difficult for consumers to read and understand -- even more difficult than documents for most other financial products. For example, consumers often think they are buying insurance, only to find they bought a list of exclusions.

2. ***Comparison Shopping is Difficult***. Consumers must first understand what is in the policy to compare prices.

3. ***Policy Lag Time***. Consumers pay a significant amount for a piece of paper that contains specific promises regarding actions that might be taken far into the future. The test of an insurance policy’s usefulness may not arise for decades, when a claim arises.

4. ***Determining Service Quality is Very Difficult***. Consumers must determine service quality at the time of purchase, but the level of service offered by insurers is usually unknown at the time a policy is bought. Some states have complaint ratio data that help consumers make purchase decisions, and the NAIC has made a national database available that should help, but service is not an easy factor to assess.

5. ***Financial Soundness is Hard to Assess***. Consumers must determine the financial solidity of the insurance company. One can get information from A.M. Best and other rating agencies, but this is also complex information to obtain and decipher.

6. ***Pricing is Dismayingly Complex***. Some insurers have many tiers of prices for similar consumers—as many as 25 tiers in some cases. Consumers also face an array of classifications that can number in the thousands of slots. Online assistance may help consumers understand some of these distinctions, but the final price is determined only when the consumer actually applies and full underwriting is conducted. At that point, the consumer might be quoted a much different rate than he or she expected. Frequently, consumers receive a higher rate, even after accepting a quote from an agent.

7. ***Underwriting Denial***. After all that, underwriting may result in the consumer being turned away.

8. ***Mandated Purchase***. Government or lending institutions often require insurance. Consumers who must buy insurance do not constitute a "free-market," but a captive market ripe for arbitrary insurance pricing. The demand is inelastic.

9. ***Incentives for Rampant Adverse Selection***. Insurer profit can be maximized by refusing to insure classes of business (e.g., redlining) or by charging regressive prices.

10. ***Antitrust Exemption***. Insurance is largely exempt from antitrust law under the provisions of the McCarran-Ferguson Act.

Compare shopping for insurance with shopping for a can of peas. When you shop for peas, you see the product and the unit price. All the choices are before you on the same shelf. At the checkout counter, no one asks where you live and then denies you the right to make a purchase. You can taste the quality as soon as you get home and it doesn't matter if the pea company goes broke or provides poor service. If you don't like peas at all, you need not buy any. By contrast, the complexity of insurance products and pricing structures makes it difficult for consumers to comparison shop. Unlike peas, which are a discretionary product, consumers absolutely require insurance products, whether as a condition of a mortgage, as a result of mandatory insurance laws, or simply to protect their home or health.

It is clear that regulation and competition, working together, produce the most effective results in insurance. Price regulation, particularly when markets are stressed, as in the cities for auto insurance and the coasts for home insurance, is essential in protecting consumers. A critical aspect of price regulation, one that is often overlooked and never disclosed by proponents of no price regulation, is that classifications are part of price in insurance. Classes must be regulated since they can be arbitrary, unfair, discriminatory and not based on any factor relating to the risk being insured, thereby undermining one of insurance's most vital social benefits, incentive for risk reduction. If an insurer decided to use race as a class, existing regulations would stop it. However, most states allow insurers to use a number of classifications that are proxies for race and income that have a very negative impact on lower income and minority consumers. For example, many auto insurers today use a combination of credit scores (exposing the poor and unemployed to higher rates, education (more education results in lower rates), occupation (higher paying jobs equal lower rates, unemployment means very high charges), limits of bodily injury insurance with the previous insurer (high limits means lower prices, if you buy only the minimum level that the state requires you pay more, a penalty for obeying the law), homeownership (yes means lower prices). Classes, and therefore prices, must be regulated.

C) CFA favors creation of a federal insurance office, with caveats.

When I was Federal Insurance Administrator, I was in charge of several statutory programs, the most important of which was the National Flood Insurance Program (NFIP). The White House also charged FIA with studying insurance and helping other federal agencies with insurance issues. So we worked on national no-fault auto insurance with the Department of Transportation, national health insurance with the Department of Health and Human Resources, risk retention proposals with several agencies and workers' compensation insurance with the Commerce Department, to give you just a few examples.

The insurance industry, which now seeks to create such an office, successfully urged President Reagan to kill the work other than that mandated by statute, thus assuring that the federal government had no insight into one of the most important industries in the nation. Interestingly, at about the same time, the industry lobbied Congress and the Administration to take away FTC's ability to study insurance, further handicapping Washington's capacity to understand insurance.

It simply makes no sense for the federal government to remove any insurance expertise. Such an office should be approved, but it must not be allowed to preempt or undermine consumer protections at the state level, or given vague, open-ended authority to conclude or interpret international agreements that include such preemption. As discussed below, the FTC should also be allowed to study insurance.

At a time when systemic risk is an obvious danger, when losses due to natural catastrophes have caused severe dislocations in some states, where international terrorism is an ever-present threat, and consumers are coping with a diverse array of insurance problems, including some problems (like the unavailability and un-affordability of D&O insurance) that are related to the economic meltdown, it is essential that the federal government has an office with insurance expertise to advise the Administration and Congress on pressing domestic and international insurance matters.

CFA supports the creation of the office because there is a strong need for a federal office to investigate and advise on insurance matters that adversely affect consumers, as well as issues that would have a serious effect on the economy.   We believe it is most likely that the office should be part of any agency dealing with systemic risk.

D) CFA is updating its study of insurance regulation to reflect the lessons of AIG and other recent regulatory failures.

As I indicated earlier, CFA is evaluating all regulatory options to see what is the most effective system or combinations of systems for protecting consumers and taxpayers, while fostering a viable insurance market. Even in these exceptional economic times, we believe that the burden of proof remains on those (including us) who now want to shift away from 150 years of state insurance regulation to show that they are not asking federal regulators and American consumers to accept a dangerous "pig in a poke" that will harm consumers. We are assessing both the history of insurance regulation and recent developments, such as the AIG debacle. We are evaluating the quality of state regulation from the consumer perspective, including the major flaws and successes of state regulation. We are also updating the principles we use to measure the quality of insurance regulatory systems (see Attachment 1) to reflect lessons from the current economic crisis. We will attempt to provide a detailed plan for dealing with systemic risk, while maximizing regulatory efficiency and assuring that needed consumer protections are in place.

The range of proposals under consideration includes such ideas as:

- Full federal takeover of insurance regulation.
- A federal systemic risk regulator only for systemically significant insurers.
- Partial federal takeover, with federal oversight of systemic risk and state consumer protection and assistance authority. Another hybrid approach would vest authority over property/casualty insurance at the state level and life insurance at the federal level. (See explanation above.)
- Federal minimum standards to be enforced or improved upon at the state level. Federal regulation would only occur in states that do not comply or on issues that are truly national or international in scope, such as implementation of international treaty requirements.
- Federal minimum standards for the states plus a national ("national" as opposed to federal) regulator to do the regulation in states that fail to comply with the minimum standards (authorized by a federal bill to empower the NAIC to act in areas requiring more uniformity).

At this stage of our consideration of these questions, our research points toward a system that looks something like this:

- A federal office of insurance to regulate systemic risk, solvency/prudential regulation and deal with international issues related to treaties, but which does not have authority to preempt any state consumer protection standards unless such authority is explicitly defined in statute.
- Continued state regulation of consumer protection. While consumer protection standards of the states must be raised, the states have a better chance of achieving excellence in consumer protection regulation than the federal government does, we believe.

Because of its historical domination by the insurance industry, however, consumer organizations are extremely skeptical about NAIC's ability to establish national minimum standards in a fair and democratic way. It is essential that the NAIC take steps so that it can operate as an effective regulatory entity, including:

- Democratic processes/accountability to the public, which must include: notice and comment rulemaking; on the record voting; accurate minutes; rules against ex-parte communication; public meeting/disclosure/sunshine rules/FOIA applicability.
- A decision-making process subject to an excellent Administrative Procedures Act.
- Strong conflict of interest and revolving door statutes similar to those of the federal government to prevent undue insurance industry influence. If decision-making members of the NAIC have connections, past or present, to certain companies, the process will not be perceived as fair.
- Independent funding. The NAIC cannot serve as a regulatory entity if it relies on the industry for its funding. The NAIC should establish a system of state funding to the NAIC at a set percentage of premiums so that all states and insured entities equally fund the NAIC.

To offset industry domination, an independent, national, public insurance counsel/ombudsman's office with significant funding is also critically needed. Consumers must be adequately represented in the process for the process to be accountable and credible. The current consumer participation program of the NAIC, which only pays expenses of a handful of consumer representatives to attend meetings, is woefully inadequate.

Whatever proposals emerge relating to insurance regulation, Attachment 1, *Consumer Principles and Standards for Insurance Regulation* provides detailed standards that we will use to test proposals to make sure that they properly protect consumers, whether at the state, multi-state or national level. In our study, we are reviewing all of these standards to update them regarding lessons from the economic crisis, AIG and the abdication by many states of strong consumer protection standards.

CFA Opposes Legislation to Create an Optional Federal Insurance Charter

The bills that have been drafted by trade associations like the American Bankers Association and the American Council of Life Insurers would create a federal regulator that would have little, if any, authority to regulate price or product, regardless of how non-competitive the market might be for a particular line of insurance.[19] The bills submitted to Congress so far offer little or no improvement in consumer protection or information systems to address the major problems insurance consumers have today.[20] Insurers would be able to choose whether to be regulated by this weak federal regulator or by state regulators, who would almost

[19] In this Congress, the bill was introduced in the House as H.R. 1880 by Representatives Bean and Royce.
[20] See Testimony of Travis Plunkett, CFA's Legislative Director, of July 29, 2008 for a full discussion of the problems, which include unfair classifications (a key part of rate regulation), improper claims practices, insurance availability issues, particularly along the coasts and in inner cities and other issues.)

certainly "compete" for insurance companies to regulate by weakening standards or keeping them low.

Consumer organizations strongly oppose an optional federal charter that allows the regulated company, at its sole discretion, to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protections. Indeed the industry drafters of such proposals have openly stated that this is their goal. If elements of the insurance industry truly want to obtain uniformity of regulation, "speed to market" and other advantages through a federal regulator, let them propose a federal approach with high consumer protection standards included that does not allow insurers to run back to the states when regulation gets tougher than they want. The merits of that type of approach are obvious. CFA and the entire consumer community stand ready to fight optional charters with all the strength we can muster.

As stated above, allowing insurers to choose who regulates them is a prescription for disaster when it comes to systemic regulation. The dual charter banking system has been proven to provide banks with an easy way to run away from regulation. "At least 30 banks since 2000 have escaped federal regulatory action by walking away from their federal regulators and moving under state supervision," says a Washington Post report.[21] State chartered banks have also used the threat of switching to a national charter to convince state regulators to keep standards low.[22] Systemic risk regulation cannot be optional. No regulation, including consumer protection regulation of any sort, can be optional and have the necessary teeth to assure insurer compliance.

H.R. 1880 would be a disaster for consumers. First, the idea of the regulated choosing its regulator is a discredited idea whose time has passed. .Banks have proven the ineffectiveness of this concept.

Second, the bill would not regulate prices. Good consumer protection requires that these items be regulated. Prices include not only overall rate level but also classifications of risk. There has been an explosion of questionable classes that have caused an uproar in many states, including the use of credit scores, education and occupation, prior limit purchased, homeownership and other anti-poor, anti-minority classes to price insurance. The lack of price regulation hurts poor and minority consumers as well as those living in coastal America.

The bill also is hugely biased in favor of the insurers. For example, the insurers do not have to contribute to fund the guarantee association until after an insolvency, recreating the same systemic risks the current state system poses. There can be no logical reason for this except that this is what the insurers want. The FTC Act is not imposed on insurers. While the policy forms must be filed, there is no authority for the federal regulator to disapprove a form, setting up a competition in fine print that would leave consumers exposed to lack of coverage surprises when a claim is filed. Rulings on policy form questions are not public. The insurers even get an Ombudsman with power to request a stay in a ruling on behalf of an insurer as if they need help in complaining to a regulator.

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[21] By Switching their Charters, Banks Skirt Supervision," Appelbaum, Washington Post, January 22, 2009.

[22] Testimony of Travis Plunkett, Consumer Federation of America, before the Senate Banking Committee on July 29, 2008 regarding the State of the Insurance Industry: Examining the Current Regulatory and Oversight Structure.

The bill includes a dangerous section on International Agreements that seems to seek a lowest common denominator approach to consumer protection in the name of "uniformity" and "competition."

Federal insurers would have to participate in residual markets such as assigned risk plans, but there is a mischievous provision, doubtless authored by an insurer lobbyist that is an exception to such participation if it "results in rates in effect for an assigned risk plan, mandatory joint underwriting association, or any other mandatory residual market mechanism that fails to cover the expected value of all future costs associated with insurance policies written by such residual market mechanism." In other words, if a state has the audacity to reject the often bloated requests of insurers for prices, requests far above reasonable levels, the insurers can walk away from the people of the state, leaving them scrambling for insurance or requiring the state chartered insurers to pick up all of the high risks. If anyone thinks that insurers would not walk away from those they insure, I call your attention to State Farm and Allstate's odious behavior in Florida home insurance.

CFA, and all of the consumer community, vigorously oppose H.R. 1800.

CFA Favors Repeal of McCarran-Ferguson's Antitrust Exemption[23]

The history of the McCarran-Ferguson Act is replete with drama, from an industry flip-flopping on who should regulate it to skillful lobbying and manipulation of Congressional processes in order to transform the bill's short antitrust moratorium into a permanent antitrust exemption in the confines of a conference committee.

In fact, the insurance industry has long-standing anti-competitive roots. In 1819, local associations were formed to control price competition. In 1866, the National Board of Fire Underwriters was created to control price at the national level, but states enacted anti-compact legislation to control price fixing.

This increased state regulatory activity led insurers to seek a federal approach to preempt the state system. In 1866 and 1868, bills were introduced in Congress to create a national bureau of insurance, but the insurer effort was unsuccessful. Failing in Congress, the industry shifted to a judicial approach.

The case on which rode the industry's hope for court-initiated reform was *Paul v. Virginia*, 75 U.S. (8 Wall) 168 (1868). But the insurance industry's hopes were dashed when the Supreme Court ruled that states were not prohibited by the Commerce Clause from regulating insurance, reasoning that insurance contracts were not articles of commerce in any proper meaning of the word. Such contracts, they ruled, were not interstate transactions (though the parties may be domiciled in different states the policies did not take effect until delivered by the

[23] For a complete discussion of the reasons we favor repeal of the antitrust exemption of McCarran, see my March 7, 2007 testimony, "The McCarran-Ferguson Act: Implications of Repealing the Insurers' Antitrust Exemption," before the Committee on the Judiciary of the United States Senate.

agent in a state, in this case Virginia). They were deemed, then, local transactions, to be governed by local law.

For the next 75 years, insurance regulation remained in the states, despite repeated insurance industry litigation seeking federal preemption. (Ironically, the industry would later adopt the Paul rationale to fend off enhanced federal scrutiny of its activities under the Sherman and Clayton Antitrust Acts.)

Until 1944, state regulation of insurance was secure, based on the rationale that insurance was not interstate commerce. But that assumption was repudiated in the 1944 Supreme Court decision *United States v. South-Eastern Underwriters Association*. That case brought the insurance industry’s swift return to Capitol Hill to seek exactly the opposite type of relief from what it had previously advocated.

Three months after the Supreme Court denied a motion for rehearing in South-Eastern Underwriters, Senators McCarran and Ferguson introduced a bill that would become the Act bearing their names. The bill was structured to favor continued state regulation of insurance, but also, ultimately, to apply the Sherman and Clayton Antitrust Acts when state regulation was inadequate.

Within two weeks of the bill's introduction, and without holding any hearings on the new measure, the Senate had passed it and sent it to the House of Representatives. As it was sent over, the McCarran-Ferguson Act provided only a very limited moratorium during which the business of insurance would be exempt from the antitrust laws.

The House Judiciary Committee also approved the bill without holding a hearing. The House floor debate indicates that House Members believed the language of the original bill already comported perfectly with the Senate amendment's stated goal of creating a limited moratorium during which the Sherman and Clayton Acts would not apply to the business of insurance.

However, despite the clear intent of both houses not to grant a permanent antitrust exemption, the conference committee proceeded to drastically transform the limited moratorium into a permanent antitrust exemption for the insurance industry. The new language provided that after January 1, 1948, the Sherman, Clayton, and Federal Trade Commission Acts "shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

The House approved the conference report without debate. The sole expression of the House's intent regarding the conference report containing the new section 2(b) proviso is the statement of House managers of the conference, which indicates they intended only to provide for a moratorium, after which the antitrust laws would apply. The Senate, in contrast, debated the conference report for two days. After repeated assurances that the proviso was not intended to preclude application of the antitrust laws, the Senate passed the bill, and President Roosevelt signed it into law on March 9, 1945.

The legislative history shows that the Senate had a serious debate on the antitrust exemption, unlike the House. Senator Claude Pepper contended that the new conference language enabled the states to evade the federal antitrust laws by mere authorizing legislation. Senator O'Mahoney stated that section 2(b) of the conference report simply provided for a moratorium, after which the antitrust laws would "come to life again in the field of interstate commerce." The "state action" doctrine of *Parker v. Brown* would apply fully, he said, so that "no State, under the terms of the conference report, could give authority to violate the antitrust laws." Therefore, he concluded, "the apprehensions which [Senator Pepper] states with respect to the conference report are not well founded." Senator McCarran likewise reassured Senator Pepper that "he is in error in his whole premise in this matter."

Unfortunately, the courts construing the Act did not make these inferences. When presented with the question of what Congress meant by "regulated," the courts found no standard in the text of the statute and, declining to search for one in the legislative history, reached the very conclusion that Senator Pepper had anticipated and vainly struggled to forestall.

The antitrust exemption has been studied on several occasions by federal authorities; each time with the determination that continued exemption was not warranted. For example:

- In 1977, when I was Federal Insurance Administrator under President Ford, the Justice Department concluded, "an alternative scheme of regulation, without McCarran Act antitrust protection, would be in the public interest."[24]

- In 1979, President Carter's National Commission for the Reform of Antitrust Laws and Procedures concluded, almost unanimously, that the McCarran broad antitrust immunity should be repealed.

- In 1983, then FTC Chairman James C. Miller III told the House Subcommittee on Commerce, Transportation and Tourism that he saw no legitimate reason to exempt the insurance industry from FTC jurisdiction.

- In 1994, the House Judiciary Committee issued its report calling for a sharp cutting back of the antitrust exemption.

For over 100 years, property/casualty insurers have used so-called "rating bureaus" to make rates for several insurance companies to use. Not many years ago, these bureaus required that insurers charge rates developed by the bureaus (the last vestiges of this practice persisted into the 1990s).

In recent years, the rate bureaus have stopped requiring the use of their rates or even preparing full rates because of lawsuits by state attorneys general after the liability crisis of the mid-1980s was caused, in great part, by insurers sharply raising their prices to return to ISO rate levels. ISO is an insurance rate bureau or advisory organization. Historically, ISO was a means of controlling competition. It still serves to restrain competition since it makes "loss costs" (the

[24] Report of the U.S. Department of Justice to the Task Group on Antitrust Immunities, 1977.

part of the rate that covers expected claims and the costs of adjusting claims) which represent about 60-70 percent of the rate. ISO also makes available expense data to which insurers can compare their costs in setting their final rates. ISO sets classes of risk that are adopted by many insurers. ISO diminishes competition significantly through all of these activities. There are other such organizations that also set pure premiums or do other activities that result in joint insurance company decisions. These include the National Council on Compensation Insurance (NCCI) and National Insurance Services Organization (NISS).

Today the rate bureaus still produce joint price guidance for the large preponderance of the rate. The rating bureaus start with historic data for these costs and then actuarially manipulate the data (through processes such as "trending" and "loss development") to determine an estimate of the projected cost of claims and adjustment expenses in the future period when the costs they are calculating will be used in setting the rates for many insurers. Rate bureaus, of course, must bias their projections to the high side to be sure that the resulting rates or loss costs are high enough to cover the needs of the least efficient, worst underwriting insurer member or subscriber to the service.

Legal experts testifying before the House Judiciary Committee in 1993 concluded that, absent McCarran-Ferguson's antitrust exemption, manipulation of historic loss data to project losses into the future would be illegal (whereas the simple collection and distribution of historic data itself would be legal – which is why there is no need for safe harbors to protect pro-competitive joint activity). This is why there are no similar rate bureaus in other industries. For instance, there is no CSO (Contractor Services Office) predicting the cost of labor and materials for construction of buildings in the construction trades for the next year (to which contractors could add a factor to cover their overhead and profit). The CSO participants would go to jail for such audacity.

Further, rate organizations like ISO file "multipliers" for insurers to convert the loss costs into final rates. The insurer merely has to tell ISO what overhead expense load and profit load they want and a multiplier will be filed. The loss cost times the multiplier is the rate the insurer will use. An insurer can, as ISO once did, use an average expense of higher cost insurers for the expense load if it so chooses plus the traditional ISO profit factor of five percent and replicate the old "bureau" rate quite readily.

It is clear that the rate bureaus[25] still have a significant anti-competitive influence on insurance prices in America.

- The rate bureaus guide pricing with their loss cost/multiplier methods.

- The rate bureaus manipulate historic data in ways that would not be legal absent the McCarran-Ferguson antitrust law exemption.

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25 By "rate bureaus" here I include the traditional bureaus (such as ISO) but also the new bureaus that have a significant impact on insurance pricing such as the catastrophe modelers (including RMS), other non-regulated organizations that impact insurance pricing and other decisions across many insurers (credit scoring organizations like FAIR Isaac is one example) and organizations that "assist" insurers in settling claims, like Computer Sciences Corporation (using products like Colossus).

- The rate bureaus also signal to the market that it is OK to raise rates. The periodic "hard" markets are a return to rate bureau pricing levels after falling below such pricing during the "soft" market phase.

- The rate bureaus signal other market activities, such as when it is time for a market to be abandoned and consumers left, possibly, with no insurance.

CFA endorses H.R. 1583, the "Insurance Industry Competition Act of 2009," introduced by Rep. Peter DeFazio, which would repeal the antitrust exemption that insurers enjoy today.

CFA Favors Allowing FTC to Study Insurance

I once attended a hearing here in a Senate committee where the Chairman asked the FTC Chairman to comment on a current insurance issue. The Chairman said that if he had the knowledge to answer, he would be breaking the law and was excused. The insurance industry had successfully lobbied Congress to take away the FTC's authority to study insurance. The triggers for this lobbying were twofold, a study of life insurance that warned consumers about whole life insurance interest rates paid to customers on the cash value of their policies that were grossly inadequate (which the life insurers hated) and a not yet completed study of redlining by property/casualty insurers (that the P/C industry wanted stopped).

It makes absolutely no sense for Congress to continue to handcuff federal agencies that have the expertise to examine the effect of certain insurance practices on consumers. The FTC should be authorized to study insurance and draw conclusions as it sees fit. Consumers will be protected and the industry made stronger when it leads to a reduction in improper industry practices.

Comments on Other Federal Legislation Related to Insurance Regulation

State Modernization and Regulatory Transformation (SMART) Act

The State Modernization and Regulatory Transformation (SMART) Act was proposed by former House Financial Services Chairman Michael Oxley and Representative Richard Baker as a discussion draft in 2005. Rather than increase insurance consumer protections for individuals and small businesses while spurring states to increase the uniformity of insurance regulation, this sweeping proposal would have overridden important state consumer protection laws, sanctioned anticompetitive practices by insurance companies and incited state regulators into a competition to further weaken insurance oversight. It was quite simply one of the most grievously flawed and one-sided pieces of legislation that we have ever seen, with absolutely no protections for consumers. The consumers who would be harmed by it are our nation's most vulnerable: the oldest, the poorest, and the sickest.

For example, the discussion draft would have preempted state regulation of insurance rates. Imagine the impact on homeowners on the Gulf Coast of that proposal, or on companies trying to purchase D&O or bond insurance today. This would leave millions of individual and business consumers vulnerable to price gouging, as well as abusive and discriminatory insurance classification practices. It would also encourage a return to insurance redlining, as deregulation of prices would include the lifting of the modest state controls on territorial line drawing. States would be helpless to stop the misuse of risk classification information, such as credit scores, territorial data, education, occupation and the details of consumers' prior insurance history, for pricing purposes. The draft approach goes so far as to deregulate cartel-like organizations such as the Insurance Services Office and the National Council on Compensation Insurance, while leaving the federal antitrust exemption fully intact, thus allowing deregulated cartel behavior!

Non-admitted Insurance/Reinsurance Regulation

H.R. 1065 passed the House of Representatives in 2007 and was introduced by Senators Martinez and Nelson as S.929. This bill preempts states only in the regulation of surplus lines of insurance and reinsurance. It provides for a method of collecting state premium taxes for surplus lines and allocating this income to the states. CFA has several concerns with this legislation:

1. Contrary to the stated intent of the authors of this legislation, this bill appears to open the door to the increased sale of poorly regulated, non-admitted personal lines of insurance to individual consumers, not just commercial insurance sold to sophisticated corporations. The bill does not exclude non-admitted personal lines of insurance from its provisions. If the bill fosters a sharp growth in under-regulated, non-admitted insurance – as it is intended to do – it could seriously harm consumers who buy non-admitted insurance, since purchasers of such coverage have no guaranty fund protection, a real danger in the present economic circumstances.

2. Great regulatory confusion and ineptitude would likely result when the state of domicile for an insured party regulates all parts of that entity's insurance transaction. (The approach prohibits any state from overseeing surplus lines of transactions other than the home state of an insured party.) Consider how Michigan might regulate a transaction in which General Motors, or another large company based in the state, has purchased a commercial automobile policy for its cars on the West and Gulf Coasts from non-admitted insurers. In all likelihood, Michigan regulators know very little about dealing with earthquake risk in California or hurricane risk in Florida in pricing insurance policies, or in handling claims resulting from such weather events if GM's cars are damaged. Moreover, since Michigan is a no-fault state for auto insurance, regulators there would likely know very little about tort laws in other states and how pricing and claims should be handled. How can 50 regulators each become experts in the laws of all 50 states? This is regulatory super-complexity, not regulatory simplification.

3. The bill was based on the incorrect assumption that the domiciled state of an insured party or reinsurance company will provide adequate oversight. The bill handcuffs states that would have a legitimate interest in acting to protect residents harmed by clearly abusive insurance practices. For example, suppose a non-admitted insurer for a company like GM acts in bad faith and refuses to pay legitimate claims regarding unsafe automobiles that harmed drivers in other states? These states would have no ability to investigate or sanction that insurance company while the state of Michigan, with limited resources and very little in-state impact, would have much less of an incentive to get to the bottom of the problem.

Moreover, a "home state" regulator has the greatest interest in pleasing a large insured party – and employer – based in that state. This could lead the regulator to lower insurance standards that protect residents and consumers who use that company's products and services across the country.

The bill would also allow large commercial insured parties to seek coverage from non-admitted insurers without determining whether the same coverage is available from an admitted carrier, which most states now require. It is not in the public interest to foster the growth of a segment of the market that does not have to meet state standards – unless admitted insurance is truly not available. For example, guaranty associations in all states do not cover claims for surplus lines insurers from other states when an insured entity and its insurer become insolvent. This may be a minor problem for the defunct policyholder and the defunct insurer, but it certainly is not minor for the people that the policyholder may have injured who are left without guaranty association protection.

Similarly, the bill only allows the domiciled state of a reinsurance company to regulate that company's solvency. What if insured entities in the state of domicile are covered by only one percent of the reinsurance written by a particular company but entities in another state are covered by seventy-five percent of the reinsurance? Moreover, allowing a domiciliary state to essentially act as a national regulator promotes forum shopping by insurers to secure the most favorable regulatory environment. The state of domicile is often under the greatest political and economic pressure not to act to end harmful business practices by a powerful in-state insurer. When I was Insurance Commissioner of Texas, I had to investigate and take down an insolvent insurer in another state because the commissioner of that state refused to do so, as several ex-governors were on the Board of the insurer.

4. Several deregulatory provisions of the bill are based on the faulty assumption that large buyers of insurance do not need protections that would normally be provided in an insurance transaction, such as prohibitions on deceptive practices and mandated verification of the legality of policy forms. (For example, the bill prohibits any state from overseeing surplus lines transactions other than the home state of an insured party.) The investigations and settlements pursued by New York Attorney General Eliot Spitzer refute this assumption. Large, sophisticated corporations were victimized by insurers and brokers through bid rigging, kickbacks, hidden commissions, and blatant conflicts of interest.

A Pro-Consumer Approach to National Insurance Regulation: The Insurance Consumer Protection Act of 2003

The drafters of this legislation--introduced by Senator Hollings before he retired, considered the consumer perspective in its design. S. 1373 of 2003 would have adopted a unitary federal regulatory system under which all interstate insurers would be regulated. Intrastate insurers would continue to be regulated by the states.

The bill's regulatory structure requires federal prior approval of prices to protect consumers, including some of the approval procedures (such as hearing requirements when prices change significantly) being used so effectively in California. It requires annual market conduct exams. It creates an office of consumer protection. It enhances competition by removing the antitrust protection insurers hide behind in ratemaking. It improves consumer information and creates a system of consumer feedback.

If federal regulation is to be considered, S.1373 should be the baseline for any debate on the subject.

CONCLUSION

Congress should consider expanding the federal role in insurance regulation, particularly in the solvency/prudential/systemic risk area. Congress should not intrude in state consumer protection regulation and should give as much attention to preserving or enhancing consumer protections as it gives to systemic risk matters.

Attachment 1

CONSUMER PRINCIPLES AND STANDARDS FOR INSURANCE REGULATION

1. **Consumers should have access to timely and meaningful information about the costs, terms, risks and benefits of insurance policies.**

    - Meaningful disclosure prior to sale tailored for particular policies and written at the education level of the average consumer sufficient to educate and enable consumers to assess a particular policy and its value should be required for all insurance; it should be standardized by line to facilitate comparison shopping; it should include comparative prices, terms, conditions, limitations, exclusions, loss ratio expected, commissions/fees and information on seller (service and solvency); it should address non-English speaking or ESL populations.
    - Insurance departments should identify, based on inquiries and market conduct exams, populations that may need directed education efforts, e.g., seniors, low-income, low education.
    - Disclosure should be made appropriate for medium in which product is sold, e.g., in person, by telephone, on-line.
    - Loss ratios should be disclosed in such a way that consumers can compare them for similar policies in the market, e.g., a scale based on insurer filings developed by insurance regulators or an independent third party.
    - Non-term life insurance policies, e.g., those that build cash values, should include rate of return disclosure. This would provide consumers with a tool, analogous to the APR required in loan contracts, with which they could compare competing cash value policies. It would also help them in deciding whether to buy cash value policies.
    - A free look period should be required; with meaningful state guidelines to assess the appropriateness of a policy and value based on standards the state creates from data for similar policies.
    - Comparative data on insurers' complaint records, length of time to settle claims by size of claim, solvency information, and coverage ratings (e.g., policies should be ranked based on actuarial value so a consumer knows if comparing apples to apples) should be available to the public.
    - Significant changes at renewal must be clearly presented as warnings to consumers, e.g., changes in deductibles for wind loss.
    - Information on claims policy and filing process should be readily available to all consumers and included in policy information.
    - Sellers should determine and consumers should be informed of whether insurance coverage replaces or supplements already existing coverage to protect against over-insuring, e.g., life and credit.
    - Consumer Bill of Rights, tailored for each line, should accompany every policy.
    - Consumer feedback to the insurance department should be sought after every transaction (e.g., after policy sale, renewal, termination, claim denial). The insurer should give the consumer notice of feedback procedure at the end of the transaction, e.g., form on-line or toll-free telephone number.

2. **Insurance policies should be designed to promote competition, facilitate comparison-shopping and provide meaningful and needed protection against loss.**

   - Disclosure requirements above apply here as well and should be included in the design of policy and in the policy form approval process.
   - Policies must be transparent and standardized so that true price competition can prevail. Components of the insurance policy must be clear to the consumer, e.g., the actual current and future cost, including commissions and penalties.
   - Suitability or appropriateness rules should be in place and strictly enforced, particularly for investment/cash value policies. Companies must have clear standards for determining suitability and compliance mechanism. For example, sellers of variable life insurance are required to find that the sales that their representatives make are suitable for the buyers. Such a requirement should apply to all life insurance policies, particularly when replacement of a policy is at issue.
   - "Junk" policies, including those that do not meet a minimum loss ratio, should be identified and prohibited. Low-value policies should be clearly identified and subject to a set of strictly enforced standards that ensure minimum value for consumers.
   - Where policies are subject to reverse competition, special protections are needed against tie-ins, overpricing, e.g., action to limit credit insurance rates.

3. **All consumers should have access to adequate coverage and not be subject to unfair discrimination.**

   - Where coverage is mandated by the state or required as part of another transaction/purchase by the private market (e.g., mortgage), regulatory intervention is appropriate to assure reasonable affordability and guaranty availability.
   - Market reforms in the area of health insurance should include guaranty issue and community rating and, where needed, subsidies to assure that health care is affordable for all.
   - Information sufficient to allow public determination of unfair discrimination must be available. Geo-code data, rating classifications and underwriting guidelines, for example, should be reported to regulatory authorities for review and made public.
   - Regulatory entities should conduct ongoing, aggressive market conduct reviews to assess whether unfair discrimination is present and to punish and remedy it if found, e.g., redlining reviews (analysis of market shares by census tracts or zip codes, analysis of questionable rating criteria such as credit rating), reviews of pricing methods, and reviews of all forms of underwriting instructions, including oral instructions to producers.
   - Insurance companies should be required to invest in communities and market and sell policies to prevent or remedy availability problems in communities.
   - Clear anti-discrimination standards must be enforced so that underwriting and pricing are not unfairly discriminatory. Prohibited criteria should include race, national origin, gender, marital status, sexual preference, income, language, religion, credit history, domestic violence, and, as feasible, age and disabilities. Underwriting and rating classes should be demonstrably related to risk and backed by a public, credible statistical analysis that proves the risk-related result.

4. **All consumers should reap the benefits of technological changes in the marketplace that decrease prices and promote efficiency and convenience.**

   - Rules should be in place to protect against redlining and other forms of unfair discrimination via certain technologies, e.g., if companies only offer better rates, etc. online.
   - Regulators should take steps to certify that online sellers of insurance are genuine, licensed entities and tailor consumer protection, UTPA, etc. to the technology to ensure consumers are protected to the same degree regardless of how and where they purchase policies.
   - Regulators should develop rules/principles for e-commerce (or use those developed for other financial firms if appropriate and applicable.)
   - In order to keep pace with changes and determine whether any specific regulatory action is needed, regulators should assess whether and to what extent technological changes are decreasing costs and what, if any, harm or benefits accrue to consumers.
   - A regulatory entity, on its own or through delegation to an independent third party, should become the portal through which consumers go to find acceptable sites on the web. The standards for linking to acceptable insurer sites via the entity and the records of the insurers should be public; the sites should be verified/reviewed frequently and the data from the reviews also made public.

5. **Consumers should have control over whether their personal information is shared with affiliates or third parties.**

   - Personal financial information should not be disclosed for purposes other than the one for which it is given unless the consumer provides prior written or other form of verifiable consent.
   - Consumers should have access to the information held by the insurance company to make sure it is timely, accurate and complete. They should be periodically notified how they can obtain such information and how to correct errors.
   - Consumers should not be denied policies or services because they refuse to share information (unless information is needed to complete the transaction).
   - Consumers should have meaningful and timely notice of the company's privacy policy and their rights and how the company plans to use, collect and or disclose information about the consumer.
   - Insurance companies should have a clear set of standards for maintaining the security of information and have methods to ensure compliance.
   - Health information is particularly sensitive and, in addition to a strong opt-in, requires particularly tight control and use only by persons who need to see the information for the purpose for which the consumer has agreed to the sharing of the data.
   - Protections should not be denied to beneficiaries and claimants because a policy is purchased by a commercial entity rather than by an individual (e.g., a worker should get privacy protection under workers' compensation).

6. **Consumers should have access to a meaningful redress mechanism when they suffer losses from fraud, deceptive practices or other violations; wrongdoers should be held accountable directly to consumers.**

   - Aggrieved consumers must have the ability to hold insurers directly accountable for losses suffered due to their actions. UTPAs should provide private cause of action.

- Alternative Dispute Resolution clauses should be permitted and enforceable in consumer insurance contracts only if the ADR process is: 1) contractually mandated with non-binding results, 2) at the option of the insured/beneficiary with binding results, or 3) at the option of the insured/beneficiary with non-binding results.
- Bad faith causes of action must be available to consumers.
- When regulators engage in settlements on behalf of consumers, there should be an external, consumer advisory committee or other mechanism to assess fairness of settlement and any redress mechanism developed should be an independent, fair and neutral decision-maker.
- Private attorney general provisions should be included in insurance laws.
- There should be an independent agency that has as its mission to investigate and enforce deceptive and fraudulent practices by insurers, e.g., the reauthorization of FTC.

7. **Consumers should enjoy a regulatory structure that is accountable to the public, promotes competition, remedies market failures and abusive practices, preserves the financial soundness of the industry and protects policyholders' funds, and is responsive to the needs of consumers.**

- Insurance regulators must have a clear mission statement that includes as a primary goal the protection of consumers.
- The mission statement must declare basic fundamentals by line of insurance (such as whether the state relies on rate regulation or competition for pricing). Whichever approach is used, the statement must explain how it is accomplished. For instance, if competition is used, the state must post the review of competition (e.g., market shares, concentration by zone, etc.) to show that the market for the line is workably competitive, apply anti-trust laws, allow groups to form for the sole purpose of buying insurance, allow rebates so agents will compete, assure that price information is available from an independent source, etc. If regulation is used, the process must be described, including access to proposed rates and other proposals for the public, intervention opportunities, etc.
- Consumer bills of rights should be crafted for each line of insurance and consumers should have easily accessible information about their rights.
- Regulators should focus on online monitoring and certification to protect against fraudulent companies.
- A department or division within the regulatory body should be established for education and outreach to consumers, including providing:
    - Interactive websites to collect from and disseminate information to consumers, including information about complaints, complaint ratios and consumer rights with regard to policies and claims.
    - Access to information sources should be user friendly.
    - Counseling services to assist consumers, e.g., with health insurance purchases, claims, etc. where needed should be established.
- Consumers should have access to a national, publicly available database on complaints against companies/sellers, i.e., the NAIC database. (NAIC is implementing this.)
- To promote efficiency, centralized electronic filing and use of centralized filing data for information on rates for organizations making rate information available to consumers, e.g., help develop the information brokering business.
- Regulatory system should be subject to sunshine laws that require all regulatory actions to take place in public unless clearly warranted and specified criteria apply. Any insurer claim

of trade secret status of data supplied to the regulatory entity must be subject to judicial review with the burden of proof on the insurer.

- Strong conflict of interest, code of ethics and anti-revolving door statutes are essential to protect the public.
- Election of insurance commissioners must be accompanied by a prohibition against industry financial support in such elections.
- Adequate and enforceable standards for training and education of sellers should be in place.
- The regulatory role should in no way, directly or indirectly, be delegated to the industry or its organizations.
- The guaranty fund system should be prefunded, national fund that protects policyholders against loss due to insolvency. It is recognized that a phase-in program is essential to implement this recommendation.
- Solvency regulation/investment rules should promote a safe and sound insurance system and protect policyholder funds, e.g., providing a rapid response to insolvency to protect against loss of assets/value.
- Laws and regulations should be up to date with and applicable to e-commerce.
- Antitrust laws should apply to the industry.
- A priority for insurance regulators should be to coordinate with other financial regulators to ensure consumer protection laws are in place and adequately enforced regardless of corporate structure or ownership of insurance entity. Insurance regulators should err on side of providing consumer protection even if regulatory jurisdiction is at issue. This should be stated mission/goal of recent changes brought about by GLB law.
    - Obtain information/complaints about insurance sellers from other agencies and include in databases.
- A national system of "Consumer Alerts" should be established by the regulators, e.g., companies directed to inform consumers of significant trends of abuse such as race-based rates or life insurance churning.
- Market conduct exams should have standards that ensure compliance with consumer protection laws and be responsive to consumer complaints; exam standards should include agent licensing, training and sales/replacement activity; companies should be held responsible for training agents and monitoring agents with ultimate review/authority with the regulator. Market conduct standards should be part of an accreditation process.
- The regulatory structure must ensure accountability to the public it serves. For example, if consumers in state X have been harmed by an entity that is regulated by state Y, consumers would not be able to hold their regulators/legislators accountable to their needs and interests. To help ensure accountability, a national consumer advocate office with the ability to represent consumers before each insurance department is needed when national approaches to insurance regulation or "one-stop" approval processes are implemented.
- Insurance regulator should have standards in place to ensure mergers and acquisitions by insurance companies of other insurers or financial firms, or changes in the status of insurance companies (e.g., demutualization, non-profit to for-profit), meet the needs of consumers and communities.
- Penalties for violations must be updated to ensure they serve as incentives against violating consumer protections and should be indexed to inflation.

8. Consumers should be adequately represented in the regulatory process.

- Consumers should have representation before regulatory entities that is independent, external to regulatory structure and should be empowered to represent consumers before any administrative or legislative bodies. To the extent that there is national treatment of companies, a national partnership, or "one-stop" approval, there must be a national consumer advocate's office created to represent the consumers of all states before the national treatment state, the one-stop state or any other approving entity.
- Insurance departments should support public counsel or other external, independent consumer representation mechanisms before legislative, regulatory and NAIC bodies.
- Regulatory entities should have a well-established structure for ongoing dialogue with and meaningful input from consumers in the state, e.g., a consumer advisory committee. This is particularly true to ensure that the needs of certain populations in the state and the needs of changing technology are met.

Comments of J. Robert Hunter before the Public Hearing Of the NAIC Capital and Surplus Working Group January 27, 2009

Good morning Mr. Chairman and members of the Working Group, my name is Bob Hunter. I am Director of Insurance for the Consumer Federation of America. I have served as Commissioner of Insurance in Texas and as Federal Insurance Administrator under Presidents Ford and Carter. I am delivering these remarks on behalf of CFA and also on behalf of the Center for Economic Justice.

The Economic Situation and Life Insurance Risk

Here is Page 1 of Saturday's (1/24/09) Washington Post:
"DOWNTURN ACCELERATES AS IT CIRCLES THE GLOBE",
"OBAMA TO DECIDE SOON WHETHER TO ADD TO BAILOUT,"
And on Page 1 of the BUSINESS Section "LIFE INSURERS TAKE A HIT"

As the economy of the world melts around us, consumers require more protection from all of its financial service regulators. Even Alan Greenspan understands that now is the time to toughen up consumer protections.

In the entire world, the only people involved in regulation apparently unable to understand that consumers need more protection, not less, is the NAIC. Just last week, an NAIC Working Group voted to recommend that states deregulate auto and home insurance. Today you are posed to recommend that NAIC remove dollars of protection that consumers have in their life insurance products. It is a shocking thing for you to even be considering lowering the dollars that consumers have today as protection as the balance sheets of their insurers are in crisis.

The Post life insurance article is very instructive about some of the risks facing the life insurers, whose stock index has fallen by one-third in this month on top of a similar drop late last year. The risks include a sharp drop in the values of bonds they hold, the likelihood that the ratings of some of these bonds will be cut and further declines ensue, the probability that some bonds will default, the fact that some life insurance products (such as annuities) of some insurers include guaranty returns no longer supported by the assets underlying those annuities, and the fact that analysis's are alarmed that current financial reports may reflect capital levels that are not truly reflective of the lowered values of the assets they hold. Further, captive reinsurance might artificially increase capital and appear to lower risk, while in fact the economics of such transactions do not improve the enterprise risk.

The article also points out that regulators have been trying to stop dubious accounting transactions such as deferred premium assets that already make capital look artificially high. The article says that the ACLI has opposed any retroactive action to correct this because, as the article quotes ACLI, that "would be like deconstructing an already baked cake."

Apparently, ACLI believes cakes that might protect life insurers by keeping capital artificially high cannot be sliced but the cake of consumer protection can be crumbled retrospectively to year-end 2008 and earlier.

NAIC Process Biased

This bias in the process is but one of several major problems with the deeply flawed process NAIC has followed. ACLI has a vested interest in helping its member companies lower consumer protections to pump up capital. When they propose reserve and other changes, the proposals uniformly work to lower dollars and RBC ratios currently protecting consumers. It is ACLI's job not to balance consumer interest with that of their members.

NAIC claims that its job is to protect consumers but you have not done so. Had you been doing so, the first step in a fair review is not to just look at ACLI's list of one-sided suggestions but to determine if the overall consumer protections are truly excessive before considering action to lower protection. For instance, NAIC should have studied aggregate reserves to determine if they are redundant before considering specific items suggested by a biased source. If you were sure aggregate reserves are excessive, surely you would have advised the public how excessive and why by revealing the calculations, before looking at individual items for change. Even then change should be both ways. You should not limit changes to one direction, against the consumer.

NAIC Process Rushed

The second flaw in the process is the big rush to do everything in 2 months. You should not attempt to make changes that would apply to the Annual Statements for 2008. The rush endangers the foundation of statutory accounting of valuing assets and liabilities conservatively to ensure insurers have cash to meet their claims. The explosion in affiliate investments and captive reinsurance agreements already undermines this conservatism. The current economic upheaval does too, in completely unknown ways.

Throughout the subprime and financial crises, state regulators have claimed that insurance companies are strong and that state-based regulation has protected insurance consumers as federal regulators have failed to do.

Given these claims, why has the industry sought and regulators conceded emergency and rushed treatment of these proposals? Absent a compelling reason for emergency action, these proposals should not be adopted in an emergency fashion, but should be treated according to normal procedures.

NAIC Process Closed and Secret

The NAIC Process has been unnecessarily closed and secret. When we asked why, the NAIC responded as follows:

> “The NAIC Executive Committee established the Capital and Surplus Working Group to perform its charges in an expedited manner. Given the ACLI proposals are asking about changes to reserves and other accounting requirements, many of the regulatory discussions were likely to involve company specific questions and comments. Per the NAIC open meetings policy, the discussion of company specific information is a key reason for holding regulator-to-regulator meetings.”

This response is inappropriate and unacceptable. Not only has there been no company-by-company analysis, and therefore, no need to close meetings to the public, but the proposals all deal with industry-wide actions – changes in manuals and procedures affecting the entire industry. The argument that, because an individual company might be discussed, the meeting should be non-public is absurd. Using this logic, there would never be an open meeting of any sort. All meetings should be open and executive session used after the open meeting concludes if company info needs to be discussed

And how does the possibility of a specific insurer being discussed justify NAIC’s secret, ex-parte meetings with ACLI? The fact that NAIC has already met secretly with ACLI undermines the argument that open meetings cannot be held because it is possible that an individual insurer’s situation might come up, because that logic would preclude meetings with ACLI too.

The NAIC has refused to hold itself publicly accountable to the same type of open government standards with which state agencies must comply, even though the NAIC is taking actions that have the force of law. This is why we have challenged the actions of the NAIC as violations of state public meeting, public records and administrative procedures acts. As long as the NAIC continues to respond in this way we will continue to pursue these challenges.

<u>Consumer Questions Remain Unanswered</u>

NAIC’s responses to our questions were incomplete or simply non-responsive in several instances.

QUESTION 1: We asked for the evidence to show that changes in reserves were needed. In response, we were told that life and annuity reserves are too conservative and that movement towards principles based reserving – relying on actuaries to certify reserve adequacy instead of relying on rules – is necessary to give industry greater flexibility and set reasonable reserve requirements.

We reject these arguments. First, where is the evidence we sought that reserves are excessive? Industry has cited “studies” by Milliman – studies done on behalf of and paid for by industry. Had Milliman determined current reserves requirements were inadequate, would we have seen that study?

Second, the concept of principles-based reserving is the same type of self-regulation by parties with conflicts of interest that led to the subprime meltdown and financial crisis worldwide. Reliance on actuaries who depend upon industry for their livelihood suffers from the same conflict found with rating agencies in the credit crisis.

QUESTION 2: We asked the NAIC to tell us the results of regulator analyses of the impact of these proposed changes on capital, surplus, reserves and RBC ratios for the industry and for individual companies most impacted by the changes.

We were astonished by your response that reads, "the impact of these proposed changes on stated versus meaningful capital and reserves *for the industry* or a particular company was not used as an analysis criteria."

This response, of course, immediately raises not only the question of why meetings were not open to the public but also questions like:

- Upon what basis is the NAIC determining that these changes will accomplish anything?
- What is the impact on the safety and soundness of insurers and will these changes leave policyholders vulnerable?

A sign of undue haste by the regulators is the complete lack of understanding of the impacts of the actions on America's policyholders.

To act without this knowledge would be irresponsible.

QUESTION 3: We asked how policyholders would be affected by the proposals, if adopted by NAIC. We were told, "Final adoption of these ACLI proposed items will not have an adverse effect on the insurance company's ability to pay its policyholder obligations." Yet no support or analysis is provided to justify this statement. Of course, this answer is, at best, misleading. It is impossible for these actions not to have an adverse effect on an insurer's ability to pay; the question is whether that adverse effect is material and necessary for insurers to remain solvent. The NAIC has refused to answer this question and instead has provided a misleading statement.

QUESTION 4: We asked if the regulators believed that the rating agencies would see these changes as an actual strengthening of capital and reserve requirements and not just cosmetic.

The NAIC did not answer this question. The reason it should be answered is that, at least at ACLI, the reason for the proposals (and for the great haste) is largely to reduce the possibility that rating agencies will lower the ratings of insurers when 2008 Statements are released.

Professor Joseph Belth's research on this question implies that the rating agencies will not be influenced by these changes, at least not in any significant way. If the reason to rush to judgment is to mollify rating agencies, then there is no need to rush if Professor Belth's research is correct. If it is not the reason why NAIC is rushing this proposal through, what is?

QUESTION 5: We asked how the various proposals would be implemented. The NAIC did not respond.

We are concerned with implementation because, in some cases, NAIC action, such as a change to certain NAIC manuals, will automatically make the adopted change effective in most states.

Therefore, the NAIC's failure to use an open public process, including the use of secret meetings and closed meetings, may violate the laws of states that require notice and open meetings, if and when they vote for such a change that becomes effective in their state.

QUESTION 6: We asked if the NAIC would help America's life insurance and annuity policyholders understand what their actions mean by demonstrating the "before and after" effect of the proposed changes on individual insurer's capital and reserve requirements.

The response was "the NAIC would simply recommend the adoption of the proposed item and the domestic regulators will have the ability to require before and after documentation."

This will pull the wool over the eyes of millions of Americans holding life and annuity contracts today. The NAIC indifference to the policyholders is troubling. Just why can the NAIC not adopt national proposals to help consumers at the very time the NAIC is adopting national proposals in undue haste to help insurers? Transparency should not be left to individual states to consider adopting if they think of it, especially since there would be insufficient time for action by the states before the 2008 Annual Statements are due on March 1, 2009, one month from now.

We propose the following language for adoption by the NAIC as part of any approval of the ACLI proposals:

> *Transparency*
>
> *In order to assist policyholders, there shall be full transparency for policyholders of what the financial impacts are from these changes adopted by the NAIC. During a transition period of the first 2 years starting with the first time these changes are applied, key capital, surplus and reserve amounts in the Statutory Annual Statement and Quarterly Statements and risk-based capital ratios shall be calculated showing amounts based on current and revised accounting and reserving rules and procedures.*

Conclusion

In conclusion, we oppose adoption of any of these changes unless the necessary research is undertaken by NAIC to justify the changes, and the important questions we have raised are answered fully and factually. We oppose allowing any of these items to be rushed into use in the 2008 Annual Statement.

If you do go forward, we request that any votes of the Executive Committee and Plenary on any recommendations from the Capital and Surplus Relief Working Group be recorded roll-call votes, so that the public can identify which regulators voted for or against the proposals.

If you move forward, we strongly urge adoption of the Transparency language we proposed earlier. We also suggest that states voting no to these proposals act to keep these proposals from becoming automatically effective in their states by asking for state exceptions to items that would automatically become effective, such as actuarial guidelines and the Accounting Practices and Procedures Manual. Finally, if you move ahead now, we offer comments on the individual

Working Group proposals as contained in my written statement. We object most strenuously to the Working Group's recommendation regarding the Deferred Tax Asset as I explain in my statement.

Answer to NAIC's Question

I would like to take one minute to respond to NAIC's written question to opponents of these proposals.

You asked: Why should NAIC not act on the request(s)? What specifically will happen if the requests are granted (how will consumer protection be decreased)?

First, NAIC should not act because there has been no analysis of the need for these capital and reserve relief proposals, no articulation of what the goals of these proposals are, no explanation of how these proposals will accomplish those goals, no analysis of the expected impact on capital and reserve levels for the industry as a whole or for individual insurance companies, and no analysis proving that consumers would not be harmed by adoption of the proposals. We ask how could any regulator responsibly vote on these proposals without these questions answered? The answer, of course, is that they cannot.

There are several specific things that will happen if you act on these proposals, including these four important ones:

1. The proposals are lessening the capital and surplus required to protect consumers. This is not my opinion -- it is the factual intent of the proposals. In some cases, the requirements for reserves will be lessened, in other cases, the amount of liquid assets representing surplus will be reduced. So the question, how will consumers be harmed is the wrong question -- the proposals by definition are harming consumers. The question really is -- will the reduction in reserves and capital requirements put consumers at a materially greater risk. The problem with the proposals -- and with the entire decision-making process -- is that regulators have not answered this primary question. There are general statements about redundant reserves, but no independent analysis. By what measure have regulators determined reserves are redundant? A study by Milliman paid for by insurers? Please. By what measure have regulator determined that a reduction in liquid assets supporting capital -- the effect of the DTA plan -- will not put some insurers at solvency risk? The fact that regulators have not analyzed - or provided the analysis to the public -- of what the impact on capital and risk based capital ratios will be is incomprehensible for us. What will the impact of these changes be -- on average and in the extreme cases? How can you vote for these proposals if you don't know whether you are increasing the reported capital by 1%, 10% or 20%? Or what the impact on reserves is for specific products? The absence of this type of analysis means that regulators cannot answer your own initial question -- how do you know the impact on consumers will not be material?

2. Consumer faith in life insurance products will be reduced.

3. If there is no transparency as part of the action, consumer groups will have to warn all persons calling that we are unable to know the impact of these changes on their specific company and that they should be more cautious than ever before about purchase or maintenance of life insurance products.

4. The consumer faith in state regulation, already falling faster than the Dow, will be dealt another blow. To give you one key indicator, for the first time CFA is actively rethinking our long support of state regulation and may be soon proposing a very significant federal role.

Attachment 3

THE AMERICAN COUNCIL OF LIFE INSURERS' PRINCIPLES ON REGULATORY REFORM: HOW WELL WILL THEY PROTECT CONSUMERS?

1. "The ACLI remains committed to pursuing as a top priority a comprehensive plan to make a state-based system of life insurance regulation more efficient."

The top priority in protecting consumers should be regulatory effectiveness, not efficiency. Efficiency can be helpful or harmful, depending on whether consumer protection standards are high. Given the trouble that life insurers now find themselves in – trouble that has caused them to call for new leniency on reserve requirements – shouldn't the top priority be to crack down on risky conduct and do a better job of protecting investors?

2. "The ACLI remains committed to making federal insurance regulation available on a voluntary basis to life insurance companies and agents to the extent consistent with the appropriate regulation of systemic risk. Such federal regulation must be equally available to life insurers regardless of their corporate form (stock, mutual, mutual holding company, fraternal) and equally accommodate insurers regardless of size. In addition, federal and state life insurance regulatory systems must be mutually exclusive."

Systemic risk regulation is, by definition, not optional – neither opt in nor opt out. If the failure of an insurer poses a systemic risk, or if the insurer is engaged in activities that create a systemic risk, it should be subject to systemic risk regulation, whether the insurer likes it or not. Moreover, why do state and federal regulation have to be mutually exclusive? For example, why not require federal solvency/capital standards/risk regulation for companies that pose a systemic risk and state consumer protection regulation that meets federal minimum standards at the same time? The combination of state and federal regulation in securities works fairly well, with states pulling up the slack when federal regulators fall down on the job, and vice versa.

3. "Any changes to the insurance regulatory system must preserve effective capital solvency oversight and investment diversification of life insurance companies…"

Capital solvency oversight needs to be <u>strengthened</u> with an eye to ensuring that life insurance companies are not taking on undue risks and have created adequate reserves to back the commitments they've made to policyholders and annuities investors. The diversification of investments by insurers must meet these strengthened risk standards. It is important to remember that risky investment diversification by banks and investment banks is what got them into financial trouble.

4. "Insurance is, and must continue to be, regulated differently from banking, securities and other types of financial services. The risks assumed by life insurance companies and the obligations that attach to those risks are inherently different than those of other financial intermediaries and call for unique regulatory requirements."

Although insurance is different in some ways from other financial services products, there are also similarities. In terms of protecting consumers, the basic tenants of meaningful insurance regulation have much in common with effective regulation of some securities and banking products. Advice offered by insurance agents ought to be subject to a fiduciary duty, just as investment advice is. Sales of insurance products should be subject to a suitability requirement, just as they should be with risky mortgage products. Systemically significant insurers should be subject to constraints on their risk-taking designed to protect taxpayers. When they fail, they should be subject to a mechanism for orderly failure like that which currently applies to banks and needs to be adopted for other non-bank, systemically significant institutions.

That said, there is an argument to be made for having systemic risk regulation done by those who know a particular industry best, rather than throwing everybody into some one-size-fits-all approach to systemic risk regulation. The argument is weakest, however, with regard to insurers where there is no existing federal insurance regulator to take on that role.

5. "Where insurance regulation is housed at the federal level (e.g., in an independent agency, in an office or department of an existing agency, as part of a consolidated federal financial regulator or otherwise) is not as important as assuring that the expertise necessary to appropriately regulate the insurance business is present."

This is true, as far as it goes. However, in addition to needing expertise, the regulator also needs to have the independence from the insurance industry to regulate effectively, something that has been sorely lacking in state insurance regulation. Moreover, if Congress does move toward federal regulation in some form, it must also create a well-funded office to advocate on behalf of insurance consumers.

6. "Regulatory reform must not result in any increase in overall state or federal corporate or policyholder tax burdens."

This statement should give lawmakers great pause, if they are considering offering their support to ACLI's proposals for greater federal regulation of insurance. What ACLI appears to be saying is that the federal government should create another layer of insurance regulation but that life insurers aren't willing to pay enough for it to make it effective.

Systemic Risk & Structural Principles

1. Systemic risk regulation "…must include a federal insurance regulatory component." Why? This may be a good idea, as long as it is not part of an optional federal charter, but why exactly does federal regulation need to extend beyond systemic risk regulation? Why can't the federal systemic risk regulator coordinate with state regulators on its own? Moreover, if a federal role for insurance regulation is authorized, it should in the form of minimum federal standards for the states to enforce or exceed as necessary.

2. "For those companies that do not have a federal functional regulator, the federal systemic regulator should be required to coordinate only directly with a life insurer's primary domestic regulator(s).

The systemic risk regulator has to be able to talk to and coordinate with whomever they choose. Maybe they should only be *required* to coordinate directly with the primary domestic regulator, but they should be *free* to coordinate with anyone they think may have relevant information about risky conduct.

3. “The federal insurance regulatory authority must have the stature and authority to represent the U.S. internationally on all relevant insurance issues, including mutual recognition agreements, …”

Yes, regulators need to do a better job of cooperating to regulate global markets at the highest level. However, mutual recognition isn’t cooperation, it is deferral. It encourages regulatory arbitrage in much the same way that an optional federal charter would and should be viewed by Congress as nothing more than back-door regulation.

4. “Systemic risk regulation should have as its goal the identification and marginalization of risks that might jeopardize the overall financial system. Its goal should not be the preservation of institutions deemed “too big to fail.”’

Systemic risk regulation should have as its goals identifying risks that jeopardize the overall financial system, taking steps through regulation to minimize those risks, and providing a mechanism through which systemically significant institutions can be allowed to fail in an orderly fashion, much as already exists for banks, so that they can fail without posing an undue systemic risk. However, the fact that the government does not protect institutions against failure does not mean that it doesn’t regulate the conduct of those whose failure would otherwise harm the overall financial system, with an eye toward making that failure less likely.

5. “Existing authority of life insurance holding companies to engage in non-financial activities must be preserved.”

This decision should be left to a systemic regulator, which should have the power to prohibit any financial or non-financial activity if it is deemed to create an unacceptable risk.

Insurance Guaranty Mechanism

1. “There should be a uniform, industry-run, mandatory insurance guaranty mechanism covering all life insurance companies that is funded through post-event assessments on insurers.”

2. “The states should be required to establish uniform coverage limits and operating requirements. Preemption of states not meeting uniform standards and reliance on a national, industry-run guaranty association for non-compliant states would be accomplished as set forth in the ACLI’s optional federal charter legislative proposal.”

As explained in the testimony above, creating an optional federal charter for insurance is a failed idea that will inevitably create great pressure on regulators to lower standards. CFA agrees that the current guaranty system is dangerous. However, as explained above, continuing the funding of guaranty funds through post-event assessment is very risky.

Testimony Before the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

of the

House Committee on Financial Services

Thursday May 14, 2009

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Testimony of Martin F. Grace Center for Risk Management and Insurance Research, Georgia State University

Introduction

Chairman Kanjorski and Members of the committee, good morning and thank you for the opportunity to testify before the Subcommittee on the topic of insurance regulation.

My name is Martin Grace. I am the James S. Kemper Professor of Risk Management at the J. Mack Robinson College of Business at Georgia State University. I am also the Associate Director of the Center for Risk Management Research and an Associate at the Andrew Young School of Policy Studies. I have been at Georgia State for 21 years coming to GSU from the University of Florida where I earned a law degree and a Ph.D. in economics. Previous to that I attended the University of New Hampshire where I earned my undergraduate degree.

My entire career at Georgia State has been spent conducting research in insurance regulation and taxation. Since the industry is regulated at the state level, this has been predominately an exercise in the study of state regulation. However, the question of whether the state is the appropriate level of regulation is becoming more important and I have spent the last four years thinking about that question.

This brings me to what I have been asked to talk about today. The question of who should regulate the insurance industry has been debated in the United States since the time of the Civil War. Insurance continues to be regulated by the states despite several challenges to their authority over the years. The states’ authority over insurance was supported in various courts' decisions until the *Southeastern Underwriters* case in 1944. In *Southern Underwriters*, the Supreme Court determined that the commerce clause of the Constitution applied to insurance and that insurance companies (and agents) were subject to federal antitrust law. The Court's ruling caused the states and the industry to push for the McCarran-Ferguson Act (MFA) in 1945, which delegated the regulation of insurance to the states.

At that time, the majority of insurance companies favored state over federal insurance regulation. However, today the bulk of insurance is written by national (and international) companies operating across state borders. Many of these insurers have come to view state regulation as an increasing drag on their efficiency and competitiveness: these insurers now support a federal regulatory system. This is reflected in recent proposals that would establish an optional federal charter (OFC) for insurance companies and agents. The proposal would allow them to choose to be federally regulated and exempt from state regulation. As you are quite aware, there is fierce opposition to an OFC from the states and from state-oriented segments of the industry.

One of the main problems with the OFC approach is that it is based upon a structure designed in the 1860s through the National Banking Act and cobbled together with state consumer protection language. The OFC approach is based on a view of the world that had changed significantly in the last two years. While the authors of the proposal now add a systemic risk regulator to the mix, they still beg some questions about who should be subject to federal regulation.

The current problem facing insurance regulation, though, is quite different from regulatory issues of the past century. Today's problem is not based on regulation of solvency, market conduct, or insurance pricing which have been undertaken by the states. It is, instead, the problem of systemic risk which, for the most part, has not been an issue with the insurance industry. Further, systemic risk is of national rather than state in scope. Specifically, the types of market failures used historically to justify regulation of the insurance industry have been ones that pertain to local markets. This is in direct contrast to the effects a failure of a company like AIG has on national and international markets.

Why Regulate Insurance?

Economists believe the role of government is to rectify market failures.[1] In the insurance industry, potential market failures are due, in essence, to imperfect information. Customers cannot, for example, observe the behavior of insurance company management. For a life insurance consumer, this might be important because of the long time between when a contract is purchased and when a payout might occur. Also, there is no effective way to discipline the insurer's management. For example, a life insurance consumer cannot "punish" a "bad" company by exchanging his long term policy for one with another insurer.   Thus, economists would argue that government can and should monitor a firm's solvency position and take action to prohibit insurer actions which reduce the value of life insurance contracts.

A second potential market failure is related to the imperfect information embodied in the insurance contract itself. An insurance contract is a complicated financial agreement, so the government could standardize contracts or approve contract language to reduce errors and misunderstandings in the contracting process.[2]

A third informational problem might arise from an insurer's strategy and marketing structure. Because insurers have different marketing (direct versus independent agents)

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[1] See Skipper and Klein (2000) for a more thorough treatment of how economists think about the regulation of insurance.

[2] This standardization is common in personal lines products (like homeowners and auto), but it does not always solve all problems as there are new problems with contract interpretation that are costly to resolve. The Katrina wind/water litigation is just an example of this problem.

approaches and different levels of capital backing, shopping for the right policy is costly to consumers because they do not have the information to make accurate judgments about the services and the quality of services provided by insurers. Arguably, the government could guarantee a level of service after a claim or set prices so that a consumer would know that the contract is priced fairly. In addition, prices could be set to keep insurers from using their market power to exploit consumers through higher prices. This last rationale is often provided for price regulation of insurance, even though most personal lines insurance markets (which are the most likely to be regulated) are competitive markets. There are many competitors in these markets which reduces the likelihood of any one of firms being able to influence prices (Tennyson, 2007).

These arguments form the standard historical rationales for insurance regulation. A further rationale, with a more immediate application in banking regulation, is that regulators should prevent market failure caused by the externality of one bank failure leading to a loss of consumer confidence in the financial system and other bank failures should be prevented. Banks have solvency regulation to protect depositors and to defend the banking system from contagion risk. Historically, insurers did not present a real contagion risk to the financial system, but this may no longer be true. Financial companies are now interconnected in ways that are without historical precedent. Holding companies have evolved which contain many different types of regulated and unregulated firms. A bank with an insurer as part of its operations can extend the contagion risk to its insurance operations. Alternatively, an insurer with a large and unregulated derivative trading business which suffers large losses can trigger questions about the overall soundness of the insurance operations. Counter parties to trades by such an unregulated entity can cause significant harm and potentially disrupt the banking system. In insurance, the focus of regulation has been on the individual company and not on the group or holding company. This needs to change, at some level, to allow for the proper accounting of systemic risk.[3] A state regulator cannot realistically regulate an insurer for its possible systemic affects on national and international markets especially in situations where the insurer within the state is a separately organized corporation from the corporation which might induce a systemic risk issue.

The Level at Which Regulation Should Be Applied

Ideally regulation should be applied at the level where the greatest costs and benefits due to the regulation arise. A simple example would be the proper placement for restaurant safety inspections versus airplane safety inspections. Local governments would be the obvious choice for restaurant cleanliness because local patrons would obtain the benefits and bear the costs of the safety inspections. In contrast, airplane safety inspections costs and benefits are national in scope and air travel is conducted nationwide. Thus it makes sense for air safety to be regulated at the national level.

A large percentage of insurance premiums are written interstate. If there are interstate externalities to insurance regulation, then it makes sense for the federal government to regulate it. Phillips and Grace, in a 2007 paper, document some of these interstate externalities in terms of how states can export the costs of regulation to other states. The authors were not able to measure the benefits of regulation, so it is not possible to provide a conclusion about the role of federal versus state regulation.

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[3] Prior to the introduction of the National Insurance Consumer Protection Act and the creation of a systemic risk regulator, I thought legislation that granted the Federal Reserve the right to assess systemic risk through the use of normal administrative agency powers of investigation would be sufficient for any firm that might create systemic risk. New legislation which sets up a formal systemic risk regulator will likely spell out these powers and their scope in more detail.

Some of the benefits of state regulation are that local tastes and preferences are best met by state legislatures responding to local voters' concerns about the insurance industry. This is often touted as a rational for federalism. Yet, I suspect that with some exceptions (price regulation, for example) a few voters could discuss their state's insurance regulations. Due to diverse state regulations, nationwide companies often have significant compliance costs which increase the price of insurance without providing any benefits provided by a federalist laboratory. States do not look to see if there is a better way to regulate insurance. So, there is tremendous inertia in state's regulatory processes and it is a rare event that causes all states to act together.

If the criterion for a state-based insurance regulatory system to be successful is that states must regulate to minimize compliance costs, then the current state regulation of insurance is doomed to failure. One of the major rationales for federal regulation is reduction of nationwide insurer costs of trying to satisfy multiple states' regulators. The NAIC has stated that it is trying to reduce these types of costs through model legislation and interstate compacts. Its good intentions notwithstanding, it is not capable of getting the states to operate quickly and efficiently together. Even Congress cannot obtain quick compliance from the states. In the Gramm-Leach Bliley Act of 1999, Congress mandated that the states set up a nationwide licensing system for agents. After ten years, not all of the states participate in this system to reduce multistate licensing costs.[4]

In 2007, for example, the NAIC proposed the Military Sales Model Practices Regulation as a result of a law enacted by Congress in 2006. This regulation is designed to protect young

[4] A recent report (NAIC, 2008) states that 43 states are in compliance. What is important is that three important states (FL, NY and CA) are not in compliance some nine years after enactment of the Gramm-Leach-Bliley Act. Without the large states participation, compliance costs are not reduced and the supposed benefits of increased state cooperation as a reason for avoiding an OFC bill are illusory.

soldiers, sailors, marines, and airmen from aggressive sales tactics directed at military personnel. As of late last year, only 18 states have enacted it. Presumably, this was an important issue for Congress, yet it has not been adopted by a majority of states in its first two years. Depending on universal action among the states to enact laws that prompt action is just not feasible. Grace and Scott (2009) document a number of other examples which suggest that joint actions by the states are never going to be able to solve national problems regarding compliance costs and uniformity quickly and efficiently.

The Potential Federal Role and Regulatory Modernization

There is a role for the federal government in insurance regulation. Where it can succeed and be economically valuable is in the area of removing the costs of conflicting state laws and reducing the effect of systemic risk on all financial markets. Reduction of compliance costs is the rationale behind the 2009 OFC proposal introduced by Reps. Bean and Royce called the National Insurance Consumer Protection Act. The new proposal includes the role of a systemic risk regulator who will have the authority to mandate that certain insurers be federally chartered companies.[5] With the exception of this concept, there is little modern thinking in the NICPA about how insurance regulation should work.

The authority of the systemic risk regulator is very important. It is only know being discussed. However, how this is undertaken can cause significant disruptions in markets. If the risk regulator’s authority is associated with a “too big to fail” certification, then the underlying competitive insurance market might be at risk. Firms designated as “too big to fail” will have an

[5] Essentially, there is a double option on the table now. From the description in the press, insurers could opt to become federally chartered, but the Federal government could opt to regulate a state chartered company if part of a holding company that might create a systemic risk.

implicit incentive to take on more risk (sell more insurance and other risky products) knowing the government will provide assistance. A rational firm may decide not to compete in that market. Thus underlying insurance markets are likely to wither away leaving only those firms that are “too big to fail”.

If all insurers are subject to the systemic risk regulator's jurisdiction, there is no signal that every firm is "too big to fail". However, most insurers will never be systematically important but will be subject to another layer of regulation that does little for its customers, its shareholders, or society in general. Even large, significant insures operating nationwide are not necessarily important from a systemic risk perspective. So the question becomes how does one determine whether a firm should be subject to risk regulation? Ideally, one would want firms undertaking risk outside of insurance risks to fall under the authority of the risk regulator. For example, suppose a future AIG-like company petitions its primary regulator to exempt its “Financial Products” subsidiary from insurance regulation. Because of that exemption, the firm should fall under the jurisdiction of the risk regulator. The risk regulator can examine the risk and require appropriate reserving techniques if needed.[6] By having to show the risk regulator the insurer’s underlying business model a specific finding can be made if a systemic risk is possible and remedies to mitigate the systemic risk can be implemented. Ideally what the risk regulator’s job would be is to prevent possible systemic risks through evaluation by a competent regulator.

One of the dangers of merely just prohibiting financial innovation is that economically valuable innovations would never evolve. However, permitting financial innovation without

[6] Note, though, that if New York did not exempt the AIG Financial Products subsidiary and treated it like a bond insurer it would have had some level of reserves. Further, because it would have to place reserves for each new bond insured it would have also limited the scope of the sale of CDSs as well as the scope of the eventual losses.

proper reserving is also harmful to society. Thus, the risk regulator must be more sophisticated about these products than a typical state insurance department in two ways. First, it must be able to understand the product and its risks. Second, it must appreciate the rewards of such innovation.

Problems with Current Federal OFC Proposals

As mentioned above, the OFC proposal is cobbled together from banking and insurance law. There has been little discussion of the structure of a regulatory body from a fresh perspective. A recent paper by Grace and Scott (2009) examined a portion of the issue from an administrative law viewpoint and showed how little discussion there was of how a federal insurance regulator should be organized. There are a number of regulatory models available in the United States. For example, there is the multi-commissioner, administrative body like the SEC. This is in direct contrast to the single administrator overseeing the Office of the Comptroller of the Currency. There is also an independent (from the executive branch) administrative agency like the Federal Reserve Board of Governors. Again, this contrasts directly with the administrator of the Office of the Comptroller of the Currency. The fact that the 2009 OFC proposal merely copies the structure of the banking system and begs the question why is the national banking system structured this way? The Treasury *Blueprint* as well as others (see e.g. Brown (2008)) discuss other options. What is noteworthy is that these options were not conditioned on the current financial crisis. The *Blueprint's* proposal is to use a three-pronged regulatory approach with a systemic risk regulator, a solvency regulator, and a market conduct regulator that would oversee *all* financial services including securities and commodities trading. This would be a major innovation in financial regulation in the United States. The OFC bills, in contrast, are not innovative from the perspective of what is regulated or how the regulation is accomplished as the approach in both bills (with the exception of a systemic risk regulator) is to shift traditional regulatory powers from the states to the federal government.

Other methods of regulation of the insurance industry are also possible. Some insurers have joined unofficial self-regulatory organizations like the Insurance Marketplace Standards Association (IMSA) to increase their ability to understand their customers and to increase the likelihood that their policies will more closely meet the needs of those customers. These types of standards are different from state-based rules which are often decades old and have not suffered an across-the-board reexamination, except after a regulatory failure. From a practical point of view, Congress is not likely to delegate monitoring powers to private entities for some time. The approach of organizations like IMSA, can assist in the development of modern approaches to market conduct regulation.

In sum, there has been no real systematic discussion of modernization of the regulatory approach over the last decade outside of allowing for greater integration of financial services through enactment of the Gramm-Leach-Bliley Act of 1999 (GLB). Other than allowing banks and insurers to be owned by a common parent, GLB did not change the content of insurance regulation beyond mandating that states attempt to resolve interstate differences in agency licensing. Other important substantive aspects of insurance regulation have not been reexamined. For example, there has been little, until recently, discussion of the proper and economically efficient regulation of risk.

In addition, solvency regulation has not been scrutinized since Congress made states and the NAIC do so in the late 1980s and early 1990s. Bank regulators have adopted aspects of the Basel accords, but insurance regulators have not. Many insurers are complying with Basel II by developing their own capital models and the tests which support the models. They are not required to do so by law but are doing it to be responsible stewards of capital. To be fair, there has been an attempt to standardize certain product approval processes through the use of the new Interstate Insurance Product Regulation Commission. However, the Commission has taken time to get started and was created, at least in part, to stave off any OFC type of regulation. This history of insurance regulation suggests that state regulation in this area is reactive. Regulation only changes because of a crisis or Congressional pressure. It is interesting that Congress (and not the states) also proposed the SMART Act that would have pre-empted the states' ability to regulate and transferred that authority to the Federal government. This proposed Act started a conversation about regulation, but it did not address the fundamentals - just what level of regulation is appropriate for insurance. The OFC bills have structured this debate in such as way as to eliminate discussion of reform. Given that many aspects of regulation are important, more reform ideas should be on the table.

The Role of the State and Federal Governments in the Future of Insurance Regulation.

The future role of states in the insurance regulatory arena is in question. There are serious barriers to coordination among the states which prohibit them from being effective regulators on certain issues. In addition, because of the predominance of nationwide operations, there are potential externalities that can be remedied by a federal approach to regulation. To be fair, there are also potential problems with federal regulation that need to be addressed. State regulation does protect the industry from bad regulation in the sense that if a state were to make a serious error regarding regulation, the negative effects of the error will likely be most felt in the state with the "bad" regulation. In contrast, a mistake at the federal level hurts the entire industry nationwide. Further, merely copying state regulation without thinking about the merits of the regulation is also inefficient. A third and final problem with federal regulation is the possibility that risks that previously were insured in private markets may become more socialized in the sense that federal regulations may reduce the ability of private insurers to set risk based prices.

Conclusion

The policy debate regarding the regulation of insurance concerns the appropriate level of regulation for the industry. Ideally, the appropriate level of government would be the one that would be able to contain all of the benefits and costs of regulation within the state (or federal level) borders. Further, it is possible solvency and market regulation conduct arguably can be conducted at the federal level at lower cost to society than separate state regulation of these same activities. Evidence suggests there are some economies of scale in these activities and the costs of regulation are spread beyond the borders of a single state.

Insurance regulation needs to move beyond this level of discussion. It is important, but the other aspects of regulatory improvements must not be forgotten. The proposed 2009 version of the OFC bill does address the issue of systemic risk. While this is important to prevent future events like AIG, it is not clear how relevant it is for a supermajority of other insurers. However, if a risk regulator law is passed, one could predict we would have a better understanding of the relationships between various aspects of the financial service industries. This is a beneficial aspect of the law, but there is still avoidance of real subject matter regulatory reform.

Finally, I am pessimistic about the role for the state in the future of insurance regulation. States have absolutely no ability or incentive to be proactive. At best they are reactive and cannot reach anything like a consensus when one is needed. The perfect example is the inability for every state to integrate its agency licensing system or join an interstate product licensing commission, even in the face of federal preemption of a significant part of regulatory authority. Thus, a uniform understanding and appreciation of systemic risk and how it should be treated in a holding company structure is not likely to be implemented on a relatively uniform base any time soon.

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Resume

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Education

B.A. with honors, The University of New Hampshire (Political Science),1980.

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Fellowships and Awards

- Inducted into Beta Gamma Sigma, 1985.
- Public Utility Research Center Research Graduate Fellowship, 1981, 1984.
- Invited to be a member of the *Risk Theory Seminar*, 1992.
- *Journal of Insurance Regulation*, Best Paper Award 1999.
- CAS Best Paper Award 2000 in an RMI Journal
- Kemper Award for Best Paper in *Risk Management and Insurance Review*, 2003
- CAS Best Paper Award, World Risk and Insurance Economics Congress 2005
- Robison College of Business, Faculty Research Award, 2006

Work Experience

Academic

September 1980-December 1985	Instructor and Graduate Research Assistant, College of Business Administration, University of Florida.
January 1986-August 1987	Visiting Assistant Professor, Department of Management, and Research Associate, Public Utility Research Center (PURC), College of Business Administration, University of Florida.
September 1987-June 1993	Assistant Professor of Legal Studies, Department of Risk Management and Insurance, Georgia State University.
June 1990-September 1991	Visiting Senior Associate, Policy Research Center, College of Business Administration, Georgia State

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September 1990-December 1992	Research Associate, Center for Risk Management and Insurance Research, College of Business Administration, Georgia State University.
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Non-academic

Summer 1984	Law Clerk to the Hon. Mimi W. Dawson, Commissioner, Federal Communications Commission, and Law Clerk to Bruce E. Fein, General Counsel, Federal Communications Commission.
Fall 1988-Spring 1989	Consultant, Metropolitan Life Insurance Company regarding Illinois discriminatory premium tax litigation.
Summer 1990	Consultant, Metropolitan Life regarding premium tax legislation in Florida.
Summer 1991	Consultant, Metropolitan Life regarding Alabama premium tax legislation.
Fall 1991	Visiting Industry Economist, Commodity Futures Trading Commission, November-December, 1991.
Fall 1995	Consultant, World Bank and Commision Nacional de Seguros y Fianza (Mexican National Insurance Commission).
Summer 1997	Consultant, World Bank regarding Caribbean Catastrophe Risk Management and Mitigation.

Non-academic (con't)

Spring 1997	Consultant, Metropolitan Life regarding Kansas Premium Tax Proposals.
Fall 1998	Consultant, Georgia Legislature, Georgia's Premium Tax.
Fall 2001-Fall 2003	Consultant, Premium Tax Working Group.
Fall 2004	Governor's Office (unpaid), Corporate Income Tax Study Committee
Summer 2005	Governors Office (unpaid), Tax Structure Committee
June 2005-	Contributor at the Manhattan Institute's Web Magazine, Point of Law Forum, www.pointoflaw.com
Fall 2005	Consultant (unpaid), Governors Office and State Insurance Commissioner on Insurance Premium Taxes.

Publications

Refereed Scholarly

1. Shared Inputs, Over-capitalization, and Regulation, 22 *Economics Letters* 381-385 (1986).

2. An Economic Analysis of the Use of Employment Defamation Waivers, with Kelly A. Vaverek, in the *Proceedings of the Southwestern Academy of Federated Administrative Disciplines* 314-318 (1989).

3. Noisy Juries and the Choice of Trial Mode in a Sequential Signaling Game: Theory and Evidence, with J. Gay, J. Kale and T. Noe., 20 *Rand Journal of Economics* 196-213 (1989) (abstracted in the *Journal of Economics Literature*). Reprinted in *Economics, Law and Individual Rights*, ed. by H. Mialon and P. Rubin (Routledge Press: New York), 2008.

4. Multinational Enterprises, Tax Policy and R&D Expenses, with Sanford V. Berg, 57 *Southern Economic Journal* 125-138 (1990).

5. An Examination of Cost Economies in the United States Life Insurance Industry, with Steven G. Timme, 59 *Journal of Risk and Insurance* 72-103 (1992).

6. X-Efficiency in the U.S. Life Insurance Industry, with Lisa A. Gardner, 17 *Journal of Banking and Finance* 497-510 (1993).

7. Financing and the Demand for Corporate Insurance, with Michael J. Rebello, 18 *Geneva Papers on Risk and Insurance Theory*, 147-172 (1994).

8. External Impacts on the Property-Liability Insurance Cycle, with Julie L. Hotchkiss, 62 *Journal of Risk and Insurance*, 738-754 (1995).

9. Risk-Based Capital and Solvency Screening in Property-Liability Insurance: Hypothesis and Empirical Tests, with Scott Harrington and Robert Klein, 65 *Journal of Risk and Insurance* 213-244 (1998).

10. Regulatory Solvency Prediction in Property-Liability Insurance: Risk-Based Capital, Audit Ratios, And Cash Flow Simulation, with J. David Cummins and Richard D. Phillips, 66 (3) *Journal of Risk and Insurance* 417-458 (1999).

11. Urban Homeowners Insurance in Texas: The Search for Redlining, with Robert W. Klein, 68 (4) *Journal of Risk and Insurance* 581-614 (2001).

12. An Economic Appraisal of Securitizing Insurance Risk via Onshore Special Purpose Vehicles," Robert W. Klein, Martin F. Grace, and Richard D. Phillips, (2001) *Risk Management and Insurance Review*, 4: 7-33 awarded the Kemper Award for Best Article in the RMIR for 2001, August 2003.

13. An Economic Appraisal of Securitizing Insurance Risk via Onshore Special Purpose Vehicles, *Risk Management and Insurance Review*. 4(1) 7-34 (2001).

14. Homeowners Insurance with Bundled Catastrophic Coverage, with Robert Klein and Paul Kleindorfer 71 *The Journal of Risk and Insurance* 351-379 (2004).

15. Household Life Cycle Protection: Life Insurance Holdings, Financial Vulnerability and Portfolio Implications, with Yijia Lin 74 *The Journal of Risk and Insurance*. 141-173 (2007).

16. The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation, with Richard D. Phillips 74 *The Journal of Risk and Insurance* 207-238 (2007).

17. Experimental Evidence on Coverage Choices and Contract Prices in the Market for Corporate Insurance, with Michael Rebello and Gautam Gotswami, 11 *Journal of Experimental Economics* 67-95 (2008).

18. Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets, with Richard Phillips, 32 *Journal of Banking and Finance* 116-133 (2008).

19. Catastrophe Loss Reserves: The Case of Florida with Andreas Miladonis, 38 *ASTIN Bulletin* 13-51 (2008).

20. *The Effect of Insurance Premium Taxes on Employment* with David Sjoquist and Laura Wheeler forthcoming in the *Proceedings of the National Tax Association.* (2008).

21. The Perfect Storm: Hurricanes, Insurance and Regulation with Robert W. Klein, forthcoming, *Risk Management & Insurance Review*.

Refereed Scholarly: Under Review

1. *Why do Insurance Insolvencies Cost so Much?*, with Richard Phillips and Robert Klein under review at the *Journal of Risk and Insurance*.

2. *The Economic Consequences of Voluntary Quality Certification Programs: The Case of the Insurance Marketplace Standards Association*, with Robert W. Klein, Center for RMI Research Report 06-01. Revise and resubmit at the *Journal of Risk and Insurance.*

3. *Issues in Measuring the Efficiency of Property-Liability Insurers,* with J. Tyler Leverty, under second review at the *Journal of Banking and Finance.* ***Conditionally Accepted.***

4. *Political Cost Incentives for Managing the Property-Liability Loss Reserve Accrual.* with J. Tyler Leverty revise and resubmit to the *Journal of Accounting Research*.

5. *How Tort Reform Affects Insurance Markets* with J. Tyler Leverty revise and resubmit to the *Journal of Law and Economics.*

6. *The Effect of Insurance Premium Taxes on Employment* with David Sjoquist and Laura Wheeler under review at *the National Tax Journal.*

<u>Refereed Professional</u>

1. Access and the Demise of Settlements and Separations, 112 *Public Utilities Fortnightly* 17-22 (September 1, 1983).

2. The Impact of Medicare's Prospective Payment System on Hospital Behavior, with Jean Mitchell, 2 *Florida Journal of Law and Public Policy* 125-135 (1989).

3. Illinois Premium Tax: Time for Repeal, with Harold D. Skipper, Jr., 14 *Southern Illinois Law Review* 345-399 (1990).

4. Public Utility Underwriting Costs and Regulatory Climate: An Examination of PUC and SEC Overlapping Jurisdictions," with Gotham Vora and Ray Gorman, 10 *Yale Journal of Regulation* 17-62 (1993).

5. Examination of Cross Subsidies in the Workers' Compensation Market, with Jean Kwon, 15 *Journal of Insurance Regulation.* 256-279 (1996).

6. Alternative Approaches to Insurance Regulation: An International Comparison, (Invited Article) with Harold D. Skipper and Robert W. Klein, 6 *Insurance Development and Research* [Publication of the Korean Insurance Development Institute] 73-149 (1997).

7. Insurance Regulation in the United States: Possible Implications for Korea (Invited Article) with Harold D. Skipper and Robert W. Klein, 6 *Insurance Development and Research* [Publication of the Korean Insurance Development Institute], 217-294 (1997).

8. Identifying Troubled Life Insures: An Analysis of the NAIC FAST System, with Scott Harrington and Robert Klein, 16 *Journal of Insurance Regulation* 249-290 (1998). *Winner of Best Paper Award in the JIR for 1998.*

9. Regulating On-shore Special Purpose Reinsurance Vehicles, with Robert W. Klein and Richard Phillips, 19 *Journal of Insurance Regulation* 551-590 (2001).

10. Regulating On-shore Special Purpose Reinsurance Vehicles: A Reply Note, with Robert W. Klein and Richard Phillips, 19 *Journal of Insurance Regulation* 665-670 (2001).

11. Increased Hurricane Risk and Insurance Market Responses with Robert W. Klein and Zhiyong Liu, 24 *Journal of Insurance Regulation* 3-32 (2006).

Monographs

1. Grace, Martin F., Klein, Robert W., Kleindorfer, Paul R. and Michael R. Murray, *Regulation, Pricing and Demand in Catastrophe Insurance Markets*, (Kluwer Academic Press: Boston) 2003.

2. Doherty, Neil *et al. Managing Large Scale Catastrophic Risks*, (Wharton Risk Management and Decision Processes Center: Philadelphia). 2009.

3. Grace, Martin F and Robert W. Klein (eds.) *The Future of Insurance Regulation forthcoming* (Brookings Institution Press: Washington) 2009.

Chapters in Books

1. Neutrality Issues in State Insurance Taxation, with Harold D. Skipper, Jr., *State Taxation of Business* (T. Pogue ed.) Praeger Publishers, pp. 243-256, (1992).

2. Ohio's Corporate Income Tax, with Jorge Martinez, in *Ohio Tax Study*, (Roy Bahl ed), Batelle Press, pp. 511 – 578 (1996).

3. Ohio's Financial Services Taxes, with Jorge Martinez, in *Ohio Tax Study*, (Roy Bahl ed), Batelle Press, pp. 579- 590 (1996).

4. Ohio's Insurance Taxes, with Jorge Martinez, in *Ohio Tax Study*, (Roy Bahl ed), Batelle Press, pp. 591-626 (1996).

5. International Trade in Insurance, with Harold D. Skipper, in *International Insurance* (Harold Skipper, ed.*)* Richard D. Irwin (1997).

6. Efficiency Implications of Alternative Regulatory Structures for Insurance, with Robert W. Klein in *Optional Federal Chartering of Insurance Companies* (ed. by P. J. Wallison) (Washington: American Enterprise Institute) (2000)

7. Auto Insurance Reform: Salvation in South Carolina, in a Joint American Enterprise Institute-Brookings Institution monograph on insurance regulation reform (2001) (ed. by J.D. Cummins).

8. Optional Federal Chartering of Insurance: Rationale and Design of a Regulatory Structure" with Hal Scott in *The Future of Insurance Regulation forthcomin*g Brookings Institution Press. 2009 (ed. by Martin Grace and Robert W. Klein),

9. Insurance Regulation: The Need for Policy Reform with Robert W. Klein in *The Future of Insurance Regulation forthcoming* Brookings Institution Press. 2009 (ed. by Martin Grace and Robert W. Klein),

10. Demand and Supply of Homeowners Insurance: A Multi-state Analysis with Neil Doherty *in At War with the Weather: Managing Large-Scale Risks in a New Era of Catastrophes forthcoming MIT Press, 2009* (ed. by Howard Kunreuther and Erwann Michel-Kerjan).

11. Risk Management in Non-profits in *Nonprofit Economics and Management: The State of Research forthcoming Edward Elgar Publishing 2009*. (ed by Bruce Seaman and Dennis Young).

Non-refereed Scholarly

1. Common Carriers: An Analysis of the Common Law and Modern Applications, in the *Proceedings of the American Business Law Association* 986-1005 (1986).

2. Cycles and Volatility: A Cross-Country Analysis Examining Differences in Regulatory Requirements," *Proceedings of the International Insurance Society* 157-170 (1990).

3. *The Regulation and Structure of Non-Life Insurance in the United States,* with Michael Barth, Policy Research Working Paper (WPS 1155) Financial Sector Development Department, The World Bank, (1993).

4. Restructuring Regulation for Developing Insurance Markets, with Harold D. Skipper and Robert W. Klein, *Proceedings of the International Insurance Society* 235-256 (1997).

5. Excessive State Taxation of the Life Insurance Industry: A Case for Reform, 31 State Tax Notes 31 January 5, 2004). (Reprinted in the *Insurance Tax Review 561-568* (April 2004).

6. Does Georgia Need a Unitary Tax? 31 *State Tax Notes* 361-375 (May 3, 2004).

7. An Examination of Georgia's Premium Tax 29 *State Tax Notes* 815-818, (March 13, 2006)

8. Facing Mother Nature, with Robert W. Klein 30 *Regulation* 28-34 (2007).

Working Papers in Progress

1. The Missing Link: Is Book Value Efficiency Recognized By the Market with J. David Cummins and Richard D. Phillips.

2. Tort Reform: Are There Real Benefits?

3. Dupes or Incompetents? An Examination of Management's Impact on Property-Liability Insurer Distress with James "Ty" Leverty. Center for RMI Research Working Paper 4-09.

4. The Effect of Insurance Premium Taxes on Employment, with David Sjoquist and Laura Wheeler,

Externally Funded Research Projects

1. The Regulation and Industrial Organization of the U.S. Non-Life Insurance Industry, January 1, 1992-June 31, 1992 from the World Bank, $7,500. Project Director and Principal Investigator.

2. NAIC Solvency Project, August 1, 1992-July 31, 1995 from the National Association of Insurance Commissioners, $120,000. Project Director and Principal Investigator (with Scott Harrington, University of South Carolina).

3. Georgia Tax Reform Project, August 1, 1993 - March 31, 1994. Co-Investigator and Senior Research Associate $100,000.

4. Ohio Tax Reform Project, June 1, 1994- December 1995, Co-Investigator and Senior Research Associate, $600,000

5. GSU Electronic Commerce Study, June 1997, Co-Principal Investigator (with Detmar Straub and Robert Klein), $40,000.

6. Urban Insurance Project, January 1999, Co-Principal Investigator (with Robert W. Klein), $20,000.

7. Insurance Receivership project. September 1999. Co-principal Investigator (with Robert Kelin and Richard Phillips), $75,000 from PriceWaterhouseCooper.

8. Special Purpose Reinsurance Vehicles: Economic and Regulatory Analysis, March 1999, Co-principal Investigator (with Robert Klein and Richard Phillips), $50,000 from the Reinsurance Association of America.

9. Housing Insurance Markets, June-August 2003, Co-principal Investigator, (with Robert Klein) $60,000 from the National Association of Realtors.

10. Crop Insurance Project, Investigator, June 2001-December 2005 $20,000 (my portion of $150,000 grant) from the US Department of Agriculture.

11. Value of Ethical Marketing Standards, Jun 2005 – August 2006, Co-principal Investigator (with Robert Klein) $70,000 from the Insurance Marketplace Standards Association.

12. Optional Federal Charters, January 2007-June 2007. Co-principal Investigator (with Robert Klein) $70,000 from the American Council of Life Insurance.

13. Optimal Insurance Regulation, August 2007-July 2008, Co-principal Investigator with Robert Klein) $90,000 from the Risk Foundation.

14. Enterprise Risk Management, August 2007-July 2008, Co-principal Investigator with Richard Phillips, $100,000 from the Risk Foundation.

15. The Economic contribution of the Life Insurance Industry, Aug-October 2008, Principal Investigator, $54,000 from the American Council on Life Insurance.

Select Papers Presented at Professional Meetings

"Common Carriers: An Analysis of the Common Law and Modern Applications," presented at the American Business Law Association Annual Meeting, Minneapolis, MN, August 1986.

"Cost Allocation Regulation," presented at the Southern Economic Association Annual Meeting, New Orleans, LA, November 1986.

"Are Warranties Truly Signals of Product Quality?" presented at the Southern Economics Association Annual Meeting, San Antonio, TX, November, 1988.

"Cost Sharing Regulation in a Multiproduct Firm: Hospital Cost Allocations under Charges and 'PPS,'" presented at the American Risk and Insurance Association Annual Meeting, Reno, NV., August 1988, and the Health Economic Research Organization Annual Meeting, New York, NY, December 1988, with Jean Mitchell.

"The Law and Economics of Defamation Waivers in an Employment Setting," presented at the Southwestern Academy of Federated Administrative Disciplines Annual Meeting, New Orleans, LA, March 1989.

"Impacts of Tort Reform on Insurance Markets," with J. Kale and T. Noe, presented at the American Risk and Insurance Association Annual Meeting, Denver, CO, August 1989.

"Illinois Discriminatory Premium Taxation: Time for Repeal?" with Harold D. Skipper, Jr., presented at the American Business Law Association Annual Meeting, Los Angeles, CA, August 1989.

"The Impact of State Policy Variables on the State's Underwriting Cycle," with Harold D. Skipper, Jr., presented at the American Risk and Insurance Annual Meeting, Denver, CO, August 1989.

"The Effect of Liability Caps and Tort Reform on the Viability of the Medical Malpractice Insurance Market," with J. Kale and T. Noe, presented at the American Risk and Insurance Annual Meeting, Denver, CO, August 1989.

"Noisy Juries and the Choice of Trial Mode in a Sequential Signaling Game: Theory and Evidence," with J. Gay, J. Kale and T. Noe., presented at the American Business Law Annual Meeting, New Orleans, LA, August 1988 and at the Econometric Society Annual Meeting, New York, NY, December 1988.

"An Examination of Cost Economies in the United States Life Insurance Industry," with Steven G. Timme, presented at the American Risk and Insurance Association Annual Meeting, Orlando, FL, August 1990.

“Neutrality Issues in State Insurance Taxation," with Harold D. Skipper, Jr., presented to the National Tax Association Seminar on State Taxation, San Antonio, TX, February 1991.

“Determinants of Interstate Differences in Insurance Tax Intensity," with Harold D. Skipper, Jr., presented at the American Risk and Insurance Association, San Diego, CA, August 1991.

“Determinants of International Supply and Demand for Non-Life Insurance," with Harold D. Skipper, Jr., presented at the Annual Meeting of the European Association of Risk and Insurance Economists, Mons, Belgium, September 1991.

“External Impacts on the Property Liability Insurance Cycle," with Julie Hotchkiss, presented at the 1992 Risk Theory Seminar, Gainesville, FL, April, 1992.

“X-Efficiencies in the U.S. Life Insurance Industry," with Lisa A. Gardener, presented at the American Risk and Insurance Association Annual Meeting, Washington DC, August 1992 and the GSU-Federal Reserve Conference, "Efficiency in the Financial Service Industries," Atlanta, GA, September 1992.

“Efficiency Comparisons Between Mutual and Stock Life Insurance Companies." with Lisa A. Gardner, Presented at the American Risk and Insurance Association Annual Meeting, San Francisco, CA, August 1993 and at the European Risk and Insurance Economists Association, Rotterdam, The Netherlands, September 1993.

“Solvency Regulatory Forbearance in the U.S. Property-Liability Insurance Industry,” presented to the American Risk and Insurance Association Annual Meeting, Toronto, ON, August 1994.

“Measuring the Relative Efficiency of the Production of Regulation by the States: An Examination of the U.S. Insurance Regulatory System” with Richard D. Phillips. Presented at the Annual Meeting of the Risk Theory Society, Madison, WI, March 1996.

“Firm Efficiency and the Likelihood of Insolvency in the U.S. Insurance Industry,” presented to the American Risk and Insurance Association Annual Meeting, Seattle, WA, August 1995.

“The Effect of Premium Taxation on State Labor Markets” with Boaz Yam, presented to the American Risk and Insurance Association Annual Meeting, Philadelphia, PA, August 1996.

“Regulatory Solvency Prediction in Property-Liability Insurance: Risk-Based Capital, Audit Ratios, And Cash Flow Simulation,” with J. David Cummins and Richard D. Phillips, presented at the 5th Insurer Insolvency and Finance Conference, London, UK, June 1997.

“A Game Theoretic Examination of Retaliatory Taxation: Evidence and Implications”, presented to the American Risk and Insurance Association Annual Meeting, San Diego, CA, August 1997.

“The Cost and Availability of Homeowners Insurance in Urban Areas: An Empirical Analysis” with Robert W. Klein, presented to the American Risk and Insurance Association Annual Meeting, Boston, MA, August 1998.

“The Profit Efficiency of Information Technology Investments – A Comparison of Alternative Distribution Mechanisms in the US Property-Liability Insurance Industry,” with James R. Garven, presented to the American Risk and Insurance Association Annual Meeting, Boston, MA, August 1998.

“The Allocation of Governmental Regulatory Authority within a Federal system of Government” with Richard D. Phillips, presented to the American Risk and Insurance Association Annual Meeting, Boston, MA, August 1998.

“Regulatory Solvency Prediction in Property-liability Insurance: Risk-based Capital, Audit Ratios, And Cash Flow Simulation" with J. David Cummins, Richard D. Phillips presented to the Actuarial Research Conference, Atlanta, GA. August 1998.

“Regulatory and Economic Issues Involving E-commerce in the Insurance Industry WP 98-2. Presented at the Competitive Enterprise Institute, Washington, DC. April, 1998 *and* at GSU’s E-Commerce Conference October 1998.

“The Cost and Availability of Homeowners Insurance in Urban Areas: An Empirical Analysis”, with Robert W. Klein presented to the Georgia State Department of Economics.

“The Industrial Organization of the U.S Life Industry” with Robert W. Klein presented at the ARIA Annual Meeting, August 1999, Vancouver. BC.

The Supply and Demand of Catastrophe Insurance presented to the Wharton/ISO Research Board, Philadelphia, PA, December 1999.

“The Missing Link: Is Book Value Efficiency Recognized By the Market” with J. David Cummins and Richard D. Phillips,” presented to the American Risk and Insurance Association Annual Meeting Montreal, PQ, August 2002.

“The Missing Link: Is Book Value Efficiency Recognized By the Market” with J. David Cummins and Richard D. Phillips,” presented to the 9th Symposium on Banking and Insurance, Karlsruhe, Germany, December 2002.

“Dupes or Incompetents? An examination of management’s impact on property-liability insurer distress” with Ty Leverty, National Bureau of Economic Research, January, 2005.

“Reserve Error Motive, Manipulation or Mistake?, with Ty Leverty, World Risk Insurance Economic Congress, August 2005. Casualty Actuarial Society, Best Paper Award for WRIEC 2005 Meeting.

“Tax-deferred Pre-event Catastrophe Loss Reserves: The Case of Florida” with Andreas Milidonis, World Risk Insurance Economic Congress, August 2005.

Contracts under Pressure: Liability Implications After Katrina, American Enterprise Institute, October 3, 2005 (Broadcast on CSPAN).

Liability Issues after Katrina, National Ass’n of Mutual Insurers, Policy Forum, November 2005.

Medical Malpractice, American Enterprise Institute December 2005, (Broadcast on CSPAN)

“Reserve Error Motive, Manipulation or Mistake, with Ty Leverty, Risk Theory Seminar, April 2006.

“The Economic Consequences of Voluntary Quality Certification Programs: The Case of the Insurance Marketplace Standards Association,” with Robert W. Klein, American Risk and Insurance Annual Meeting, Washington DC, August 2006.

“The Supply and Demand of Catastrophe Insurance,” Wharton Cat Project, Philadelphia, PA December 2006.

“The Welfare Implications for Tax-Deductible Pre-Event Catastrophe Loss Reserves”, with Andreas Milidonis, American Risk and Insurance Annual Meeting, Quebec City, August 2007.

“The Effects of an Optional Federal Charter on Competition in Life Insurance and Annuities Markets” with Robert Klein, American Risk and Insurance Annual Meeting, Quebec City, August 2007.

"Adverse Selection in Reinsurance Markets," with James R. Garven, American Risk and Insurance Annual Meeting, Quebec City, QB August 2007.

Premium Deceit or Legislative Deceit: Does Tort Reform Cut Insurance Premiums? With James T. Leverty, American Risk and Insurance Annual Meeting, Quebec City, August 2007.

Supply and Demand Analysis of Catastrophe Insurance with Neil Doherty, presented to the Wharton Catastrophic Project Meeting, National Association for the Advancement of Science, Washington DC, October 2007.

"The Effect of Insurance Premium Taxes on Employment with David Sjoquist and Laura Wheeler, presented at the National Tax Association Annual Meetings, Columbus, OH, November 2007

How Tort Reform Affects Insurance Markets, with J. Tyler Leverty, *presented at the Searle Research Symposium on Insurance Markets and Regulation, Northwestern University Law School, Chicago, IL,. April 2008.*

The Past and Future of Insurance Regulation: The McCarran-Ferguson Act and Beyond *with Robert W. Klein presented at the Searle Research Symposium on Insurance Markets and Regulation, Northwestern University Law School, Chicago, IL,. April 2008.*

The Perfect Storm: Hurricanes, Insurance and Regulation, with Robert W. Klein presented at the NBER Insurance Project conference, Cambridge MA May 2008.

Issues in Measuring the Efficiency of Property-Liability Insurers, with J. Tyler Leverty presented at the Journal of Banking and Finance Special Issue conference, London, UK, July 2008.

How Tort Reform Affects Insurance Markets, with J. Tyler Leverty, *presented at the Florida State College of Law, September 2008.*

Federal Insurance Regulation, ACLI Annual Conference, Boston, October 2008.

A Reexamination of Federal Regulation of the Insurance Industry, presented to the 6th Annual NFI Forum, Washington, DC March 2009.

Dissertation Committee Service (Committee member unless otherwise noted)

Elizabeth Goldin, Insurance, no degree, 1988.

Kenneth Young, "Essays on Information Effects on Capital Markets," Finance Ph.D. 1989.

Yong Kil Shin, "Essays on Anticipated versus Unanticipated Security Issues: Evidence on Capital Structure and Signaling Hypothesis," Finance Ph.D. 1990.

Kwangbong Lee, "Capital Market and Risk Theory in Reinsurance Decision Making: Empirical Tests on Life Insurance Demand," Insurance Ph.D. 1991.

Imbum Cheong, "An Analysis of Financial Regulation and Insolvency in Life Insurance," Insurance Ph.D. 1991.

Sung Chang Jung, "Syndicated Underwriting of Equity Issues and Information Production: Theory and Evidence," Finance Ph.D. 1991.

Sung Min Kim, "Information Production of Underwriters and the Underwriting of Initial Public Offerings," Finance Ph.D. 1991.

Lisa A. Gardner, "An Analysis of Cost Inefficiencies in Life Insurance Companies," Insurance Ph.D. 1992.

Janet Payne, "The Information Content of Repeated Security Offerings," Finance Ph.D. 1992.

Arthur Young, "Institutional Investors, Monitoring, and Firm Performance," Finance Ph.D. 1994.

Sharon Taylor, "Cycles in the Health Insurance Industry," Insurance Ph.D. 1994.

Don Yolun-Mathews, "An Economic Theory of the State," Economics Ph.D.1993.

Loren Williams, "The Economics of State Mandates," Economics, Ph.D., 1993.

Loriliee Medders, "Workers Compensation under Single Moral Hazard,", Insurance Ph.D., 1995, Chairman.

Jean Kwon, "Workers Compensation and Cross-Subsidization," Insurance Ph.D. 1995, Chairman.

Hun Soo Kim, "The Efficiency of Mergers in the U.S. Life Insurance Industry," Insurance Ph.D. 1995, Chairman.

Michael Jordan, "A Computable General Equilibrium Model for the Individual Life Insurance Business in the United States, " Economics, Ph.D. 1997, member.

Fitzroy Lee, "Optimal Taxation of the Telecommunications Industry," Economics Ph.D. , 1997

Susan R. Snyder, 2000, "The Effect of Physician Compensation on Health Care Provision," Economics Ph.D, member.

Sal Saheli, "A Computable General Equilibrium Model of the State of Georgia," Economics Ph.D. 1997, member.

Tsai, Chenshein, A new rationale for the existence of random-premium policies : theory and empirical tests, member 1998.

Pam Boonyasai, 1999, The Effect of Liberalization and Deregulation on Life Insurance, Ph.D., member.

Patrica Ketche, Marginal Effective Tax Rates and the Demand for Health Insurance, Ph.D. 2000, member

Ian Webb, The Effect of Financial Intermediation on Economic Growth, member. Ph.D. 2000.

Minglai Zhu, The effect of income taxation on life insurance purchases and private pension contributions, Ph.D. Chair 2003.

Shahur, Husayn, Industry structure and horizontal takeovers : analysis of wealth effects on rivals, suppliers, and corporate customers, member 2003.

James Leverty, Methodological Issues in Efficiency Analysis, Chair, Ph.D. 2005.

Paul Kagunda, Member, Ph,D Economics, 2006.

Artidiantun Adji Member, PhD. Economics 2007

College Committee Assignments

Faculty Development Committee, 1996-1999

Research Program Council, 1993-present

Digital Commerce Curriculum Committee, 1997-1998

Promotion and Tenure Committee, 1999-2001, 2006-

Digital Commerce Director Search Committee, 1999

Economics Department Chair Search Committee, 2000

Doctoral Committee 1993-2001, 2003-2006

University Committee Assignments

Member, Ad Hoc University Committee on Information Infrastructure, 1995.

Member, University Senate, 2000-2002

Member, Andrew Young School Evaluation Committee, 2002

Significant Service Activities within the Academic Unit during the Past Five Years

Member, Department Scholarship and Fellowship Committee, 1987-present.

Member, Department Faculty Recruitment Search Committee, 1993-present.

Member, Department Curriculum Committee, 1995-present.

Center for Risk Management and Insurance Research, Associate Director, 1993-present.

Ph.D. Coordinator, 1993-2001, 2003-2006.

Chair, Faculty Search Committee, 2004-2007.

Chair, Departmental P&T Committee, 2003, 2005, 2007

Member, RMI-CIS Working Group, 2005-2007

Service Activities in Academic and Professional Organizations

Governor's Office, Corporate Income Tax Study Committee, 2004 -2005.

Risk Theory Seminar Organizer, Atlanta, 2003

Associate Editor, *The Journal of Risk and Insurance*, 1994-present.

Staff Editor, *American Business Law Journal*, 1987-1994.

Reviewer, Journal *of Risk and Insurance*.

Reviewer, *Southern Economic Journal*.

Reviewer, *Journal of Economics and Business*

Reviewer, *Geneva Papers on Risk and Insurance Theory*

Reviewer, *CPCU Journal*.

Reviewer, *Journal of Banking and Finance*

Reviewer, Journal of Financial Intermediation

Member, Shadow Insurance Regulatory Committee, 1999-2001.

Member of the Board, Southern Risk and Insurance Association, 1993 - 1997

Member, American Business Law Association Research Committee, 1988.

Co-organizer, GSU/Atlanta Federal Reserve Bank, *Conference on Financial Service Industry Efficiency*, 1992.

Member, American Risk and Insurance Association, Kulp Wright Book Award Committee, 1989-1991, 1993, 1994, 2001.

Member, American Risk and Insurance Association, Conference Organizing Committee, 1991, 1993, 1995.

Member, American Risk and Insurance Association, Nominations Committee, 1991, 1993.

Member, Florida Bar, 1987-.

Placement Coordinator, American Risk and Insurance Association, 1994 –2000.

Member, Risk Theory Society, 1992 -

Organizer of 1994 Risk Theory Society Meeting in Atlanta, GA.

Secretary, Risk Theory Society, 1995-1996.

President, Risk Theory Society, 1996-1997.

Co-organizer of Future of Insurance Regulation conference held at the American Enterprise Institute, July 2008.

Instruction in Continuing Education Activities

International Visiting Fellows Program, 1993- 2007.

Legal Risk Management, CERMAS Certificate Program, 2005, 2006.

Electronic Commerce, International Visiting Fellows Program, 1998-2006.

Russian Tax Training Seminar, Corporate Income Taxation, Insurance Taxation, 1994-1995.

Chinese Tax Training Seminar, Corporate Income Taxation, Insurance Taxation, 1994.

Russian Business Development Training Seminar, Corporate Income Taxation, Insurance Taxation 1995.

Kazakistan Tax Training Seminar, Corporate Income Taxation, Insurance Taxation, 1996.

Sri Lanka Tax Training Program, Financial Institution Taxation, 1999.

Texas Farm Bureau Executive Education Program. 2008

Statement Regarding Federal Grants or Contracts

I receive no funds from any current federal grants or contracts. Further, I have not received such grants are contracts in the past two years. My employer, Georgia State University, has received and continues to receive grants and contracts from the U.S. Government typical of a research university, but I receive no direct benefit from these grants or contracts. Further any grants and contracts received by the University are not relevant to the subject matter of my testimony.

Statement of Scott E. Harrington
Alan B. Miller Professor
The Wharton School, University of Pennsylvania

On "How Should the Federal Government Oversee Insurance?"

Before the
Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

May 14, 2009

Chairman Kanjorski, Ranking member Garrett, and members of the Subcommittee:

I am pleased to have this opportunity to testify on an issue of fundamental importance to the economic security of individuals and businesses in this country. My main points are as follows:

1. Insurance is not banking and should not be regulated as if it were. The case of AIG notwithstanding, insurance markets are characterized by minimal systemic risk and by strong market discipline. Any new federal regulatory initiatives encompassing insurance should be designed not to undermine the strong market discipline that presently exists.

2. The creation of a systemic risk regulator with authority to regulate "systemically significant" insurance organizations would likely have several adverse consequences. It could easily undermine insurance market discipline and reduce competition without significantly lowering the likelihood of future crises. There is also no compelling reason to expand federal authority for the resolution of financially distressed insurers.

3. Legislative proposals for optional federal chartering of insurance companies should be designed to the extent possible not to undermine market discipline and should specifically seek to avoid expanding the scope of explicit or implicit government guarantees of insurers' obligations.

Insurance is not banking and should be regulated differently

Insurance markets are fundamentally different from banking. Sensible regulation, including the design of government guarantees of banks' and insurers' obligations, should recognize the differences. Government guarantees help reduce systemic risk. Virtually everyone knows that they also create moral hazard: they reduce market discipline. Greater systemic risk – the risk that financial problems at one institution involve major spillovers that threaten other institutions and the overall economy – favors stronger government guarantees to prevent runs and contain spillovers, along with more stringent regulation to mitigate the additional moral hazard induced by stronger guarantees.

Systemic risk is much greater in banking than in insurance. Depositor and creditor runs on banks threaten the entire payment system. Banking crises involve immediate and widespread harm to economic activity and employment. This systemic risk provides some rationale for relatively broad government guarantees, both explicit and implicit, of bank obligations. Because such guarantees undermine market discipline, they create a need for tighter regulation, including more stringent capital requirements. The need for relatively stringent capital requirements in turn creates pressure from banks to relax capital requirements and/or to make them more accurate. The first and second Basel accords in part reflect this pressure.

Insurance is inherently different, especially property/casualty and health insurance. There is much less systemic risk and thus need for government guarantees to prevent widespread runs that would destabilize the economy. Insurance guarantees have appropriately been narrower in scope than in banking. Capital requirements have been much less binding. Because insurance capital requirements generally bite less; their accuracy generally has been less important.

Despite these differences, there has been pressure for and movement towards applying bank models of capital regulation to insurance, as illustrated by some proposals for federal insurance regulation and by the Solvency II initiative in the European Union. I regard these developments as misguided. They reflect excessive optimism concerning the ability of seemingly sophisticated regulation to substitute for market discipline, and they pay too little attention to promoting market discipline. Any new regulatory initiatives regarding insurance in the United States should avoid this path.

A systemic risk regulator would be counterproductive for insurance entities

The potential benefits of creating a systemic risk regulator that would have authority to regulate nonbank institutions strike me as relatively modest and highly uncertain. Regarding insurance, creation of such a regulator with authority to designate particular insurers as systemically significant and therefore subject to its authority would have several adverse consequences. There is likewise no compelling case at present to create or expand federal authority to intervene with and/or resolve financially distressed insurers.

There are at least three major problems with the proposed creation of a federal entity with authority to regulate any insurer it deemed to be systemically significant:

First, market discipline could easily be undermined with an attendant increase in moral hazard. Any insurer designated as systemically significant would be regarded by many market participants as too big to fail. The implicit if not explicit government backing of its obligations and operations would lower its cost of funding and increase its incentives to take on risk. I am skeptical that tougher capital requirements or tighter regulation of such firms would be adopted and, if so, effective in limiting such risk taking over time. Government / taxpayer bailouts could become more rather than less likely.

Second, level competition between insurers designated as systemically significant and those not so designated would not be possible. Insurers designated as systemically significant would likely have a material competitive advantage. The resulting distortions would tend to increase market concentration and amplify the moral hazard problem.

Third, given the lessons from the current crisis and the earlier savings and loan crisis, it is hardly certain that a systemic risk regulator would be an effective means of limiting risk in a dynamic, global environment. Even without any increase in moral hazard, it could be ineffective in preventing a future crisis, especially once memories of the current crisis fade. This crisis underscores (a) the imperfect nature of federal regulation of banks and related institutions, (b) the necessity of renewed vigilance in bank oversight, and (c) the desirability of encouraging additional market discipline in banking.

Apart from the unique case of AIG, the insurance sector has thus far withstood the events of the past two years tolerably if not remarkably well. That some large life insurers need to replenish capital is hardly surprising, given the sharp fall in equity values, the reductions in values of mortgages and other real estate holdings, and minimum return guarantees provided on many of their products. The AIG intervention, in response to a liquidity crisis resulting from banking and securities-type activities, often with banks as counterparties, was not due to its insurance operations. Those operations appear to have been fundamentally sound at the time of intervention.

The ultimate consequences of having extended “too big to fail” (TBTF) policy to the largest publicly-traded insurance organization, in significant part to protect bank counterparties, are still uncertain. It can be argued plausibly that bankruptcy for AIG, perhaps with additional direct assistance to some of its counterparties, would have been preferable. In any case, however, the lessons to be learned from the AIG anomaly do not include the need for a systemic risk regulator with authority over insurance companies.

Federal intervention in insurance regulation, if any, should be designed to encourage, or at least not undermine, market discipline

Before the AIG intervention, insurance markets had been largely outside the scope of TBTF regulatory policy. Consistent with lower systemic risk, state guarantees of insolvent insurers’ obligations are limited, which reduces moral hazard and helps preserve market discipline. Customers, especially business insurance buyers, and agents / brokers generally pay close attention to insolvency risk. Ex post funding of state guaranty association obligations by assessments against surviving insurers’ obligations is appropriate. Insurers can respond effectively to such assessments without pre-funding. Ex post funding also provides incentives for financially strong insurers to press for effective regulatory oversight. Some people advocate pre-funding of guarantees with risk-based premiums. It is unlikely, however, that meaningful risk-based premium variation would be achieved in practice. Pre-funding would sacrifice the advantages of ex post funding without achieving enough risk-rating to significantly improve incentives.

If the Subcommittee in due course considers possible adoption of optional federal chartering and regulation of insurers, I hope that it will do so in view of possible alternatives, such as those that could encourage regulatory competition among the states or possibly preempt anti-competitive state regulation. In any event, I urge you to recognize the fundamental importance of avoiding expanded government guarantees of insurers’ obligations. Under optional federal chartering, this might be achieved in principle by requiring federally chartered insurers to participate in the state guaranty system and/or by designing federal guarantees along the lines of existing state guarantees. The design of any government guarantees also might be tailored in principle to help encourage additional market discipline. It should be recognized from the outset, however, that a monopoly federal guaranty program might ultimately ensue with optional federal regulation.

Incentives for safety and soundness, too big to fail, and the housing bubble

Appropriate policy responses to the housing / mortgage finance bubble, whether for banks, insurers, or other financial institutions, require a full understanding of what went wrong and why. Many commercial banks, investment banks, thrifts, hedge funds, mortgage originators, subprime borrowers, and AIG placed heavy bets on continued housing price appreciation and against any fall in prices. They gambled, and the losses have been both huge and widespread.

Why did so many players place these bets? A simple yet significant part of the answer is that the potential gains and losses were asymmetric. If housing prices continued to climb, or at least not fall, the participants could achieve large payoffs. If housing prices failed to appreciate, or even fell, the losses would be largely borne by others. Before they became de jure, de facto guarantees of government sponsored enterprises' debt lowered their financing costs and contributed to mortgage credit expansion and housing price appreciation. Bank deposit insurance and implicit guarantees of banks' obligations encouraged risky lending and investment, especially given political pressure to expand subprime lending. The shift to corporate ownership of investment banks, with limited liability, plausibly encouraged them to take on more risk in relation to capital, especially given expanded competition with investment banking affiliates of bank holding companies. The SEC's adoption in 2004 of consolidated supervision allowed large investment banks to substantially increase leverage, in significant part by taking on more subprime exposure. Many subprime mortgage originators were new entrants with little reputational capital at risk and only modest participation in the risk of underlying mortgages. The Federal Reserve helped finance these risky bets by keeping short-term interest rates at historically low levels, thus fueling demand for credit and housing, and encouraging relaxation in historical mortgage lending standards.

Given what we know, the major objectives of any changes in federal regulatory policy should be to encourage market discipline as a means to incentivize safety and soundness, and to avoid further extension of explicit or implicit TBTF policies beyond banking. Creation of a new systemic risk regulator and/or expanded federal resolution authority for distressed insurers and other nonbank institutions could easily run counter to both objectives. The potential benefits seem modest in relation to the potential adverse results and risks of unintended consequences.