TESTIMONY OF
WAYNE F.WHITE
PRESIDENT & CHAIRMAN OF
HOME MUTUAL FIRE INSURANCE COMPANY

ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

ON INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT-SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 4, 2002

Chairman Baker, and members of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, my name is Wayne White. I am President and Chairman of Home Mutual Fire Insurance Company in Conway, Arkansas.

Today, I am here as a representative of the National Association of Mutual Insurance Companies (NAMIC). It is an honor to have this opportunity today to address you at this hearing on "Insurance Regulation and Competition for the 21st Century."

I have been asked to discuss the history of state insurance regulation, including the evolution of the National Association of Insurance Commissioners (NAIC); the role of advisory organizations like the Insurance Services Office (ISO) in creating standard forms and collecting loss control data; the effect that rating agencies like A.M. Best and Standard & Poor's have on the insurance industry; and, finally, to provide you with NAMIC's perspective on the future of insurance regulation.

As you may know, the first insurance company formed in the American colonies was actually a mutual: The Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. It was created in 1752 after Benjamin Franklin and a group of prominent Philadelphia citizens came together to help insure their properties from fire loss.

In those early days before America declared its Independence from British rule, most insurance companies followed the Contributionship model; that is, groups of neighbors typically formed entities to help each other avoid the certain financial ruin that would befall them if their properties were destroyed by fire.

While we honor our roots, today's mutual industry also has a clear vision of the future. I come here today to speak in defense of the proposition that a reformed system of state insurance regulation is superior to an unproven system of federal regulation.

NAMIC's position is representative of a dynamic cross section of the property/casualty (p/c) industry. We are the nation's largest p/c trade association with 1,300 members that underwrite 40 percent of the p/c insurance premium written in the United States. NAMIC's membership includes 5 of the 10 largest p/c carriers, every size regional and national insurer and hundreds of farm mutual insurance companies.

Because of our position, NAMIC welcomes this series of hearings. At their conclusion, we believe you and your colleagues will reach the same judgment as our member companies: while insurance regulation cries out for reform, industry governance is best based in the states.

Calls for reform of the state insurance regulatory system have been heard for years but little substantive reform, other than the NAIC financial accreditation program, has occurred. Frustrations have grown as the marketplace becomes more competitive, and more global. Complicating matters further is that the NAIC is often --wrongly in our view -- held to account for implementation of sweeping reform.

THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

By the middle of the 19th century, several insurance entities, like the Philadelphia Contributionship, had expanded beyond their original neighborhoods or cities and had begun to insure residents in other parts of their states. State legislators took notice of this development and believed that a more formal system of insurance regulation was needed, the first of which was established in New Hampshire in 1851.

In May 1871, insurance regulators from around the country convened the first meeting of the National Convention of Insurance Commissioners (later the NAIC). Regulators adopted the following objectives to help each other regulate companies doing business in more than one state:

- To promote uniformity in legislation affecting insurance;
- To encourage uniformity in departmental rulings under the insurance laws of the several states;
- To disseminate information of value to insurance supervisory officials in the performance of their duties;
- To establish ways and means of fully protecting the interest of insurance policyholders of the various states; and
- To preserve to the several states, the regulation of the business of insurance.

Indeed, the early work of the NAIC was focused on achievement of uniformity in the regulation of national companies. By 1981, the NAIC's purpose was streamlined as follows:

- Maintenance and improvement of state regulation of insurance in a responsive and efficient manner;
- Reliability of the insurance institution as to financial solidity and guarantee against loss; and
- Fair, just and equitable treatment of policyholders and claimants.

While states continue to regulate the business of insurance today, the federal government has had an abiding interest over the years in how well the industry has been regulated.

The first Supreme Court of the United States decision on state versus federal power to regulate insurance was Paul v. Virginia (1869). The Court held that delivery of an insurance policy in Virginia issued by a New York company was not interstate commerce. A narrow definition of "commerce" was employed by the Court. As a mere contract rather than a physical good or commodity, Congress was not empowered to regulate it.

Around the time of the Paul case, segments of the industry, responding to fierce rate and commission competition that had resulted in enough failures to damage public confidence, organized themselves into rating bureaus to establish and maintain adequate rates, control excessive commissions and standardize policy forms. These industry-run "cartels" operated through the mid-1940's without disruption.

In 1944, the Supreme Court redefined insurance as interstate commerce, triggering passage of the McCarran-Ferguson Act by Congress the following year. Under McCarran, states can preempt federal anti-trust laws by regulating the business of insurance. The industry and the NAIC were given three years to devise a regulatory framework that could be put into effect across the country to halt enforcement of federal anti-trust and discrimination acts.

Toward that end, the NAIC developed model acts and regulations related to insurance rates and policy form language that were quickly enacted by the states. Industry bureaus, at issue when Paul was overturned, were given new life. Although the new state laws typically subjected bureau rates to regulator endorsement, companies were either required or at least strongly encouraged to employ bureau-established rates. This set of circumstances gave birth to the present regime of prior approval for property-casualty products now operational in more than half the states, against which many of the arguments in favor of speed to market reform are based.

In the late 1980s and early 1990s the House Energy and Commerce Committee held a series of hearings, not unlike what this Subcommittee is doing today, to question state regulators in the wake of some highly publicized insurer insolvencies.

The House Energy and Commerce Committee's persistence in challenging regulators was instrumental in the NAIC adopting its Financial Regulation Standards and Accreditation Program in 1989. The program consisted of a set of financial regulation standards for state insurance departments, which identified model laws and regulations, and regulatory, personnel and organizational processes and procedures necessary for effective solvency regulation.

Nearly all the states, with the help of their legislatures, subsequently adopted the accreditation standards, but this has not stopped Congress and others from continuing to ask probing questions about the continued viability of the program. As recent as August 2001, a report prepared by the General Accounting Office outlined "gaps and weaknesses" in the accreditation program in response to the Martin Frankel fraud scandal. This, in turn, has caused the NAIC to re-evaluate certain aspects of its accreditation standards.

Clearly, this type of "oversight" of state insurance regulation seems appropriate for Congress to continue to pursue. It is also important here to mention another "role" that Congress has played with respect to state insurance regulation in the past decade. In 1992, Congress enacted legislation that had the effect of standardizing the Medicare supplemental insurance policies. While Congress mandated this requirement, it was left to the NAIC and the states to "design" the standardized forms and to implement their use in each state.

While this particular piece of legislation appears to have worked well in protecting citizens from purchasing unnecessary multiple Medigap policies, it is not yet clear to us whether this approach would work for other lines of insurance or in possibly bringing more uniformity to certain state regulatory functions.

The Gramm-Leach-Bliley Financial Services Modernization Act (GLBA) contained at least two provisions directly affecting state insurance regulation. The first called on state regulators to develop a better system of licensing out-of-state insurance producers, or face a Congressionally mandated entity to perform that function.

Regulators responded with a uniform producer licensing model act and two years' worth of effort enacting it in most state legislatures. As of May 2002, 45 states have passed the model act or other licensing laws to satisfy the reciprocity licensing mandates of GLBA. Five more state legislatures are considering the model act this year. At the same time, regulators have begun to coalesce behind a plan to develop a national database for processing producer applications.

While improvements are still needed, it does appear that regulators have met your mandate and are creating an improved producer licensing process.

The other GLBA provision required insurers to protect the nonpublic personal information of their policyholders. Forty-nine states and the District of Columbia have met the GLBA privacy standards, largely based on the NAIC privacy model. Discussion is now focused on developing uniform interpretations of the law in each state.

Taking the intent of GLBA one step farther, regulators agreed to a "Statement of Intent" in March 2000 outlining their desire to change the organizational structure of insurance regulation to better address the rapidly evolving changes to the financial services industry.

This brief review of the NAIC's origins and its objectives over the years can only lead to the conclusion that the NAIC is the protector of the principles of insurance regulation in general and state regulation in particular and as such it should be the source of comprehensive reform.

However, in our judgment this is incongruent. In describing its own work, the NAIC has said that regulators have long realized that diversity and experimentation are strengths of the state system, but they also recognize that the basic legislative structure of insurance regulation requires some degree of uniformity throughout the states. This inherent tension between sovereignty and uniformity in the context of a voluntary organization of mostly appointed state officials with no authority to enact the models they write has produced both large expectations and large disappointments.

While one must be cautious not to over-evaluate the NAIC's efforts, it is an obvious question to ask how they have done. Regulators have met the requirements imposed on them by GLBA. They also have spent considerable time in the past two years discussing how to make certain of their processes and procedures more uniform. For example, all jurisdictions now use a uniform licensing application for companies, and a new project is underway to determine what requirements are necessary and can be made uniform for insurers after a merger or acquisition.

As my home state commissioner Mike Pickens likes to say, "the NAIC has a good story to tell," and they will be here to tell it themselves as part of these hearings.

NAMIC is encouraged by the NAIC's post-GLBA performance with respect to the mandated tasks as well as the Statement of Intent initiative. The NAIC also deserves recognition for focusing attention on key marketplace improvements such as speed-to-market and market conduct for which NAMIC member-companies are asking. Out of necessity, much of their work concerns the procedural or functional aspects of regulation. Unfortunately, by themselves, better procedures do not satisfy the deeper needs of the industry.

While individual state regulators can recommend standards for reform and raise the profile of important market reform issues, they cannot act alone. Simply put: the NAIC cannot be expected to do what it is not empowered to do, that which is the most pressing task for all of us concerned about the future of the insurance industry: enactment of fundamental public policy reform.

In the final analysis, before Congress intercedes, state legislative action must be the focus of modernization initiatives. There are important and effective national organizations prepared to lead reform efforts in the states.

ROLE OF NATIONAL LEGISLATIVE ORGANIZATIONS

NCOIL. The National Council of Insurance Legislators was formed in 1969 to help legislators make informed decisions on insurance issues affecting their constituents and to oppose any encroachments of state authority in regulating insurance.

NCOIL members collectively represent residents in states where 90 percent of insurance premium is written each year. In addition to conducting annual meetings/seminars for its members, NCOIL has been instrumental over the years in developing its own set of model laws that have been enacted in several states. These models have addressed issues such as financial information privacy, mental health parity, life settlements, long-term care tax credits, federal choice no-fault, commercial lines deregulation and property/casualty domestic violence.

NCOIL was the first organization of state officials to support establishment of a federal backstop to cover terrorism, sending a letter in support of such an initiative to House leadership in October 2001. The leadership of NCOIL also has testified at several Congressional hearings in opposition to initiatives that would have created a dual system of insurance regulation, in opposition to Congressional initiatives that would have usurped the existing authority of states to regulate insurance rates, and on the viability of having an interstate compact to govern key aspects of insurance regulation.

ALEC. The American Legislative Exchange Council was founded in 1973 by a small group of bipartisan state legislators with a common commitment to the Jeffersonian principles of individual liberty, limited government, federalism, and free markets. Today, ALEC has grown to become the nation's largest bipartisan individual membership organization of state legislators, with more than 2,400 members in 50 states.

ALEC remains committed to preserving the state regulation of insurance and has developed its model Property/Casualty Insurance Modernization Act to facilitate the replacement of outmoded, inefficient insurance regulations with market-based reforms. In addition, ALEC has developed a special project, national in scope, designed to educate state lawmakers about the importance of making insurance regulatory changes that are less intrusive and more uniform in nature, which is one of the primary goals of those clamoring for federal preemption. ALEC has even formed a National Insurance Modernization Working Group to help facilitate this project and to discuss other cutting edge policy ideas related to the business of insurance.

One of the most exciting aspects of ALEC's involvement with this issue is its extraordinary record of success in affecting public policy changes in other areas. ALEC, for example, is the preeminent force for state level tort reform efforts facilitated through ALEC's Disorder in the Court Project. ALEC legislators introduced model tort reform legislation in more than 20 states alone last year. Members are also responsible for passing model pension reform legislation in 13 states over the past two years, a monumental success. This leadership is likely to continue. More than 100 ALEC members hold senior leadership positions in their state legislatures, while hundreds more hold important committee leadership positions.

NCSL. The largest state legislative organization is the National Conference of State Legislatures, formed in 1975.

Recently, the organization created an Executive Committee Task Force to Streamline and Simplify Insurance Regulation. The Task Force includes leaders from NCOIL, members of ALEC and enjoys the support of the NAIC.

While NCSL has no more power to bind than does the NAIC, there is a fundamental difference in authority. The primary component of NCSL's mission is to advise Congress and the Administration as to the effect of federal action on the states. Its members are elected officeholders with obvious influence over the outcome of legislative proposals in the states.

The work of this particular Task Force is especially distinguished because it will develop a set of recommendations to streamline state insurance regulation and ask state legislators to consider them. One recommendation may be an interstate compact that would facilitate the approval of annuity, life insurance and disability income products by a single entity for use in all insurance jurisdictions as well as various speed to market proposals that affect the property-casualty industry. For the NCSL to depart from its federal advisory function to make specific state proposals is an extraordinary step.

NCSL has only suggested model legislation for state consideration three other times. The first time was in 1990 when an NCSL Executive Committee Task Force on Insurance endorsed the first 11 model bills dealing with the NAIC accreditation process, created to forestall the threat of federal solvency regulation. Within two years, 48 states had enacted the models that would permit their accreditation.

A decade later, the NCSL Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce drafted model legislation to bring together state revenue department officials to discuss ways to streamline sales and use tax collections. By the end of 2000, 32 states, either through legislative enactment or an executive order of the governor, had officially joined what is now called the Streamline Sales Tax Project.

Finally, the same E-Commerce Task Force drafted and endorsed model legislation in 2001 to help policymakers finalize the terms of a streamlined sales tax interstate agreement. Last year, 22 states enacted this second model act on sales tax reform and presently another 13 states are considering the model bill during this year's legislative session.

To round out the most important elements of the insurance regulatory landscape, I want to touch on rating bureaus and rating organizations.

RATING BUREAUS/ADVISORY ORGANIZATIONS

The property-casualty insurance industry today is intensely competitive and fragmented, particularly in the commercial insurance marketplace with no single insurer having more than a 5% market share. Not only do insurers compete in the way they package and price their products, but they also compete in the way they distribute and service them. Within the industry, today’s modern "advisory organizations" provide insurers with critical insurance information that promotes competition between all insurers and adds economies of scale to those functions vital to each individual insurer. Access to a broad base of reliable information and standardized coverage parts that comply with state requirements permits any insurer to enter new insurance markets and compete in existing ones that might not otherwise be possible if individual insurers had to rely solely on their own, internal information.

The evolution of today’s advisory organizations dates back to the early to middle 1800's when fire insurers formed compacts (otherwise known as rating bureaus) to establish and maintain adequate rates and to standardize policy forms. These bureaus sought to bring discipline to an industry known for overly excessive competition and rate and commission wars which resulted in many insurance company failures and erosion of public confidence in the insurance industry. Although initially local and regional in nature, rating bureaus ultimately began to consolidate on a national level to eliminate duplication of resources and to take advantage of expense savings associated with economies of scale. By the mid-20th century a number of rating bureaus had evolved into several national entities, all serving multiple lines of business.

In 1968, the National Bureau of Casualty Underwriters and the National Association of Automobile Underwriters merged into the Insurance Rating Board. In 1971, many of the functions of the Insurance Rating Board, the Multi-Line Insurance Rating Bureau, and the Inland Marine Insurance Bureaus were undertaken by a new organization, the Insurance Services Office (ISO). Although ISO is the largest advisory organization, there are other organizations that provide similar services to property casualty insurers. These include the Surety Association of America (surety), the National Council on Compensation Insurance (workers compensation), and the American Association of Insurance Services (property-casualty lines other than workers compensation and commercial fire).

Today's advisory organizations operate very differently from the bureaus in the early 1900's. ISO's charter specifically states that all ISO information and services are purely advisory -- that is, insurers select among any of ISO's services and use them as they choose to. ISO no longer develops advisory rates and instead provides "advisory prospective loss costs," which do not include any provisions for insurer profit and expenses. Today, insurers that purchase advisory organization information may or may not use any of that information, and each company makes its own independent decisions based on individual company circumstances. Rate setting is now a matter between individual insurers and regulators.

ISO provides statistical and actuarial information and analyses, policy forms, information about specific locations, fraud-identification tools, data processing and related services for a broad spectrum of commercial and personal lines of insurance. (For example, ISO develops advisory policy forms, in compliance with the coverage requirements of each state, to address diverse coverage needs). ISO is regulated as an advisory organization and performs its various functions in each of the fifty states, D.C., Puerto Rico, Guam and the Virgin Islands. ISO information is available to any property-casualty insurer. All services are advisory in nature and insurers are free to use, modify or not use ISO information as they determine their own strategies in a highly competitive insurance marketplace. In the United States and around the world, ISO serves insurers, reinsurers, agents, brokers, self-insureds, risk managers, and insurance regulators and other government agencies.

The pro-competitive benefits of advisory organization products and services are well documented and include:

<u>Accurate projections of future claims payments</u>: Pricing insurance is difficult. Unlike most businesses, insurers can't set a price based on known costs for production and distribution. When pricing a policy, an insurer needs to project the costs of future insurance claims by examining historical data. This method is reliable only when the insurer uses a sufficient amount of accurate data. Advisory organization actuaries are highly trained to compile, edit for quality, process and combine compatible data from many companies into statistically credible pooled data bases accessible by any insurer which, along with its own data and other information, enables an insurer to independently determine its own prices and competitive strategies.

<u>Economies of scale</u>: For many states and lines of insurance, if individual insurers had to replicate the pooled database, actuarial analyses, professional staff and data processing provided by

advisory organizations, the costs would be so great that a number of insurers could be forced out of many markets. Those insurers that remained would pay for any resulting insolvencies, as well as incur higher expenses for replicating advisory organization materials, thereby making the cost of insurance more expensive.

Ease of market entry: Access to advisory organization products and services enables insurers of all sizes to more easily enter product lines or geographic markets they might not otherwise consider worth the risk or the start up costs. An example of this effect recently occurred in Texas, where the Governor noted that the availability of an ISO policy form would enable more insurers to offer affordable homeowners insurance.

Availability of a credible aggregate industry database: Advisory organization's data compilations increase data quality for both insurers and regulators and facilitate research and development of new products and innovations to existing products. ISO submits summaries of this information to insurance regulators—as required by law—to help the regulators evaluate the price of insurance in each state.

RATING ORGANIZATIONS

Another important service to the insurance industry is the work provided by the handful of companies that produce independent ratings for insurance companies. These analyses serve to provide bankers and investors with invaluable information upon which they can make informed decisions. The rating organizations also act as an "adjunct" regulator by providing insurance regulators with another perspective on companies licensed in their jurisdictions.

Among the oldest of these service companies is A.M. Best, which was founded in 1899. Other ratings firms are Standard & Poors Corporation, Fitch, Weiss, Demotech and Moody's.

Although ratings firms may seek and consider regulators' criticisms and orders concerning market practices, ratings firms' fundamental concern lays in the claims-paying ability of the entity rated. Indeed, whether or not it is the first thought they may have in securing insurance protection, policyholders' fundamental concern—certainly the one foremost at the time of any loss—is the claims-paying ability of their insurance carrier. They want the promise to be kept.

Any rational process of decision-making in purchase of goods and services involves the prospective purchaser's perceptions of price and quality. In this context, i.e. the purchase of a promise, policyholders, lenders, and others are concerned with the quality of the promise made by the insurance entity. Although there may be qualitative details with respect to the contract for that promise, there is, finally, the matter of whether the insurance company now possesses resources to timely execute its promise and whether it will continue to be able to pay to policyholders its promises.

To understand the resources required for, and to systematically rate the claims-paying ability of an insurance entity is, without question, complex. Policyholders, lenders, and those whose business is otherwise affected by indemnification of policyholders from loss, perceive value in the guidance of those who credibly provide simplification of what is complex. Ratings firms offer such value. Their analyses of the claims-paying ability of insurance entities are used in decisions where the quality of the promise is of weight.

Insurance ratings firms are in a position of extraordinary leverage because of their input into the purchase of hundreds of billions of dollars of insurance protection. Ratings firms thereby, fairly or otherwise, will affect insurers' behavior to the extent insurers' understand their criteria for rating claims-paying ability. Ratings firms will also, through that extraordinary leverage and according to the rating rendered, affect the fortunes of insurance entities. A positive rating may be a factor toward a company's growth and prosperity. Somewhat more surely, a negative rating published by a credible ratings firm will diminish the going-concern prospects of an insurance entity.

With that overview of the function of ratings firms and the potency of their published analyses, it is also important to understand their relationship to the states' structures for the regulation of the business of insurance.

A brief sketch of the relationship is that ratings firms are independent of state regulation with respect to their judgments of the claims-paying ability of an insurance entity. Yet the relationship is more complex than pure independence and is notable for ratings firms' use of information generated from the states' regulatory regime. States' grant of the privilege to conduct insurance business is accompanied by extensive and highly formalized requirements for accumulation and delivery of information on the financial results and status of the insurance entity—in addition to much additional detail on other aspects of the business. Ratings firms are beneficiaries of these regulatory requirements: They understand and intensively use this regulatory information generated as a result of states' regulatory requirements.

Please understand that the states, using the NAIC for common development of accounting principles, prescribe with great rigor how and when insurance entities will account for all transactions undertaken. Although many additional non-accounting rules for financial regulation are also prescribed, the essence of this solvency regulation is called statutory accounting, which gives greater emphasis to conservatism than generally accepted accounting principles (which will also be used for reporting to investors by those companies subject to SEC regulation). Again, with respect to ratings firms' relationship to state regulation, statutory accounting prescribed by the states, is the raw material for much of the business of ratings.

Do the states rate insurance entities in their domicile? In effect they do, but it is a more confidential process and one very much directed toward identifying and supervising weakened companies—rather than placing companies on a comprehensive scale of relative claims-paying ability. Use of companies' risk-based capital measures, sets of financial ratios, and other means for judging financial strength are fundamental tools—some of them conducted for states by the NAIC—for identification of those companies that become weak with respect to their ability to pay claims.

Do regulators use ratings developed by ratings firms? We are aware that they are sometimes used to identify weak companies or, more likely, to affirm state examiners' judgments as to companies' viability. It would be accurate to say, however, that state- and NAIC-developed analyses are by far the more important in states' procedures and legal process affecting weakened insurance entities.

Why do ratings firms exist alongside the state regulatory apparatus when states have power to prescribe content and period of reporting? Ratings firms obviously publish for their specific market of policyholders, lenders, and others concerned with insurance entities' claims-paying ability. States do not. Further, ratings firms publish annually and update still more frequently, thereby accommodating users need for current information. States conduct financial examinations on a cycle of three to five years, occasionally accelerating that schedule for companies perceived to be weakening.

In that business of providing information for those concerned with insurance entities' claims-paying ability, ratings firms digest large amounts of specialized and complex data on insurance entities and present it to readers in a form more easily used by those with interest. In short, users of such information pay for value added by ratings firms' efforts to gather, analyze, and interpret complex data.

We should say additionally—and this relates to concerns of NAMIC—that users are paying additionally for somewhat more subjective analysis by ratings firms of subject companies' management. This more qualitative element of ratings includes the ratings firm analyst's view of the capability of the subject company's management to cope with shocks and swings in the market for the company's products and how adaptable and aggressive management may be in that context. This more subjective dimension of the ratings process, NAMIC and others with concern have suggested, is that continuity through time, and continuity from analyst to analyst, may not always be present. Indeed, even with respect to more objective financial data, consistency and continuity may be less than perfect as time passes and analysts change.

It is not a revelation, then, that companies' experience with the rating process may include some perceptions of unfairness or neglect of the subject company's having historically met all valid promises. We admit that the essence of the relationship between a ratings firm and a rated company has an inherent adverse dimension. Companies may have wholly tenable reasons for disagreement with a tentative rating; the company must then muster its best arguments for revision.

Ratings firms are part of the insurance market. Buyers seek advice from those who can gather and interpret complex data on carriers' ability to execute their crucial function of paying claims. Ratings firms purport to provide that advice; they will not always be accurate; we do know they will continue to be part of the marketplace.

THE ROAD TO REFORM FROM THE NAMIC PERSPECTIVE

NAMIC recently released a public policy paper articulating our argument against federal regulation of insurance. Entitled ***Regulation of Property/Casualty Insurance: The Road to Reform,*** it is the culmination of years of member study. Our member companies began their consideration with an open mind, but as work progressed it became clear that the best option for consumers and the insurance industry is to reform the state system rather than running to Congress for a solution that promises to be worse than the original problem.

As you know, the insurance industry is at a crossroads. Many in our industry already have chosen the path of reform that runs through Washington. They believe the state system of regulation is irreparably broken and only can be fixed by Congressional action. Others take a wait and see approach to reforming the state system. Indeed, they are engaging in efforts of reform, but with one eye on the clock, almost waiting to jump on the bandwagon making the most progress.

Missing from this debate is the point of view that a federal regulator, or even a dual charter, is not in the best interest of the industry or consumers. It is this point I wish to also make today.

Flaws in The Enactment and Implementation of a Federal Solution

In developing our public policy paper, NAMIC identified a series of "flaws" in a federal solution to insurance regulation. They include:

1. **We oppose federal action because it is often used to enact social regulation**. Under a federal system, insurance is likely to be treated as another "government entitlement" with all the trappings associated with that term. This would cause serious erosion to the basic risk sharing principles upon which the industry is built and I do not believe is the intention of this committee.

2. **Asking Congress to intercede is fraught with danger for consumers and industry.** Proponents of federal regulation may design their idea of "a perfect system," but they can neither anticipate nor prevent the imposition of social regulation in exchange for the new regulatory structure. In our judgment, the chances of the "perfect system" going from draft legislation into law are almost nil.

3. **A federal or dual charter not only would not reduce regulation, it would add regulatory layers and complexity to the current system**. It is by no means certain that a new federal regulator would be the "single" regulator for even the largest property/casualty insurance companies. Dual regulation would produce an unfair environment for the thousands of smaller companies, and create regulatory competition that often produces poor policy in financial institution regulation.

4. **Costs and bureaucracy will increase under a federal framework.** Will a federal charter reduce regulatory costs that are indirectly paid by consumers and/or taxpayers, and will it bring about less bureaucracy for companies choosing this option? There is no evidence that a federal insurance regulator is going to depart from the tradition of creating an expensive and inefficient government program. In addition, each state has its own unique tort laws that significantly affect insurance. Federally licensed insurers would have to tailor products to accommodate each state's tort laws. Not doing so will significantly hamper gaining efficiencies from a federal system.

The cost to consumers will inevitably rise as well. Currently, states derive significant income from premium taxes, which exceed the cost of regulation. The cost of a new layer of federal regulation must be accounted for somehow. The necessary funds must either come directly from the federal budget, or from fees assessed to insurers. Since taxes and fees must be passed on to consumers, they will have to pay for two regulatory systems, unless the states forego premium tax revenue. Considering the current condition of most state budgets, it is hard to imagine that they would do so voluntarily.

5. **When the single national regulator makes a mistake, it has significant economy-wide consequences**. When a state regulator makes a mistake, the damage is localized and can be more easily "fixed." In other words, what if Congress gets it wrong? Industry proponents argue that Congressional action could be bring a system resembling that found in Illinois to the entire country. But what if the system created looks more like highly regulated states? The economic fallout from a strict national regulatory climate would be crippling, and the accountability would be at Congress' door.

6. **The time for further change has not arrived**. The new balance necessitated by GLBA is still evolving. It has shown great promise, but requires more time to mature fully. Unlike 1999 when GLBA passed, there is no major impetus, such as convergence of the financial services industry, to further change the balance between federal and state regulation. In times past, momentous change has been the consequence of significant needs or events. No such need exists today. Change without need could destabilize a system that has worked well throughout our nation's history.

State Regulation is More Pro-Consumer

From a consumer's perspective, the state system of regulation has performed admirably. It has proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts. Proposals for federal and dual charters offer few advantages for consumers, and consumer interests are rarely cited as reasons for changing from the state system.

Federal regulation is no better than state regulation in addressing market failures or consumer interests. Regulated industries of all types have had failures at both regulatory levels. Neither can claim immunity from market failure. Additionally, claims that consumers are well served by federal bureaucracies seem dubious.

The clear advantage to consumers in the state system is accessibility. It is easier to deal with regulators in every state than having to contact a regional federal office to intervene in disputes.

A Reformed System of State Insurance Regulation is Superior

Changes must be made to create a reformed, rationalized and consistent system that will benefit both consumers and industry. NAMIC is working with national legislative organizations on four specific areas for state reform:

RATE REGULATION

States should eliminate the approval process for pricing insurance products**.** The NAMIC Board of Directors has endorsed the NCOIL Property/Casualty Modernization Act approved in 2001. The model lays out a "use and file" regime for personal lines in competitive markets and a "no file" standard for commercial lines. There is unanimous support among the industry trades for this language.

Still, this is a potentially controversial issue among some state legislators. However, rate modernization not only is not radical, it is not new. Two brief examples speak to its success as public policy:

- In 1969, the **Illinois** legislature repealed outright the prior approval law that was put in place following passage of McCarran-Ferguson in 1945. Property/casualty rates in Illinois remain unregulated today. Several vital signs demonstrate that this policy works well. Today, consumers enjoy stable rates, ranking in the middle of all states in average personal expenditures because the Illinois market attracts the largest share of all private passenger auto and homeowner insurers in the nation. Low residual markets indicate affordability and availability. These positive signs are all the more remarkable when you consider that Illinois includes the third largest urban area in the United States, and two-thirds of the state's residents live in the Chicago area. With over three decades of success and no legislative proposals to reinstitute regulation, there can be no argument that this structure is well tested and beneficial to everyone involved.

- The demonstrably negative impact of prior approval on **South Carolina**'s state auto insurance market prompted the Legislature to act in 1999. Only 78 companies offered policies in the state in 1996 and over 40 percent of all insured drivers were in the assigned risk pool. With the elimination of prior approval in favor of a flex rating system,

> 105 new companies are in the market, rates are lower and residual market participants, once numbering over a million, have declined to 58,000.

Finally, even **New Jersey**, one of the most restrictively regulated states in the nation, is in the process of a public policy overhaul. Noting that consumers pay the highest auto premiums in the country and that more than 20 insurers have left the state during the 1990s, Governor McGreevy has agreed to support language in his legislature very similar to the NCOIL model.

The NAIC has endorsed an interstate compact that would facilitate the approval of annuity, life insurance and disability income products by a single entity for use in all insurance jurisdictions. The compact will be the principal topic of discussion at the NCSL Task Force meeting that convenes this Friday in Philadelphia.

As has been often and loudly stated, the product approval process is especially challenging for the life industry because of direct competition with banks in certain financial services. NAMIC agrees that the life industry and its consumers would be well served by a streamlined regulatory process. Efforts to create a more competitive marketplace for insurers and consumers alike must not begin and end on the life side of the equation. I cannot conceive that many p-c insurers would be supportive of that approach.

As Congress continues its oversight, we strongly encourage you to look for progress in achieving speed to market for both life and property-casualty products.

MARKET SURVEILLANCE

States vary widely in how they staff and approach their market surveillance activities. A few states, for example, regularly schedule market conduct exams, regardless of whether an insurer has problems or not. The open-ended costs of these exams (salaries, meals and lodging) are charged to the company under examination. A lack of uniformity and coordination among states in performing exams often results in duplicative and costly processes, especially for multi-state insurers, who are most likely to be targeted for review.

As state insurance departments spend less time on "front end" regulation (i.e. prior approval), states need to adopt a market regulation program that relies on analysis of existing and available market data to reveal performance deviations rather than largely open-ended market conduct examinations relied upon today. With this approach, regulators can focus their limited resources on companies that fall outside a predetermined set of standards developed from data analysis. Any new market regulation process must be proportional, allowing insurers to mitigate complaints or market inconsistencies before being subjected to more severe actions like a market conduct exam, administrative penalty or fine.

SOLVENCY MONITORING

State regulators have adopted several solvency tools over the past decade to strengthen oversight of the insurance industry. While the industry has supported improvements in solvency monitoring, there remains a high degree of variation among states in how financial exams are conducted. NAMIC recently helped to produce an industry white paper that identifies three primary recommendations to facilitate discussion of the examination system by all stakeholders. Recommendations under consideration by the NAIC center on controlling expenses, integration of private CPA auditor work and risk-oriented financial reporting.

COMPANY LICENSING

States, working through the NAIC, have made some progress in the past few years in bringing more uniformity to the company licensing process. One outcome is the Uniform Certificate of Authority Application (UCAA), which is now used in all insurance jurisdictions. The states should now consider draft language so future amendments to the UCAA can be adopted without seeking legislative approval each time. However, the key to more uniformity of this process is ensuring that state deviations are reduced or eliminated.

NAMIC joins with our colleagues in asking for fundamental reform of insurance regulation. We disagree with some on the method to bring this about. State insurance regulation can be reformed through emphasis on state legislatures, not Congress, but it will take some big thinking and outstanding leadership to bring this about.

The areas for reform have been defined. Now it is up to the states to enact changes in public policy that will make the difference. We urge you to continue your efforts to assure that change takes place in the states. Significant activity is already underway. As it has in the past, your interest alone will prompt a redoubled resolve on the part of state legislatures. We believe this pressure, given time, will bear fruit.