STATEMENT

OF

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ON

INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS AND

GOVERNMENT SPONSORED ENTERPRISES

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Introduction

Mr. Chairman, Ranking Member Kanjorski, and members of the Subcommittee, my name is Paul Mattera. I am Senior Vice President and Chief Public Affairs Officer of the Liberty Mutual Group. Liberty Mutual is a diversified property and casualty insurance group based in Boston with $14 billion in revenue and over 35 thousand employees in the U.S. and in 15 foreign countries.

I am here today to express our long held belief that state based insurance regulation is fundamentally strong and that the public policy objectives of insurance regulation – to protect consumers by assuring the financial soundness and solvency of providers, promoting competitive markets, and enforcing the insurance laws – can be met best in the context of a modernized state regulatory structure.

Also, I have been asked to discuss the European regulatory model and to consider what lessons might be learned from the EU experience. My views in this regard are informed by the Company's current position as Chair of the International Insurance Council, although my own experience with comparative insurance systems is limited. While Liberty Mutual operates in over a dozen countries, our experience in the European Union is limited to Spain and the UK.

The European Model of Insurance Regulation

The Europeans are attempting to create a regulatory structure that is compatible with the goal of a single EU insurance market. This is an evolving process. While there are certainly lessons for US policymakers, it may be too soon to reach conclusions about the wisdom or need to import such a system.

The first step towards the creation of a single EU insurance market was taken in the mid 1970s with the first set of insurance directives adopting the system known as "host country control." A non-life insurance company domiciled in one member country could operate as a branch or through a subsidiary in any other member country without further

licensing requirement. However, the company's activities were regulated by the country in which it conducted business – the so-called host country.

A second set of directives in the early 1990s established the freedom to conduct cross-border insurance. Companies were allowed to write both personal and commercial insurance outside of their country of domicile without having to register their business, but host country control prevailed. Thus, the host country was free to impose its own rate regulation or other regulatory requirements. There was and remains significant variation among the EU countries in the level and intensity of regulation applied.

In the mid 1990s, a third set of directives reinforced the single license concept and the principle of host country control, but abolished rate and product regulation. This means that today companies are free to conduct their business in any EU member country without additional licenses or being subject to rate and product approval. Nevertheless, insurance companies remain subject to the non-rate and form regulations of the countries in which they do business, including local financial, accounting, and tax rules.

While the EU model facilitates the development of a common insurance market in Europe, it has not yet evolved into a unified regulatory system. In the parlance of the debate over federal vs. state regulation in the US, the EU model represents dual regulation with some aspects of a company's operations regulated by the home state, some by the host state, and both subject to the insurance directives of the European Commission.

It is too simple to say, as some do, that the European insurance regulatory system should serve as a model for the US. This is an argument frequently heard from supporters of a federal model. Certainly, aspects of the EU system if adopted in the US would make our insurance markets more competitive. De-emphasis on rate and product approval, re-emphasis on solvency, and ease of multi-state licensure are three notable areas. It is no coincidence that reform initiatives are underway in each of these areas of regulation in the US. Without apologizing for the slow pace of regulatory reform in the US, it should be pointed out that regulatory reform in the EU has taken 20 years, and there is still much to do.

Reexamining the State-Based System of Insurance Regulation

The current system of insurance regulation is under scrutiny by insurance companies, trade associations, consumer groups, agents, regulators, and the Congress. A reexamination is necessary and it is healthy; and so I commend the Subcommittee for holding these hearings.

A modern, efficient regulatory system is essential to meeting the challenges of the 21st century insurance market. These challenges include the emergence of new competitors and competing regulatory priorities associated with the implementation with Gramm-Leach-Bliley, industry frustration with current regulatory practices and resulting inefficient or redundant regulation, the competitive imperatives of e-business, and the economic pressures associated with market consolidation and increasing globalization.

Today's consumers demand efficient delivery of every type of product and service, especially financial services. However, insurance regulation today often impedes the ability of providers to meet their customers' demands. Unnecessary delays, inconsistent treatment, and misplaced priorities frustrate an insurance industry that is simply trying to meet the expectations of its customers.

Let me be very clear: virtually every area of regulation needs to be improved if the state system is to meet the challenges of a modern insurance market. Unlike those who would abandon the state system and start over with federal regulation or dual regulation, Liberty Mutual is committed to doing the hard work in the state capitols necessary to bring about ameliorative change.

Building on Strengths and Correcting Weaknesses

The regulatory modernization agenda of the NAIC and the individual states is well underway. Significant progress is being made in several critical areas of regulation:

- Producer Licensing – 45 states have adopted the NAIC Producer Licensing Model Law which seeks to establish a uniform and reciprocal system for agent licensing. This is something the Congress challenged the states to do in GLB, and the states are responding.

- Company Admission – The NAIC is promoting the so-called ALERT system that facilitates the licensure of companies in multiple states by providing a uniform application and accelerated regulatory review. However, state specific requirements such as seasoning and fingerprinting persist. ALERT should be expanded to encompass a variety of corporate filings such as change in control and related filings. For example, virtually all states have adopted the NAIC Model Holding Company Act, but there are wide variations among the states in the documentation required or review period, making it difficult and expensive to complete mergers or acquisitions where multiple states are involved.

- Speed to Market – There has been significant, but incomplete, progress towards more open and competitive markets, especially in commercial lines such as property, general liability and commercial automobile. But, there is no good reason why any state should retain approval authority over rates or terms of coverage for commercial risks of any type or size, with the possible exception of the very smallest commercial package policies. Progress in personal lines such as auto and home insurance has been slower. Whether or not true rate and form deregulation is possible -- practically or politically -- in such historically regulated markets as New Jersey and Massachusetts is an open question. However, even in highly regulated markets, greater certainty of filing content and disposition (well established data requirements and adherence to established time frames) would represent significant improvement.

- Market Conduct – NAIC efforts to streamline market conduct examination lags behind efforts to modernize other areas of regulation. Nevertheless, progress is being made and there is every reason to think that a more rational, efficient, and better coordinated system can be implemented.

- Financial Regulation – In some respects, the NAIC's solvency agenda of the early 1990s which established a system of accreditation based on states' adoption of a uniform set of prudential requirements, coupled with uniform risk based capital standards, represents the best of state regulation. There is no reason why the accreditation concept could not be extended to other areas of state regulation.

The Case for State Regulation

State regulation of insurance is a product of our "federal" system of government. Federalism reserves to the states the powers not expressly granted to the central government – and for good reason. As the Founding Fathers believed in 1787, the sovereignty of the states, especially in the areas of the civil and criminal law and the administration of the courts, would become a bedrock principle for our country.

The states have the constitutional prerogative to establish liability systems and similar laws to promote social responsibility. Since insurance is so closely associated with the tort and contract laws of the states, it follows that insurance regulation should remain state-based. For example, liability laws affecting automobile accident reparations, workers compensation, property damage, and personal injury differ from state to state reflecting diverse public attitudes about responsibility and compensation. Insurance products are designed and priced differently in each state to account for these differences. Likewise, our system of contract law is well developed, and with respect to insurance policies is based on more than a century of policy interpretation by state courts.

The best characteristics of the state system including diversity, innovation, and responsiveness would be lost in a federal or national model of insurance regulation. Federal or national models imply a single, uniform set of rules applying equally across all states and all insurance markets. It is difficult to imagine a single regulatory system working in harmony with the diversity of underlying reparation laws and differing public expectations about the role of insurance regulation. For example: Will an open and competitive rating law work in a state with a tradition of subsidizing urban drivers? How responsive will a

federal regulator be to market dislocations in individual states caused by extreme weather or seismic activity? Can market conduct be fairly assessed by a federal regulator unfamiliar with the underlying state law or court interpretation?

Implications of Federal or National Regulatory Models

A single federal or national regulatory model implies a rejection of the fundamental notion of diversity and state sovereignty, discussed above. This is an important issue and should be considered carefully by the Subcommittee. Unlike banking or securities, even perhaps life insurance, that have their roots in federal law, property and casualty insurance is inextricably tied to state law. Move insurance regulation to Washington, D.C. and the underlying substantive law will inevitably follow. Does the Subcommittee really want a national workers compensation law or automobile reparations law that ignores local attitudes about responsibility and compensation?

Other attributes of diversity and innovation would be lost in a federal or national regulatory model. Today, the state system reflects a diversification of regulatory risk. In a federal model, regulatory policies would be imposed uniformly on the industry. The advantage of state experimentation and innovation would be lost. For example, the successful open and competitive rating model in Illinois may not have come to pass were the prevailing federal model one of strict prior approval.

Efforts to achieve a federal model are likely to result in dual regulation. For example, Congressional interest in preempting state solvency regulation in favor of uniform financial requirements enforced by a federal insurance regulator may not extend to rate and form regulation. The risk of separating financial regulation from market regulation is real and, if attempted, would present the very worst in dual regulation. Even optional charter proposals invite dual or redundant regulation, and at best add significantly to the cost of regulation by maintaining two separate regulatory systems.

Finally, whatever the inefficiency and ineffectiveness of state regulation – which we would argue does exist but is improving – there is no reason to believe a federal regulatory

system would be any better. Critics of both state and federal regulation can point to failures of either system. However, the single largest regulatory failure in recent times was the disastrous failure of the savings and loan industry in the 1980s, costing taxpayers billions of dollars. Neither the federal nor state sector has a monopoly on good financial regulation, but state regulators along with the industry financed guaranty funds are serving insurance policyholders well.

Conclusion

In deciding whether to replace the system of state-based insurance regulation with a mandatory or optional federal model, the Subcommittee should consider the strengths as well as the weaknesses of the current system, should be skeptical of claims that other countries have superior regulatory structures, and should consider ways to encourage the states to undertake a more rapid and comprehensive review and reform. Our current system of state-based insurance regulation is fundamentally sound, but significant reforms are needed if the system is to meet the challenges of a 21st century insurance market.

Thank you.